

New Zealand Law Society

SUBMISSION ON TAXATION (ANNUAL RATES, RETURNS FILING, AND REMEDIAL MATTERS) BILL

Introduction

1 The New Zealand Law Society (Law Society) welcomes the opportunity to comment on the Taxation (Annual Rates, Returns Filing, and Remedial Matters) Bill (Bill). The Law Society's submission addresses various aspects of the Bill, generally of a technical nature, in relation to:

- (a) profit distribution plan (PDP) rules;
- (b) look-through companies (LTCs);
- (c) remedial amendments to the PIE rules;
- (d) the proposal to allow the Commissioner to refuse to rule on the exercise of his reconstruction power in relation to a tax avoidance arrangement; and
- (e) goods and services tax (GST).

Profit distribution plans: Clauses 7 to 10, 82, 83, 85 and 88

General comment

2 The Law Society generally accepts the Government's rationale for making the tax treatment of profit distribution plans (PDPs) the same as the tax treatment of bonus issues. Its submissions are technical drafting ones.

3 The Law Society notes that the changes do not affect the repurchase of shares pursuant to periodic pro rata offers to repurchase shares, where the periodic offers are not preceded by a bonus issue. These repurchases will continue to be taxable as dividends because they fail the bright line test. It assumes this is deliberate, and that section BG 1 will not apply to such repurchases in the absence of some material aggravating feature. If that is not the case, the Commissioner should say so.

Submissions

First submission

4 Clause 10 proposes to amend the definition of "returns" in section CD 43(2)(c) of the Act, so that it includes a new subparagraph (ii), referring specifically to *repurchases* of shares pursuant to a PDP. This is appropriate in concept, but the drafting is not appropriate. Paragraph (c) already refers to a cancellation of a share. A cancellation of a share is defined to include its

acquisition by the issuing company, i.e. a repurchase. Accordingly, all that is required by way of amendment to paragraph (c) is to include a reference to new section CD 23B.

- 5 There is also a typographical error in the currently proposed subparagraph (i) – after “section CD 24”, “of” should be “or”.

Second submission

- 6 The definition of a PDP in clause 88(14) requires *all* shareholders to be notified of the issue of shares. This is an unnecessary requirement. It is not clear that notification of shareholders other than those receiving the shares should be required, nor why failure to notify one or more of those shareholders who are receiving the shares should take the transaction outside the PDP definition. The key element is that the company makes a bonus issue of shares and gives the shareholders an option to have some or all of the shares repurchased or redeemed.

Recommendations

The Law Society recommends:

- (a) Clause 10 be amended, so that it simply inserts the words “, section CD 23B” after the words “section CD 22”.
- (b) Paragraphs (a) and (b) of the definition of a PDP in clause 88(14) be amended to read “(a) *makes a bonus issue of shares; and (b) gives the shareholders who receive the bonus issue an option to have some or all of the bonus issue shares repurchased or redeemed by the company.*”

Look-through companies: Clause 34 – Section HB 1(6)

Submission

- 7 Clause 34 of the Bill is problematic in a number of respects. The Law Society suggests that it be withdrawn and replaced with guidance, or redrafted with similar language included in subpart HG of the Act.

Comment

- 8 The Law Society agrees with the policy outcome that Officials are seeking to clarify with clause 34. The basic principle is that an LTC (or similar look-through vehicle such as a partnership) should determine its tax position on a stand-alone basis and then allocate each tax item through to the shareholder¹ or partner in accordance with the relevant allocation rules.

¹ The correct tax term is the owner of a “look-through interest”, we use the term shareholder for clarity.

9 We understand that clause 34 is intended to clarify that outcome in the particular cases of “elections” and “methods” made and used by LTCs. However, we have a number of criticisms of the clause as presently drafted. We discuss these criticisms below and then suggest what we believe is a more durable and robust solution for achieving this policy outcome.

Background

10 The transparency rules in section HB 1(4) (in relation to LTCs) and section HG 2 (in relation to partnerships) (Transparency Rules) are preceded by the language “unless the context otherwise requires”. This language excludes the operation of the Transparency Rules from those parts of the Act where their application would bring them into conflict with more specific sections or would lead to absurd outcomes. A clear instance where the “context otherwise requires” is in the application of the associated persons rules, where limited partnerships and LTCs are expressly identified as separate entities.

11 Whether a Transparency Rule applies in the context of a particular section of the Act is, necessarily, a complex and subtle interpretative exercise. In the partnership context, for example, when determining whether an interest payment made by a partnership has a New Zealand source, the payment is treated as being made by the partners (and all the partners are treated as New Zealand residents)². However, the withholding obligation that arises under subpart RF is imposed on the *payer* of the interest (i.e. the partnership). It would be nonsense for these obligations to be borne by the partners who had no involvement in making the payment. In this example the partnership is treated as transparent for some purposes, and not for others, within the same subpart.

12 Section HB 1(4) and section HG 2 also contain another subtle but important limitation on the Transparency Rules in that they only apply to a shareholder or partner in their capacity as shareholder in an LTC or partner in a partnership. This “different capacity” point has been the subject of limited Inland Revenue Commentary, but no comprehensive guidance. For example:

- (a) Inland Revenue guidance (correctly) indicates that a partner who holds a partnership interest in a land dealing partnership will not be treated as a dealer in his or her personal capacity. The Transparency Rule treats the partner as a dealer only for the purposes of the land held by the partnership.³

² This is the necessary implication of section YD 4(17B).

³ Tax Information Bulletin, Vol 20, No 8 (September / October 2008) at page 5.

- (b) An Exposure Draft recently released by the Inland Revenue⁴ also (correctly) confirms that an LTC that acquires its shareholder's home as a rental property will be entitled to a deduction for interest incurred on financing such an acquisition. This is because the capacity in which the shareholder is deemed to incur the interest obligation is a separate capacity from the personal capacity in which he originally owned the home.

Dealing with one aspect of the Transparency Rules in isolation is liable to cause confusion.

- 13 In summary, there are circumstances where the operation of the Transparency Rules is impliedly excluded and, even in those areas where they operate, they only affect the shareholder or partner in their capacity as such. In the Law Society's view, these two limitations on the Transparency Rule need to be considered and dealt with together in the form of legislation and comprehensive guidance that clarifies and explains the scope and operation of the relevant Rule.
- 14 Rather than excluding discrete regimes from the operation of the Transparency Rules (under section HB 1(1)) and drafting clauses such as the proposed clause 34, either legislation or guidance (or both) should be drafted which clarifies the principles outlined above.

Wording of clause 34 is vague and liable to lead to confusion

- 15 Clause 34 refers to "elections" and "methods" relating to an LTC. Neither of these terms is defined. The Commentary to the Bill⁵ refers to "elections concerning the tax treatment of an LTC's income or property or any valuation or timing methods adopted in relation to an LTC's income or property." It is not entirely clear what elections are intended by this clause. However, we assume it is not intended to cover LTC elections contained in section HB 13.
- 16 There are a number of tax positions that should be taken at the LTC level that are neither elections nor methods. An LTC should be able to qualify as a "cash basis person" under section EW 54(1) of the Act. However "qualification" as a cash basis person is neither a method nor an election. Rather than providing clarification, the clause raises further interpretative issues about what it is intended to cover.

⁴ "Income Tax – Look-Through Companies and Interest Deductibility", 7 October 2011.

⁵ Commentary to the Taxation (Annual Rates, Returns Date and Remedial Matters) Bill, September 2011, Inland Revenue Department, at page 99.

Lack of a counterpart in the partnership context is confusing

17 Furthermore, there is no similar change proposed to the treatment of partnerships. The rules dealing with the taxation of LTCs in subpart HB have been copied, almost word for word, from the provisions dealing with the taxation of partnerships (in subpart HG). Yet a specific section for the treatment of “elections and methods” has been not provided for partnerships. Given how closely the LTC rules track the partnership taxation rules, it is not clear why the same approach was not adopted. Clause 34 effectively creates a dissonance between the partnership and LTC form, which will lead to further interpretive difficulty.

Law Society’s suggested approach

18 As indicated above, the Law Society believes that the current language of the statute is largely adequate to bring about the outcomes addressed in the Bill. The Law Society also firmly believes, however, that urgent comprehensive guidance on the proper treatment of transparent entities is needed to:

- (a) clarify in what circumstances the Transparency Rules will not apply; and
- (b) confirm the implications of a shareholder in an LTC or a partner in a partnership being taxed in that capacity only.

The Law Society would be willing to work alongside the Inland Revenue in developing this guidance, which is urgently required both to address basic misunderstandings as to how these rules are designed to operate and to provide more certainty for those who practice in this area.

19 If legislative clarification is considered appropriate it ought to be more comprehensive and carefully drafted than simply a reference to elections and methods. The drafting should make it clear that:

- (a) An LTC shall calculate its assessable income (including any amount arising as a result of the application of subpart HB) on a standalone basis.
- (b) The LTC shall not be liable to tax on its own account. Each item that is taken into account in arriving at the LTC’s assessable income, together with any credits, shall be attributed to its shareholder (or partner) in accordance with HB 1(4).
- (c) Such items will retain the same character, nature and source that they had when calculated by the LTC, and the shareholder shall include each item when determining that shareholder’s tax liability.

Similar language should also apply to partnerships.

Further proposal to amend section HB 1(1)

20 It follows from the analysis above that, in our view, the Bill should amend the preparatory language of section HB 1(1) (and the corresponding paragraph (abb) of the definition of “company” in section YA 1) to remove the references to withholding taxes so far as they apply to LTCs. In our view such language is unnecessary, confusing and potentially harmful:

- (a) The references to withholding taxes are unnecessary because the manner in which withholding obligations are imposed generally requires the separate status of the payer and payee to be respected.
- (b) The deliberate exclusion of withholding tax regimes from the operation of the Transparency Rules in the LTC context raises the question as to how these rules should apply to partnership. For example, is an employee of a limited partnership to be treated as employed by the partners for the purposes of complying with the PAYE rules?
- (c) Applying certain withholding tax regimes to LTCs is positively harmful in certain circumstances. For example, the application of the Resident Withholding Tax and Non-resident Withholding Tax rules to LTCs could mean that income derived through an LTC is subject to economic double taxation: once in the hands of shareholders when it is derived by the LTC (applying the Transparency Rule); and then again under the withholding tax rules when it is distributed (as a dividend).

Recommendations

21 The Law Society recommends that:

- (a) clause 34 of the Bill be withdrawn; and
- (b) if clarification is deemed necessary, either:
 - (i) Inland Revenue provide comprehensive guidance of the circumstances when the Transparency Rules will not apply, and the implications of a shareholder in an LTC or a partner in a partnership being taxed in that capacity only; or
 - (ii) a clarifying clause be inserted into both the LTC and partnership rules whereby it is made clear that the assessable income of an LTC or partnership must first be analysed and calculated on a stand-alone basis and then attributed to its owners or partners, while retaining the same character, nature and source; and

- (c) section HB1 (1) and the paragraph (abb) definition of “company” be amended to remove references to the withholding tax regimes.

PIE Remedial Provisions: Clauses 41 to 65

Submission

- 22 The proposed amendments to section HM 6B of the Act are respectfully flawed, and do not resolve the existing difficulties with the section. A more fundamental approach is required, which clarifies the purpose of the section.

Explanation

- 23 The drafting of proposed sections HM 6B(2) and (4) is confused. Subsection (2) intends to allow a retail PIE to treat itself as earning directly its share of the income earned by a wholesale PIE into which the retail PIE invests. However, the section refers to the retail PIE:
- (a) applying a look-through approach to the income derived *from* (rather than *by*) the wholesale PIE; and
 - (b) treating that income derived from the wholesale PIE as if derived directly from the person who paid the amount to the wholesale PIE. However, there is no person who paid to the wholesale PIE the income derived by the retail PIE from the wholesale PIE.
- 24 There are also a number of errors in subsection (4). For example, the first two lines should refer to the income derived by the retail PIE *from the wholesale PIE*. The terms used in the formula are also unclear. What is the “income” that is “paid” to the wholesale PIE? Much of the wholesale PIE’s income will not be “paid” to it in the relevant year or at all, e.g. income arising from foreign exchange fluctuations, from derivatives or from foreign shares. Such income is derived, rather than paid.

Recommendation

- 25 Section HM 6B should be fundamentally reviewed, and much more care taken to draft it properly. The Law Society would be happy to assist with this.

Other remedial matters: Commissioner’s discretion not to rule on how section GA 1 applies:

Clause 118

Submission

- 26 Clause 118 would confer on the Commissioner of Inland Revenue (Commissioner) a new discretion not to give a binding ruling on how section GA 1 would apply to an arrangement.

The Law Society submits that granting the Commissioner the proposed discretion is unjustifiable and unnecessary, and that the proposed amendment should not proceed.

Explanation

- 27 Section GA 1 empowers the Commissioner to adjust a person's taxable income and/or tax credits in order to counteract a tax advantage obtained by the person from or under an arrangement that is a tax avoidance arrangement. Section GA 1 therefore becomes relevant in circumstances where an arrangement is a tax avoidance arrangement under section BG 1.
- 28 The proposed amendment is unjustifiable. If the Commissioner is able to conclude that an arrangement is a tax avoidance arrangement, he should also be able to determine (and therefore give a ruling on) the tax advantage to be counteracted. This is because the tax advantage is a reflection of the tax avoidance underlying the conclusion that there is a tax avoidance arrangement. If the Commissioner has not been able to identify a particular tax advantage to be counteracted, he should not have been able to conclude that there is a tax avoidance arrangement in the first place.
- 29 The Commentary on the Bill⁶ states that one reason for the proposed amendment is that: "Requiring the Commissioner to make a ruling on exactly how the Commissioner would apply the reconstruction provision is not ideal and can be difficult without an investigation."
- 30 However, sections 91E(3) and 91E(4) of the Tax Administration Act 1994 (TAA) already provide the Commissioner with a discretion not to provide a ruling, or preclude him from doing so, where to do so would require him to determine factual matters, or where for some other reason insufficient information exists:

Section 91E

- (3) The Commissioner may decline to make a private ruling if -
- (a) the Commissioner considers that the correctness of the ruling would depend on which assumptions were made about a future event or other matter; ...

⁶ See above note 5, at page 85, under the heading "background".

- (4) The Commissioner may not make a private ruling if -
- (a) The application for the ruling would require the Commissioner to determine a proscribed question;
 - ...
 - (h) **In the Commissioner's opinion the applicant has not provided sufficient information** in relation to the application **after the Commissioner has requested further information;...**

[Emphasis added]

["Proscribed question" is defined in section 3 of the TAA as including "whether a fact is correct or exists".]

- 31 If a ruling cannot be made without an investigation, the reason it is unable to be made is due to a lack of knowledge of factual matters. If the Commissioner holds the opinion that the applicant has not provided sufficient information in relation to an application for a private binding ruling after the Commissioner has requested further information then, pursuant to section 91E(4)(h) of the TAA, the Commissioner may not make a private ruling. Even if the applicant has provided the information requested, the Commissioner may still decline to rule in a particular case if to rule would require him to determine the correctness of factual matters (see section 91E(4)(a)). The proposed amendment, which would impose a blanket rule effectively denying taxpayers the ability to require the Commissioner to rule on section GA 1, is therefore unnecessary.

Recommendation

- 32 The Law Society recommends that clause 118 be removed from the Bill, and the proposed amendment not proceed.

GST: Clause 135 – Proposed changes to the definition of land

Submission

- 33 The amendment proposed in clause 135 to paragraph (b)(iii) of the definition of "land" in section 2 of the Act is intended to:
- (a) clarify that the transfer of a lessee's interest in a lease is treated in the same way as the transfer of a freehold interest in land for purposes of the compulsory zero rating provisions; and

(b) continue also to ensure that the supply of land under a non-residential lease is subject to GST at the usual 15% rate, except where there is a significant lease premium paid.

34 The Law Society does not consider that the definition of land is an appropriate place to address the "transfer of interest in land" point to which clause 135 is targeted. The definition of land includes and excludes specific types/categories of land. By contrast, the *transfer* of an interest in land is actually a transaction, rather than a type/category of land. Put another way, it does not make sense to draft a provision which is intended to create a distinction between different types of transactions (grant of lease versus transfer of lessee's interest) by way of amending the substantive definition of the thing being transacted.

Recommendation

35 The Law Society considers that the policy intent underlying this proposed amendment would be better achieved by:

- (a) deleting paragraph (b)(iii) of the "land" definition altogether: and
- (b) excluding from zero rating in section 11(1)(mb) the grant of a leasehold interest in land, so long as the grant does not involve a large up-front payment (a limitation of this kind currently exists in paragraph (b)(iii), but as discussed below, in our view it needs refinement).

36 In support of this general approach, we note that the current paragraph (b)(iii) in section 2 of the Act may not be an appropriate exclusion from the definition of land for the purposes of those provisions in the Goods and Services Tax Act 1995 that do not relate to zero-rating (for example, the adjustment provisions in section 21E, 21G(5) and 21H(3)).

37 If paragraph (b)(iii) is retained as it is, then it is important that section 11(1)(mb) can apply to the transfer of items which would otherwise come within paragraph (b)(iii). The Law Society's alternative recommendation is therefore not to amend paragraph (b)(iii), and instead put an additional inclusion in paragraph 11(1)(mb) to the effect that zero rating applies to a transfer of an interest which is not land only by virtue of paragraph (b)(iii).

GST: additional changes to the definition of "land" required

Submission

- 38 Additionally, there are serious difficulties with the drafting of paragraph (b)(iii), both as currently drafted and as proposed in clause 135.
- 39 First, that paragraph includes reference to consideration specified in an agreement in addition to regular payments when determining total consideration.
- 40 The Law Society considers that the inclusion of the phrase "in addition to any regular payments" creates ambiguity when applying paragraph (b)(iii). For example, a lease under which \$100 rental is payable each month could arguably remain outside of the exclusion in paragraph (b)(iii) if there was as little as \$1 of key money paid at the commencement of the lease. In that case the total consideration, *in addition to the regular payments*, is arguably just the \$1 key money – and as all of it is paid upfront, the paragraph (b)(iii) definition arguably does not apply. The Law Society acknowledges that this cannot be the intended outcome.
- 41 Secondly, in many cases it will not be possible to determine the total consideration specified in an agreement to lease. This is particularly the case where there is a periodic tenancy, so that there is no fixed term of the lease. There may also be a difficulty in net leases in quantifying the lessee's obligation to pay operating costs.

Recommendation

- 42 The Law Society suggests that the current test based on total consideration be replaced by a test based on the lease payments that would be owing for a period equal to the shorter of, say, a year or the agreed term of the lease (the Law Society believes that it is in the Government's interest to set a relatively low threshold, in order to ensure that the purpose of the zero-rating rule is not able to be circumvented). This will be a much simpler and more certain test.

GST: Clause 137 – Late payment fees

Submission

- 43 Proposed section 5(25), set out in clause 137, provides that a fee charged for the late payment of an account is treated as being consideration for the supply of services in the course or furtherance of a taxable activity.

- 44 The Law Society is concerned that the term "late payment fee" is not defined as part of these amendments. While the Commentary on the Bill⁷ draws a distinction between late payment fees and "penalties" and "default interest payments" (which are specifically exempt from GST), this distinction is not drawn at all in the proposed amendments.
- 45 The Law Society considers that a uniform rule imposing GST on all late payment fees is not appropriate, as it does not provide the required flexibility to deal with late payment fees imposed where the underlying supply to which the unpaid account relates was outside of the GST net. For example, deeming late payment fees to be consideration for a supply made in the course of a taxable activity would presumably result in taxpayers treating late payment fees for supplies of financial services as being subject to GST. In the Law Society's view such an outcome is inconsistent with the policy intent that consideration for supplies of financial services should be exempt from GST.
- 46 As was noted by Richardson J in *Databank Systems Ltd v Commissioner of Inland Revenue* [1989] 1 NZLR 422 and more recently repeated in *Rotorua Regional Airport Ltd v Commissioner of Inland Revenue* (2010) 24 NZTC 23,979, it is a fundamental principle that GST is a tax on transactions rather than receipts or turnover. Accordingly, in situations where there is an insufficient link between a late payment fee and a particular taxable supply, GST should not be imposed.
- 47 The Law Society considers that the GST treatment of such fees should be dependent on the circumstances of the underlying supply. This has previously been acknowledged in the Officials' Report to the Taxation (Annual Rates, GST, Trans-Tasman Imputation and Miscellaneous Provisions) Bill in 2003:⁸

"In most cases, as outlined in the government discussion document GST: A Review (March 1999) and as enacted in the Taxation (GST and Miscellaneous Provisions) Act 2000, penalty interest is equivalent to the payment of interest on the outstanding balance of the purchase price. The charge therefore compensates for the time value of money, and is comparable to supplies included in the section 3 definition of "financial services". Officials consider that the same argument does not necessarily

⁷ See above note 5 at pages 58-59.

⁸ Officials' Report to the Taxation (Annual Rates, GST, Trans-Tasman Imputation and Miscellaneous Provisions) Bill 2003, at pages 117-118.

apply in respect of all "flat fee" charges for late payment. Rather, each case needs to be considered on its facts.

[...]

In the case of "flat fee" late payment charges imposed under contract, officials consider that ordinary principles should determine whether GST applies. This means that there needs to be a nexus between the "flat fee" and a taxable supply of goods and services for GST to apply."

Recommendations

- 48 Accordingly, the Law Society recommends that clause 137 should not proceed in its current form.
- 49 In the alternative, if a departure is intended with respect to late payment fees from the principle that there must be a nexus between a taxable supply and a payment in order for GST to apply, the Law Society considers that the amendment as currently drafted is not sufficiently clear.
- 50 The scope of the term "late payment fees" could potentially cover both fees for late payments and penalty interest, the latter already categorised as consideration for an exempt supply in section 14(3)(a). A specific definition of "late payment fee" is still required as part of the amendment to resolve this ambiguity.

GST: Clause 140 – Accounting basis

Submission

- 51 Proposed section 19(3B), set out in clause 140 of the Bill, removes the ability for a liquidator or receiver of a registered person to apply to change the person's accounting basis from a payments basis to an invoice basis.
- 52 The Law Society considers that this amendment draws an artificial line, and one which on particular facts may not be appropriate. While the Law Society accepts that a change of accounting basis may not be inappropriate if the only purpose of that change is to generate GST refunds, this may not be true of all situations. There may in some cases be genuine commercial reasons for a liquidator or receiver to request a change in accounting basis.
- 53 In addition, the amendment may not be necessary as the current wording of section 19(3) already provides the Commissioner with the discretion to deny a taxpayer's application to change their accounting basis.

- 54 Section 19(3) as currently enacted requires a registered person (or a liquidator or receiver on their behalf) to apply to the Commissioner to change the person's accounting basis from a payments basis to an invoice basis. The key phrase in this section is "The Commissioner may, on application in writing ... direct that the registered person account for tax payable". This wording provides the Commissioner with discretion as to whether to approve or reject the application.
- 55 This discretion is confirmed by *Case J60* (1987) 9 NZTC 1,359. This case interpreted the former section 19 as providing the Commissioner with discretion to accept or reject any application to change accounting basis. While this case considers the former section 19, the key phrase is common to both the old and new sections.
- 56 Public Information Bulletin No. 143 – February 1986 also recognised (in relation to former section 19) the discretion to accept or reject such applications:

"The 'general' rule is that all persons shall account for tax payable on an invoice basis. A payments basis can only be adopted with the approval of the Commissioner.

[...]

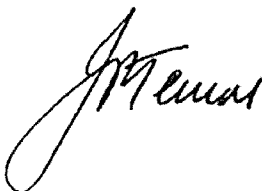
Any such person MAY adopt a payments basis from registration or from the first taxable period after which the approval to adopt a payments basis is given." [emphasis in original]

Recommendation

- 57 Accordingly, the Law Society recommends that proposed section 19(3B) should not proceed.

Conclusion

- 58 The Law Society wishes to appear in support of this submission.



Jonathan Temm
President
27 January 2012