NEW ZEALAND
LAW SOCIETY

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Taxation (Annual Rates for 2017-18, Employment and Investment Income, and Remedial Matters) Bill

05/07/2017

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1. The New Zealand Law Society (Law Society) welcomes the opportunity to comment on the Taxation (Annual Rates for 2017-18, Employment and Investment Income, and Remedial Matters) Bill (Bill). The headings in this submission correspond to the relevant headings of the Minister of Revenue's *Commentary on the Bill* (Commentary). All statutory references in this submission are to the Income Tax Act 2007 (Income Tax Act), the Goods and Services Tax Act 1985 (GST Act) or the Tax Administration Act 1994 (TAA).

Employee Share Schemes

General Comments

2. The Bill proposes to change fundamentally the basis on which employee share schemes are treated for tax purposes. The Law Society does not express a view on the merits of the proposed change in basis other than to note that:

    - there was significant opposition to the proposals when they were consulted on during 2016, including from the Law Society; and
    - the proposals outlined in the Bill would result in a very complex regime when compared to the current rules and would materially increase compliance costs for companies offering employee share schemes, and in many cases for employees as well.

    In light of the above the Law Society encourages the Select Committee to critically consider this aspect of the Bill and whether the case for fundamental change is made out.

Comments on drafting of new provisions

3. Because employee share schemes have tax consequences for a company's employees, as well as the company itself, it is important from an employer's perspective that the applicable tax rules are clear, logical and easy to apply for both employers and employees. As noted above, the Law Society considers the proposals in the Bill to be more complex than the current rules, in their interpretation and application.

4. From an interpretive perspective, we submit that the following drafting issues should be considered in order to improve clarity and certainty:

    - Clauses 7 and 10 of the Bill introduce new rules that would alter the available subscribed capital of a company as a result of benefits being granted under an employee share scheme. While these proposals are intended to be taxpayer-friendly, they introduce a new layer of complexity that is not present in the current regime which in many cases will outweigh the benefit. Consideration should be given to making these rules optional for taxpayers.

- Paragraphs (a)(i) and (a)(ii) of the "employee share scheme" definition in new section CE 7 are too broad and should be limited to arrangements that are entered into in connection with a person's employment or service (as is the case for paragraph (a)(iii)).
- Unless reference is made to the Commentary to the Bill and other material the exclusion from the "employee share scheme" definition in new section CE 7(b)(iii) for an arrangement that requires an employee "… to put shares, acquired by them for market value, at risk …" is difficult to understand. The drafting of this exclusion should be amended to make clear what it does and does not include.
- Similarly, the meaning of the phrase "no real risk", as used in the definition of "share scheme taxing date" (new section CE 7B(1)), is uncertain, especially when it needs to be interpreted and applied by an employer on the establishment of a scheme on a forward-looking basis.
- The definitions of "employee share scheme" and "share scheme taxing date" have an element of circularity in that section CE 7B(1) defines "share scheme taxing date" by reference to shares or rights under an employee share scheme (i.e. it is necessary for there to be an employee share scheme for there to be a share scheme taxing date), but one of the exclusions from the employee share scheme definition (i.e. that in section CE 7(b)(ii)) includes reference to a "share scheme taxing date".
- Section CW 26C(2)(a) could be clarified by inserting "for purchase or subscription" after "available".
- Proposed sections DV 27(4) and DV 28(2) should be amended to clarify that costs incurred in establishing a scheme are deductible (as stated in the Commentary to the Bill). As currently drafted, it is not clear that all expenses incurred in establishing a scheme would fall within the description of “expenditure or loss … for administrative or management services provided”. For example, legal and accounting advice in relation to establishment might not ordinarily be regarded as “administrative or management services”.

Comment on retrospectivity

5. New section DV 28 would prohibit a company from claiming a tax deduction for costs incurred in operating a share purchase scheme, except for the cost of administrative or management services. The Bill proposes that this prohibition would apply from the date of introduction of the Bill, so would have retrospective effect. The Law Society submits that a high hurdle should be met for any amendments to tax laws that are adverse to taxpayers to have retrospective effect, and that such a

hurdle has not been met in the case of section DV 28 which would change a longstanding and orthodox position.

<u>Other Policy Matters (Demergers, Bank Account Requirement for IRD Numbers, Trustee Capacity)</u>

Demergers

Transfers to shareholders by ASX-listed Australian company of shares in subsidiary (clauses 8 and 45)

6. The Law Society supports the proposed insertion of a dividend exemption for demerger transactions involving ASX-listed Australian companies. Enacting the dividend exemption will correct an anomaly in New Zealand's current dividend taxation rules that can result in New Zealand shareholders being taxed on their own capital where a member of the corporate group into which they have invested demerges.

7. The Law Society understands that consideration was given to a broader demerger regime (for instance, a full demerger regime covering all New Zealand and foreign companies, or a demerger regime covering all foreign listed companies) but that the decision was ultimately made to limit the demerger rules in the Bill solely to ASX-listed Australian companies. It appears that this more limited approach was adopted largely because of concerns about whether there was sufficient time to develop a more comprehensive demerger regime before the 2017 omnibus tax Bill was released.

8. While the Law Society appreciates why this approach is being adopted, it would expect that the provisions in the Bill are not the final position in relation to demergers and that further work will be undertaken towards expanding the demerger rules as soon as is practicable. The proposals in the Bill are a useful start toward addressing the demerger issue but, unless the demerger rules are expanded further, there will inevitably be situations in future where New Zealand shareholders will be taxed on their own capital when a non-resident company (other than an ASX- listed company) demerges (particularly, where the New Zealand shareholder is not being taxed under New Zealand's foreign investment fund rules).

Bank Account Requirement for IRD Numbers

Information relating to offshore persons and tax file numbers (clause 244)

9. The Law Society supports the proposed insertion of new section 55B into the Tax Administration Act 1994, which will provide the Commissioner of Inland Revenue with a discretion to issue an IRD number to an offshore person who does not have a New Zealand bank account, if the Commissioner is satisfied as to the person's identity and background. The Law Society considers that it would be useful if Inland Revenue could provide detailed guidance on how an offshore person could satisfy Inland Revenue of their identity and background. For example, the types of identification documents

and background information that Inland Revenue would expect to receive with an application from the various offshore persons that may apply for an IRD number (i.e. companies, limited partnerships, partnerships, joint ventures, look-through companies, and trusts).

Trustee Capacity

General comments

10. The Law Society agrees that the Income Tax Act (and the GST Act) should be amended to clarify that, subject to clearly identified exceptions, an individual or company acting as a trustee of a trust is to be treated as a separate person for income tax purposes (and GST purposes), and where an individual or company acts as a trustee of more than one trust, that individual or company should be treated as acting in a different capacity in respect of each trust. The Law Society also welcomes the proposed amendment to the definition of "close company" to enable a company owned by a family trust to be treated as a "close company".

11. The High Court decisions in *Concepts 124 Limited v C of IR* [2014] NZHC 2,140 and *Staithes Drive Development Limited v C of IR* [2015] NZHC 2,593 are at odds with the previously held views of both Inland Revenue and taxpayers. Prior to these cases, it was generally accepted that a person (including a company) acting as trustee was acting in a different capacity for tax purposes than their personal (or corporate) capacity. Further, a person (including a company) acting as trustee of more than one trust would be treated as acting in a different capacity in respect of each trust.

12. The Law Society does not wish to criticise the reasoning of the above cases, but notes that:

- In the *Concepts 124* case, the vendor (Ormiston) and the purchaser (Concepts 124) would have been associated under the tripartite test of association in section 2A(1)(i) of the GST Act even if Clifford J had respected the capacity in which Flatbush Holdings Limited held the shares in Ormiston. That is, Mr Cummings would have been associated with both Ormiston and Concepts 124 under the company / person test of association in section 2A(1)(b) of the GST Act, as Mr Cummings held at least 25% of the voting shares in each company (on a look-through basis). The Law Society notes that the tripartite test of association in section 2A(1)(i) of the GST Act applies where the two persons (Concepts 124 and Ormiston) are associated with the same third person (Mr Cummings) under the same test of association (the company / person test), unlike the tripartite test of association that applies for income tax purposes (section YB 14 of the Income Tax Act).
- In the *Staithes Drive* case, Edwards J agreed with the Taxation Review Authority that the convoluted ownership structure was put in place to enable Staithes Drive to claim an input tax credit to which it would not otherwise have been entitled. As such, Edwards J held that even if

Staithes Drive and Whitby were not associated persons, the input tax credit would have been denied on the basis that the input tax credit claim was part of a tax avoidance arrangement.

13. As such, the decisions in *Concepts 124* and *Staithes Drive* would have been the same even if their Honours had looked beyond the legal ownership of the shares in the vendor and purchaser in each case.

Location of trustee capacity provision (cl 173)

14. The Law Society considers that it would be more logical if proposed section YA 5 of the Income Tax Act is inserted as section YB 22, rather than section YA 5, and that the heading of subpart YB of the Income Tax Act is changed to "Associated persons, nominees and trustees". The Law Society notes that section YB 21 already deals with bare trustees, so the position of trustees (other than bare trustees) should logically be dealt with immediately after section YB 21.

Recommendation

15. The Law Society recommends that proposed section YA 5 of the Income Tax Act is inserted as section YB 22 of the Income Tax Act, and that the heading of subpart YB of the Income Tax Act is changed to "Associated persons, nominees and trustees".

Definition of "company" and "natural person" (clauses 172(5) and 172(35))

16. Clause 172(5) of the Bill proposes to add the following subparagraph to the definition of "company" in section YA 1 of the Income Tax Act: "(abc) does not include a company that is acting in the capacity of trustee:". Clause 172(35) of the Bill proposes to replace the definition of "natural person" in section YA 1 of the Income Tax Act with the following: "… (a) does not include a natural person who is acting in the capacity of trustee: …".

17. It is bad drafting to refer to a defined term in the definition of that defined term. It would be better if clause 172(5) of the Bill was worded as follows: "(abc) does not include an entity that is acting in the capacity of trustee:", or "(abc) does not include a person that is acting in the capacity of trustee:". In a similar vein, it would be better if clause 172(35) of the Bill was worded as follows: "… (a) does not include an individual who is acting in the capacity of trustee: …" or "… (a) does not include a person who is acting in the capacity of trustee: …".

Recommendation

18. The Law Society recommends that the proposed amendments to the definition of "company" and "natural person" in the Income Tax Act do not refer to the defined term in the definition of that defined term.

Application of “asset stripping” provision to corporate trustees (cl 77)

19. The Law Society does not agree with the proposed amendment to section HD 15 of the Income Tax Act (asset stripping of companies) to expressly include corporate trustees. The Law Society does not share Inland Revenue’s view that section HD 15 applies to a company acting in the capacity of a trustee of a trust.

20. The purpose of what is now section HD 15 of the Income Tax Act is set out in chapter 10 of the Business Tax Policy Statement (the Statement) issued by the then Minister of Finance (Ruth Richardson) on 30 July 1991. There is nothing in the Statement that implies Parliament intended the “asset stripping” provision (now section HD 15) to apply to corporate trustees. Case law on section HD 15 of the Income Tax Act (and its forerunners) does not support Inland Revenue’s view that section HD 15 applies to corporate trustees either.

21. The wording of section HD 15 implies that the shareholders of the company have an interest in the assets being stripped or otherwise derive a benefit from the arrangement. Section HD 15(4) limits the controlling or interested shareholder’s liability to the greater of the market value of that person’s shareholding in the company at the time of the arrangement and to the value of the benefit that person derives from the arrangement. Shareholders of a corporate trustee, however, have no beneficial interest in assets held by the corporate trustee on trust. The market value of the shares in a corporate trustee where all of the assets of the corporate trustee are held on trust is nil.

22. The Law Society does not agree with the statement on page 137 of the Commentary which states: “Without the proposed amendment, a corporate trustee could enter an arrangement to deplete its assets so that it is unable to satisfy its tax liabilities, and the Commissioner would have no means of recovering any of the corporate trustee’s unpaid income tax from its directors or shareholders”. First, the courts have made it clear that the forerunner to section HD 15 of the Income Tax Act is not a general tax recovery provision (see *Case X11* (2005) 22 NZTC 12,175 at paragraphs 19, 20 and 25, and *BNZ Finance Limited v Holland* (1997) 18 NZTC 13,156 at pg. 13,176). Secondly, the Commissioner has the same rights of recourse against the directors as any other creditor in these circumstances.

23. The Commissioner can, and often does, take action against the directors of corporate trustees for breach of their duties under the Companies Act 1993, where the directors are not able to meet their tax liabilities as a result of their actions. It is not appropriate for the Commissioner to bring an action against the shareholders of a corporate trustee, as these shareholders have no proprietary interest in the assets held on trust.

Recommendation

24. The Law Society recommends that the proposed amendments to section HD 15 of the Income Tax Act do not proceed.

Amendments to definition of "associated persons" for GST purposes (cl 309)

25. The Law Society does not disagree with the inclusion of a trustee / appointor test of association for GST purposes, but notes that the outcome of the *Concepts 124* and *Staithes Drive* cases would have been the same without resorting to this test of association (as noted in paragraph 13 above).

26. The Law Society considers that amendments will also need to made to the definitions of "market value interest" and "voting interest" in section 2A(3) of the GST Act to overcome the reasoning in the *Concepts 124* and *Staithes Drive* cases. In particular, the cross-reference to the income tax definitions of "market value interest" and "voting interest" should specifically refer to and import the nominee / bare trustee provision in section YB 21 of the Income Tax Act (which provision was not considered in *Concepts 124* or *Staithes Drive*), along with the trustee capacity provision in proposed section YA 5 of the Income Tax Act (or section YB 22 if the Law Society's submission (at paragraph 15) in respect of the numbering of the proposed provision is accepted).

27. The Law Society is concerned with the piecemeal manner in which section 2A of the GST Act is to be amended. The current provision suffers from a number of defects, including:

- Overreach in the manner in which the tripartite test of association applies. This means, for example, that two companies will be associated under section 2A(1)(i) of the GST Act if a person holds at least 25% of the voting interests in each of those companies, notwithstanding that those companies would not be associated under the company / company test of association in section 2A(1)(a)(i) unless that person held at least 50% of the voting shares in each of those companies.

- Difficulties in applying the corporate tests of association in sections 2A(1)(a) and 2A(1)(b) of the GST Act to limited partnerships, which are treated as companies for GST purposes.

28. The Law Society considers that section 2A of the GST Act should be rewritten to be consistent with the non-land based tests of association in subpart YB of the Income Tax Act. This would more appropriately deal with instances of underreach and overreach than the proposed piecemeal amendment.

Recommendation

29. The Law Society recommends that section 2A of the GST Act is rewritten entirely to be consistent with the non-land based tests of association in subpart YB of the Income Tax Act, as this would more appropriately deal with instances of underreach and overreach than the proposed piecemeal amendment.

30. The Law Society also recommends that the definitions of "market value interest" and "voting interest" in section 2A(3) of the GST Act are amended to overcome the reasoning in the Concepts 124 and Staithes Drive cases. In particular, the cross-reference to the income tax definitions of "market value interest" and "voting interest" should specifically refer to and import the nominee / bare trustee provision in section YB 21 of the Income Tax Act, along with the trustee capacity provision in proposed section YA 5 of the Income Tax Act.

Remedial Items

Tax on net assets of deregistered charities (cl 90)

Application of new section HR 12 to entities wholly or partly tax-exempt under section CW 42

31. Clause 90(1) proposes a new section HR 12 of the Income Tax Act that would extend to persons who are not tax charities, but who derive exempt income under section CW 42 of the Income Tax Act. Section HR 12 currently treats the value of net assets retained after a tax charity is deregistered as a charitable entity under the Charities Act 2005 as income to the extent those net assets are not distributed or applied to charitable purposes within 12 months of the date of deregistration. Section CW 42 provides that income derived by, or for, or for the benefit of, a tax charity is exempt income where other criteria are satisfied.

32. The Law Society is concerned that the proposed amendment to section HR 12 may apply much more widely than intended. The proposed amendment to section HR 12 seems to be predicated on the assumption that the net assets of an entity to which section CW 42 applies were funded by tax-exempt income that should be applied to charitable purposes. That is not necessarily the case.

33. For example, a corporate entity could, by deed, declare that a fixed percentage of its income is to be applied for the benefit of a tax charity, either indefinitely or for a fixed period of time. Such an entity would be able to apply section CW 42 to treat income derived for the benefit of the tax charity as exempt income. However, the net assets of such an entity would not have been funded by tax-exempt income set aside for charitable purposes.

34. If section HR 12 of the Income Tax Act were amended as proposed, and a taxpaying entity derived income for a tax charity that was subsequently deregistered, then the value of the net assets of the

taxpaying entity would be treated as income to the extent those assets were not disposed of or transferred for charitable purposes within 12 months of the date the tax charity is deregistered. If section HR 12 is amended as proposed, then this would create a disincentive for taxpaying entities to “tithe” a percentage of their profits for charitable purposes, as the value of the taxpaying entity’s net assets would be treated as income if the tax charity ceased to be registered for some reason.

Recommendation

35. The Law Society recommends that proposed section HR 12(3) is redrafted so that the amount of income of “person B” is limited to the lesser of (i) the value of the net assets of “person B” as at the date the tax charity is deregistered less assets that are disposed of or transferred within 12 months of the deregistration date for charitable purposes; and (ii) the amount of exempt income derived by “person B” under section CW 42 that has not been applied to charitable purposes within 12 months of the date the tax charity is deregistered.

Application of new section HR 12 to entities deregistered under the Charities Act that are still tax-exempt

36. The proposed new section HR 12 of the Income Tax Act under clause 90(1) recognises that the new section should not apply to entities that have been deregistered under the Charities Act or that have ceased to meet the requirements for exemption under section CW 42 in certain circumstances.

37. Currently this is limited, under proposed section HR 12(2), to:

- an entity to which the section *prima facie* applies because it has been deregistered under the Charities Act ("Person A"), but which re-registers within 12 months of the date of deregistration; and
- an entity to which the section *prima facie* applies because it has ceased to meet the requirements for exemption under section CW 42 ("Person B"), but which meets the requirements for exemption within 12 months.

38. However, the current drafting does cover the situation where "Person A" does not re-register under the Charities Act, in particular because it does not need to be registered in order to be tax-exempt under section CW 42 (because the entity derives business income for another registered charity), but "Person A" meets the requirements for exemption under section CW 42 within 12 months of the date of deregistration. The Law Society considers that drafting should cover this situation, so that "Person A" is not disadvantaged compared with "Person B".

Recommendation

39. The Law Society recommends that the proposed section HR 12(2) in clause 90(1) be amended so that the new section HR 12 does not apply to "Person A" if, within 12 months of the date of

deregistration, "Person A" re-registers under the Charities Act and/or meets the requirements for exemption under section CW 42.

Grandfathering provision for entities that have taken tax positions relying on the current section HR 12

40. Clause 2(18) of the Bill provides for the new section HR 12 to apply retrospectively, from 14 April 2014 (which is the date that the current section HR 12 came into force). Clause 90(2) then includes a grandfathering provision to ensure that entities that have taken tax positions in reliance upon section HR 12 as it is currently drafted are not disadvantaged.

41. The Law Society is concerned, first, with the retrospective nature of the amendment and, secondly, that the current drafting of the grandfathering provision in clause 90(2) is too narrow. In particular, if the amendment is to be retrospective, it should not apply to an entity that has taken a tax position relying on the current section HR 12, even if the entity has not filed a return of income with respect to that tax position (as is currently required under the grandfathering provision). This is important in this context because entities affected by the retrospective amendment will include entities that have not filed any returns of income because they are fully tax-exempt and therefore not required to file returns.

42. The Law Society is also concerned that clause 90(2)(b) is unclear. It provides that the tax position relying on the current section HR 12 must be one that relates to "the derivation of exempt income to which subsection (1) [i.e., clause 90(1) of the Bill] applies". The only references in subsection (1) to exempt income are references to exempt income derived by "Person A" prior to deregistration under the Charities Act and exempt income derived by "Person B" prior to ceasing to meet the requirements for exemption under section CW 42. A tax position relying on the current section HR 12 will not relate to that exempt income. The tax position will most likely be that the current section HR 12 does not apply to the entity or does not give rise to any deemed income that would be assessable to the entity.

43. Clause 90(2)(b) would in any event appear to be superfluous. For the grandfathering provision to apply, it should be sufficient that an entity has taken a tax position relying on the current section HR 12.

Recommendation

44. The Law Society recommends that either:

- the proposed section HR 12(2) should not apply retrospectively; or

- the grandfathering provision in clause 90(2) should be amended, by deleting the requirement that an entity must have taken a tax position relying on the current section HR 12 *in a return of income* that the entity has filed, and by deleting or amending clause 90(2)(b).

<u>Maintenance and Minor Rewrite Items</u>

Trustee's requirement to file income tax returns (clauses 73 and 225)

45. Clause 225(2) of the Bill inserts proposed section 33(1D) of the TAA, which states: "(1D) A trustee of a trust that must calculate the trust's taxable income under section HC 2 of the Income Tax Act 2007 must provide a return of income for the trust for a tax year unless section 43B applies in relation to the trust." Clause 225(3) of the Bill provides that proposed section 33(1D) applies retrospectively from the 2008/2009 income year.

46. Proposed section 33(1D) of the TAA replaces section 42(1)(a) of the TAA, which was repealed by the Taxation (Limited Partnerships) Act 2008. Section 42(1)(a) required trustees to file a return only where the trustees derived or incurred an amount. Many trustees relied on the wording of section 42(1)(a) not to file an income tax return where the trust's sole asset was the family home which was made available to one or more of the beneficiaries of the trust without charge.

47. Proposed section 33(1D) of the TAA refers to section 43B of the TAA, which excuses certain non-active trusts from filing income tax returns. Section 43B was enacted on 16 November 2015 and does not apply retrospectively.

48. The Law Society is concerned that Inland Revenue may interpret proposed section 33(1D) more widely than section 42(1)(a) to require all trusts (including those without IRD numbers) to file income tax returns, whether or not those trusts have derived any income or incurred any expenditure. Further, the Law Society is concerned that Inland Revenue may apply this interpretation with retrospective effect, to require all trusts (including those without IRD numbers) to file income tax returns from the 2008/2009 income year, even where such trusts have not derived any income or incurred any expenditure. Such trustees could not rely on section 43B to excuse the trust from filing income tax returns, as section 43B was only enacted on 16 November 2015 and does not apply retrospectively.

49. If Inland Revenue applied the above interpretation then, based on the Commissioner's interpretation in PUB00261 of the criteria for a trust to be a "complying trust" in section HC 10(1)(a)(ii) of the Income Tax Act, arguably such trusts would be treated as "non-complying trusts" unless or until all tax returns had been filed. This would result in any "taxable distribution" made by the trust, including the market value of the beneficiaries occupying the trust property and distributions of realised

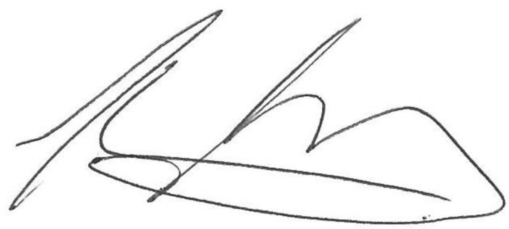
capital gains upon the sale of the trust property, being subject to income tax at the rate of 45%. The Law Society does not consider that such an outcome was intended, particularly as the insertion of proposed section 33(1D) has been referred to as a “maintenance amendment” in the Commentary.

Recommendation

50. The Law Society recommends that the Commissioner clarifies in the Tax Information Bulletin following the enactment of the Bill that section 33(1D) of the TAA does not require trusts that do not (and are not required to) obtain an IRD number to file income tax returns if those trusts do not derive income or incur expenditure.

Conclusion

51. The Law Society does not wish to be heard.



Kathryn Beck
President

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