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Public Consultation
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Exposure Draft ED0198: Standard Practice Statement: Loss offset elections between group companies

Introduction

1. The New Zealand Law Society (Law Society) welcomes the opportunity to comment on *Exposure Draft ED0198: Standard Practice Statement: SPS XX/XX Loss offset elections between group companies* (Exposure Draft).
2. The references in the main headings below correspond to those in the Exposure Draft. All statutory references are to the Income Tax Act 2007 (the Act) unless otherwise stated.
3. The comments below outline a number of areas where in the Law Society's opinion the Exposure Draft could be made clearer, or where the Law Society considers that the approach taken by Inland Revenue is inconsistent with the Act.

Summary

4. Paragraph 4 of the Exposure Draft reads: "*The loss company must make an election for the loss offset and where applicable **make** a subvention payment ...*". Under section IC 5(2)(b) of the Act, the loss company agrees to receive a subvention payment, and does not make a subvention payment. The wording of this paragraph should be amended to make clear that the loss company may:
 - (a) make an election to offset its losses; or
 - (b) agree to receive a subvention payment in respect of its losses.

Prerequisites

5. Paragraph 17 of the Exposure Draft reads:

*The amount of loss to be offset must not exceed **the net income of the elected profit company** for the tax year, or the total taxable income of all the elected profit companies and **nor does** the amount that the profit company agrees to pay the loss company exceed the loss company's tax loss: sections IC 8(1) and (2). [Emphasis added].*

6. Paragraph 17 refers to the 'net income' of the elected profit company in specifying the limit on the amount of loss which is permitted to be transferred. This is presumably drawn from the wording of section IC 8(1) of the Act, which limits the amount of losses which can be transferred to "*the amount that would be Company B's net income for the year in which it subtracts the amount of the tax loss*".
7. However, section IC 8(3) of the Act further provides that for the purposes of grouping tax losses, Company B's net income is found after taking into account, firstly, its own losses and, secondly, a tax loss made available to it by another company. The effect of this is that a profit company must utilise its own losses before availing itself of a group loss offset.
8. In our view, this concept is more accurately represented by the term 'taxable income', which is defined in section BC 5 of the Act to mean the amount of a person's net income, less any tax losses which are available to that person. While the term 'taxable income' is not used in section IC 8(1), and Inland Revenue will understandably wish to reflect the precise statutory language, the special use of the term 'net income' in a group loss offset context should be noted. The Law Society suggests that the special meaning of the term 'net income' in the loss offset provisions should be outlined more clearly in the Exposure Draft. We note that the term 'taxable income' is used in the equivalent paragraph of SPS 05/12, which the Exposure Draft seeks to replace.
9. We also note that the use of the phrase 'nor does' appears to be a typographical error. The equivalent paragraph of SPS 05/12 uses the phrase 'neither may' which we consider to be more grammatically accurate.

Example 1

10. The Exposure Draft states, in Example 1, "*it is anticipated that Company B will be in profit and that the amount of the **taxable profit** will be about \$2,000 ...*". We consider that a defined term, such as net income or taxable income, should be used in this example, to assist with clarity and application of the rules. We consider that the term 'net income' is most appropriate, for the reasons discussed above.

The election

11. Paragraph 19 of the Exposure Draft sets out the three ways in which a loss company may give notice of the loss offset election. The third of these is "*sending a notice either manually or electronically (either with the return or separately)*."
12. The Law Society considers that the Exposure Draft, when it is published as an SPS, will be of more use to taxpayers and practitioners if further detail is given about what is required to be included in the notice. The equivalent paragraph of SPS 05/12 contains specific details about what information should be included in the election. The Law Society's view is that this information should be restored to the Exposure Draft.

Late elections and extensions of time for filing them

13. Paragraph 22 of the Exposure Draft quotes extensively from SPS 16/01 *Requests to amend assessments*, and at paragraph 23 states that the rationale(s) from that statement will apply in respect of whether the Commissioner will exercise her discretion to accept late elections.
14. Paragraph 22, quoting from SPS 16/01 at paragraph 59, states:

... while the requested adjustment may be a correct interpretation of the law when considered in isolation, the Commissioner would not be convinced that the resulting assessment would be correct given the presence of tax avoidance.
15. The Law Society's view is that this principle cannot be applied wholesale in the context of the Commissioner exercising her discretion to accept a late loss offset election, after the Commissioner has adjusted a taxpayer's income as a result of a tax avoidance scheme. In that situation, if the taxpayer had originally structured their affairs in the way the Commissioner considers they should have (as determined by applying her reconstruction powers in that way) then the full loss amount would have been available to the taxpayer at that time. The Commissioner should approve all consequential adjustments which result from a reconstruction in the case of a tax avoidance arrangement. This will include loss offset elections, which will almost invariably be out of time when they result from a reassessment and reconstruction.
16. The Law Society does not consider that the above analysis should apply in cases of fraud or evasion.

Example 2

17. The Law Society suggests that Example 2 be reworded in order to make clear that it applies only to applications for loss offset elections made out of time. In other words, the example should be clear that in cases of tax avoidance, if a loss offset election is nevertheless received on time, it will be effected as requested.

Part-year losses

18. At the first bullet point of paragraph 25, a typographical error has resulted in an open bracket with no corresponding closing bracket.

Amended assessments

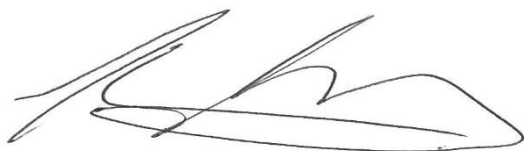
19. This section of the Exposure Draft, from paragraphs 28 – 33, deals with the four possible consequences of an amended assessment, and how a loss offset election will be treated in respect of each different situation. The four scenarios are:
 - a) reduced loss;
 - b) increased loss;
 - c) increased profit; and
 - d) reduced profit.

20. In the discussion relating to how loss offset elections will be treated in each of the four scenarios above, the Exposure Draft states that (other than in the case of a reduced loss) a further loss offset election may be made in respect of the increased loss, increased profit, or reduced profit (where the reduction of the profit of one company enables losses to be offset against the profit of another company). In respect of these further loss offset elections, the Exposure Draft states that these elections must meet all criteria for loss offset elections, including the requirement that they be received on time. In the case of loss offset elections, 'on time' means on or before 31 March of the year after the year to which the loss offset relates.
21. Where a further loss offset election is required as a consequence of an amended assessment, it will almost always be impossible for a taxpayer to make this election 'on time' unless the taxpayer has filed their return several months early. The Law Society understands that it is rare for taxpayers to file their returns significantly early, especially taxpayers of the type that will be performing group loss offsets (generally larger and more sophisticated taxpayers). Accordingly, the guidance relating to further loss offset elections is of limited use in these circumstances.
22. The Law Society recommends that the limited application of this guidance is made clearer in the Exposure Draft so that taxpayers and practitioners do not misunderstand the recourse available to them in the case of an amended assessment affecting a group loss offset election. Alternatively, Inland Revenue should consider waiving the requirement that a loss offset election be received 'on time' in these circumstances, as this requirement is not legislatively prescribed.

Conclusion

23. This submission was prepared with assistance from the Law Society's Tax Law Committee. If you wish to discuss this further please contact the committee convenor Neil Russ, through the committee secretary Jo Holland (04 463 2967 / jo.holland@lawsociety.org.nz).

Yours faithfully

A handwritten signature in black ink, appearing to read 'Kathryn Beck', with a large, sweeping flourish underneath.

Kathryn Beck
President