New Zealand Law Society
Te Kāhui Ture o Aotearoa

Taxation (Annual Rates for 2022-23, Platform Economy, and Remedial Matters) Bill (No 2)

1/11/2022

Taxation (Annual Rates for 2022-23, Platform Economy, and Remedial Matters) Bill (No 2) 2022

1 Introduction

1.1 The New Zealand Law Society | Te Kāhui Ture o Aotearoa (**Law Society**) welcomes the opportunity to comment on the Taxation (Annual Rates for 2022-23, Platform Economy, and Remedial Matters) Bill (No 2) (**Bill**).

1.2 This submission has been prepared with input from the Law Society's Tax Law Committee,[1] and addresses the following topics:

(a) Rollover relief for the residential land bright-line test and interest limitation rules;

(b) Amendments to the definition of "dispose" in the Income Tax Act 2007;

(c) Proposed changes to GST apportionment and adjustment rules;

(d) GST on accommodation and transportation services provided through electronic marketplaces;

(e) Information reporting for digital platforms;

(f) The income tax treatment of dual resident look-through companies;

(g) Aligning the foreign-sourced income exemption with the foreign trust disclosure rules; and

(h) GST on investment management fees.

1.3 The Law Society does not wish to be heard but is happy to discuss this submission with the Finance and Expenditure Committee, or with officials, if that would assist.

2 Rollover relief for the residential land bright-line test and interest limitation rules

Commencement date of proposed changes (clauses 2, 7(1) and 8(1))

2.1 Clause 7(1) of the Bill contains the proposed changes to the rollover relief provisions to the residential land bright-line test and interest limitation rules, including the proposed extension of rollover relief to certain transfers of residential land between trusts. Clause 8(1) contains the proposed changes to the rollover relief provisions to the residential land bright-line test and interest limitation rules for certain Māori family trusts.

2.2 The Law Society understands, from recent discussions with officials, that these proposed changes are intended to apply from the date the original rollover relief provisions apply. That date is 27 March 2021 for the purpose of the interest limitation rules, and 1 April 2022 for the purpose of the residential land bright-line test. However, the Bill does not provide for any specific commencement dates for these clauses. As a result, the proposed rollover relief provisions (including the proposed extension of rollover relief to certain trust resettlements) will not come into force until the Bill is enacted and receives the Royal assent.[2]

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[1] See the Law Society's website for more information about this Committee: https://www.lawsociety.org.nz/branches-sections-and-groups/law-reform-committees/tax-law-committee/.

[2] Clause 2(1) of the Bill.

2.3 While those provisions, once enacted, will have a retroactive effect on transfers to and from trusts on or after 1 April 2022 (based on the wording of those provisions), this will not extend to transfers to and from trusts on or after 27 March 2021 for the purpose of the interest limitation rules. The Law Society therefore recommends amending clause 2(18) to include references to clauses 7(1) and 8(1).

Drafting issues in the proposed rollover relief provisions (clause 7(1))

2.4 Proposed section CB 6AB(1) of the Income Tax Act 2007 defines the person who transferred the residential land to the trustees of a trust who are seeking rollover relief for a subsequent disposal of that land **(‘trustees seeking rollover relief’**), as “the transferors”, but then twice refers to that person as “the transferor”. The drafting of this provision should be reviewed to ensure that defined terms are used correctly and consistently.

2.5 Where the transferors who transferred residential land to the trustees seeking rollover relief are also trustees of another trust, proposed section CB 6AB(1) of the Income Tax Act refers to those transferors as the “head trust”. The use of the term “head trust” is misleading, as it implies that rollover relief is restricted to situations where the residential land was previously transferred from a head trust to a sub trust, which is not the case. We therefore suggest using the terms “trust A” and “trust B” in this section to improve readability and reduce the risk that the proposed extension of rollover relief to transfers of property between certain trusts is not applied more restrictively than intended.

2.6 Proposed section CB 6AB(2) of the Income Tax Act defines the person (the settlor) who is seeking rollover relief for a subsequent disposal of residential land as “the transferee”, but then subsequently refers to that person as “the transferees”. The drafting of this proposed section should also be reviewed to ensure that defined terms are used correctly and consistently.

Requirement that each transferee is a principal settlor of the trust (clause 7(2))

2.7 Proposed section CB 6AB(2)(b) of the Income Tax Act restricts rollover relief from the residential land bright-line test, where the trustees of a trust transfer residential land to the settlors of the trust, to situations where the settlors are the principal settlors (as defined) of the trust both at the time the trustees acquired the land and at the time the trustees transfer that land to the settlors.

2.8 The requirement that the transferees are the principal settlors of the trust – both at the time the trustees acquired the land, and at the time the trustees transfer that land to the transferees – is too restrictive and likely to give rise to problems in practice, especially in relation to life partners. This is because the term “principal settlor” is defined in section YA 1 of the Income Tax Act as the settlor whose settlements on the trust are the greatest or greatest equal by market value. There will be many trusts where life partners have not settled exactly the same amount (by market value) on the trust at both the time the trust acquired the property in question, and the time the trustees transferred that property to the life partners. In such cases, rollover relief will not apply if the trustees transfer the property to both life partners.

2.9 There is no sound policy basis for restricting the application of rollover relief from the bright-line test in this way. The Law Society submits that proposed section CB 6AB(2)(b) should therefore be redrafted as follows:

> "(b) trust A is a rollover trust and–
>
> (i) at least one transferee is a principal settlor of trust A at the time the trustee acquired the land; and
>
> (ii) at least one transferee is a principal settlor of trust A at the time the trustee transfers the land to the transferee; and
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> (iii) all transferees (if more than 1) are associated with each other under section YB 4(1)(b) at the time the trustee transfers the land to the transferees."

Guidance on completing form IR833 where rollover relief applies

2.10 Inland Revenue requires taxpayers to complete form IR833 (*Bright-line residential property sale information*) where the disposal of residential land is subject to the bright-line test. Although form IR833 was last updated in June 2022 (after the original rollover relief provisions to the bright-line test were enacted in March 2022), it does not refer to the effect of rollover relief on completing the form.

2.11 Form IR833 does not need to be completed if an exclusion to the bright-line test applies. However, rollover relief is not an exclusion to the bright-line test. Rather, it affects the date that land is deemed to have been acquired for the purpose of the bright-line test, and the amount for which the land is deemed to have been acquired or disposed of. As such, form IR833 still needs to be completed where rollover relief applies. However, the availability of rollover relief may be relevant in completing Box 4 (acquisition date), Box 6 (sale price) and Box 7 (purchase price) of form IR833.

2.12 We suggest updating form IR833 to note that it must still be completed where rollover relief applies, and that the availability of rollover relief is relevant to how the form is completed. The guidance notes to form IR833 should also be updated as follows:

(a) Box 4 (acquisition date) should refer to the deemed acquisition date under section CB 6AB of the Income Tax Act where rollover relief applied on the purchase of the property;

(b) Box 6 (sale price) should refer to the deemed sale price under section FC 9B of the Income Tax Act where rollover relief applies to the sale of the property; and

(c) Box 7 (purchase price) should refer to the deemed acquisition price under section FC 9C of the Income Tax Act where rollover relief applied on the purchase of the property.

3 Amendments to the definition of "dispose" in the Income Tax Act (clause 98(6))

3.1 Clause 98(6) of the Bill proposes an amendment to the definition of the term "dispose" in the Income Tax Act to ensure that the allocation of subdivided land among the co-owners of

the original undivided land does not constitute a disposal for the purpose of the land provisions.[3]

3.2 The Law Society welcomes this amendment in principle. However, the wording of proposed new paragraph (ab) of the definition of "dispose" is not sufficiently clear to establish the intended position set out in the Commentary on the Bill. In particular, the definition should set out what is intended by the term "same proportionate economic ownership", and/or ensure that the example in proposed new subsection (ab) assists in the understanding of that term. It does not do so currently, as the term "a piece proportionate to" provides no practical guidance.

3.3 In addition, the Commentary on the Bill, and the examples provided in that Commentary, do not clearly set out the position in respect of development and construction costs. The Commentary simply states that the value of the properties needs to align with "the co-owners' interests in the original undivided parcel of land and contributions to development and construction costs".[4]

3.4 We also note that example 39 (on page 136) appears to be based on the position (although not expressly stated) that Ash and Larna each paid 50% of the cost of building a house on each parcel of land (or, at least, that the cost of each house was the same). This is very unlikely to be the case in practice, and it would be helpful to have some guidance on how this proposed amendment is intended to apply if the co-owners each incur different costs when constructing a house on the part of the property that they will ultimately own once the partitioning exercise is complete. Even if the relative proportion of construction costs incurred by each party are taken into account, the market value of the resulting properties will not necessarily reflect the proportion of the construction costs, as market value is affected by many factors other than cost. As such, this approach may lead to a 'disposal' for tax purposes when it is not appropriate.

3.5 In practice, it is common for two or more parties to purchase a property as co-owners, with the intention of subdividing the property and allocating ownership of one subdivided title to each co-owner. Under the proposed amendment (as explained in the Commentary on the Bill), if it is assumed that the subdivision costs are allocated to the parties in the same proportion as their ownership interest in the property, there will be a disposal if the market value of the subdivided title received by each party, as a percentage of the market value of the entire property (i.e. the two titles), is not the same as their percentage interest in the land at the time of purchase. It is not possible for the co-owners to accurately predict, at the time they purchase the property, what the market value of each subdivided section will be on the date the subdivided sections are allocated to the different co-owners. In practice, the co-owners may have a commercial arrangement to adjust their respective contributions to the original purchase price of the property to reflect the market value of each party's section at the time titles are issued to each co-owner. The Law Society considers that there should be no disposal in these circumstances.

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[3] Commentary on the Bill, page 134.

[4] Commentary on the Bill, page 135.

3.6 This point could be further illustrated using an example where two parties decide to purchase a property for the purpose of subdividing it into two lots, and for one lot to be allocated to each of them. They expect that the value of the subdivided lots will be equal, so they purchase the property as 50:50 co-owners. They have a commercial agreement in place which provides that if the value of the subdivided lots is not equal, then the party who obtains the more valuable lot will pay an additional portion of the purchase price to the other party. The parties share the subdivision costs equally, and once the subdivision is completed, they each receive title to one subdivided lot. It subsequently becomes apparent that one of the subdivided lots has a market value of $100,000 and the other has a market value of $105,000. Under the terms of the commercial agreement between the parties, the co-owner who receives the $105,000 lot pays an amount to the other co-owner, so that the contribution by each co-owner to the purchase of the property and the subdivision costs reflects the relative market values of the subdivided lot each co-owner receives. The Law Society considers that there should be no disposal in this situation.

3.7 There is a higher likelihood of an unintended disposal arising in these circumstances if there is an existing house on the property and one party will receive the part of the property which includes the house when the subdivision is completed, or where buildings are constructed on the property before the subdivided titles are allocated to each party (for example, in respect of a unit title development where the fit-out of each unit is completed to different specifications and each co-owner pays for their own fit-out). In each of these situations, while it is intended that each party acquires their ultimate interest in the property from the outset, it is not possible to accurately predict the relative market value of each completed title to ensure there is no disposal for income tax purposes.

3.8 The wording of clause 98(6) should therefore be reviewed to ensure it is capable of being interpreted and applied without reference to the Commentary on the Bill or any Inland Revenue guidance. The Law Society also submits that the wording of this amendment should be reviewed in the light of the fact that the market value of the subdivided sections will not necessarily be proportionate to the cost of those sections, and that it is not possible to predict the market value of the subdivided or developed sections at the time the property is acquired.

4 Proposed changes to GST apportionment and adjustment rules

The treatment of a supply of goods as an exempt supply (clause 113)

4.1 Clause 113 of the Bill contains new section 14(4) of the Goods and Services Tax Act 1985 (**GST Act**), which allows registered persons to treat the supply of goods that were not acquired or used for the principal purpose of making taxable supplies as an exempt supply. It is proposed that new section 14(4) will apply to supplies made on or after 1 April 2011, unless an assessment has been made in respect of a supply before 30 August 2022.

4.2 A registered person may elect that the supply of a good is an exempt supply if "the person has not previously claimed a deduction under section 20(3) for the supply of goods".[5] Registered persons who sell goods before the Bill is enacted will be subject to GST on the

[5] Proposed new section 14(4)(a), in clause 113.

supply under the GST Act as currently enacted, and are entitled to claim an input tax credit under section 21F of that Act. This means that once proposed section 14(4) is enacted, the registered person will have claimed a deduction under section 20(3) of the GST Act. It is not clear on the proposed wording of section 14(4)(a) whether a person who has accounted for GST when the good is sold, and claimed an input tax credit by way of a section 21F adjustment under the current law, will be entitled to elect, once proposed section 14(4) is enacted, that the supply of the good was an exempt supply.

4.3 The Law Society further notes that proposed section 14(4) applies retrospectively, but not to registered persons for whom an assessment has been made before 30 August 2022. This is problematic for two reasons:

(a) First, this means tax-compliant registered persons who have correctly applied the GST Act as currently enacted, and have accounted for GST on the disposal of a good with minor taxable use, are in a worse position than registered persons who have failed to comply with the GST Act as currently enacted (either deliberately or because they did not know they were liable to account for GST on the disposal of the good). It would be a perverse outcome if the proposed amendment is more favourable for non-compliant taxpayers than for compliant taxpayers.

(b) Second, the retrospective application of proposed section 14(4) gives rise to practical difficulties for registered persons who have to take a position under the current law, knowing their position will change once proposed section 14(4) is enacted. This gives rise to considerable uncertainty in the context of land transactions where the amount of GST is significant, parties to the agreement make pricing decisions based on their cost/sale proceeds, and parties to the transaction provide warranties regarding the accuracy of GST statements in the sale and purchase agreement.

4.4 The Law Society therefore recommends:

(a) clause 113 should be amended to clarify that proposed clause 14(4)(a) refers only to a deduction claimed under section 20(3) before the good is sold;

(b) clause 113 should apply to persons who have correctly applied the current law and accounted for GST on the disposal of a good which had minor taxable use before 30 August 2022; and

(c) Inland Revenue should issue guidance as soon as possible regarding the position registered persons should take in respect of contracts to supply goods entered before the Bill is enacted.

Adjustments for apportioned supplies (clause 118(3))

4.5 Clause 118 of the Bill proposes to add paragraph (e) to section 21(2) of the GST Act, to provide that a registered person is not permitted to make an adjustment if they have elected to apply section 14(4) to the supply. The Commentary on the Bill indicates that this amendment seeks to ensure that the registered person is not required to monitor their

actual taxable use and make adjustments for goods for which they apply the proposed new rules in sections 14(4) and 91 of the GST Act.[6]

4.6 A registered person can only elect to apply section 14(4) of the GST Act "to the supply" at the time they are supplying the good, and only if the criteria of section 14(4) are satisfied at that time. As the ability to make an election under section 14(4) depends upon the registered person's use of the good and whether GST has been claimed up until the time of sale, the registered person cannot elect to apply section 14(4) "to the supply" at the end of each adjustment period (as there has been no supply).

4.7 We further note that the amendments in clause 118, which apply where the supply of the good is an exempt supply under proposed new section 91 of the GST Act, do not actually include a reference to new section 91.

4.8 The Law Society therefore submits that the amendment in clause 118(3) should be replaced with a new subclause which provides that a registered person can choose not to make an adjustment if they intend to make an election to apply section 14(4):

(a) When the good is disposed of, or deemed to be disposed of (and the criteria in section 14(4) are satisfied at the date the adjustment would otherwise be required); or

(b) If they have made an election under section 91 of the GST Act and repaid the GST previously claimed on the good (or paid the nominal GST amount).

Wash up adjustments on permanent change of use (clause 122)

4.9 Clause 122 of the Bill proposes changes to allow a registered person to make a wash-up adjustment under section 21FB of the GST Act when there is a permanent change to the percentage of taxable use of a good. The Commentary on the Bill also states that the Bill proposes an amendment so the wash-up calculation in section 21FB is applied at the end of the adjustment period in which the change of use occurred.[7]

4.10 The Law Society welcomes these proposed amendments, but notes that proposed new section 21FB still provides for the adjustment to be "for the adjustment period following the period in which the change occurred", which is the wording in the GST Act as currently enacted.[8] The Law Society submits that proposed new section 21FB(2) should be amended to delete the words "following the period" so that it provides for the adjustment to be made for the adjustment period in which the change of use occurred.

5 GST on accommodation and transportation services provided through electronic marketplaces

GST treatment of the supply of transport services (clauses 109, 129 and others)

5.1 The Bill provides for a new approach to the GST treatment of the supply of transportation services which are ride-sharing services and beverage and food delivery services. This new

[6] Hon David Parker *Taxation (Annual Rates for 2022–23, Platform Economy, and Remedial Matters) Bill (No 2) – Commentary on the Bill*, page 87.

[7] Commentary on the Bill, page 91.

[8] See section 21FB(1)(c)(ii).

approach appears to be premised on the fact that these drivers are not employees. However, the Employment Court has recently determined that the drivers who provide transportation services through the Uber app are in fact deemed to be employees.[9] This decision will likely be appealed and considered in the higher courts, and any resulting judgments will provide further guidance regarding the employment status of those who supply transportation services via digital platforms.

5.2 The employment status of drivers can have significant implications for the income tax and GST treatment of such services, as well as other regulatory consequences for the applicable app-based business model. Rather than impose significant changes to the GST treatment of such services now, the Law Society submits that it would be a more efficient use of Parliament's and Inland Revenue's resources if a comprehensive policy in respect of such services was developed once the legal status of these drivers is clarified by the courts.

The extension of the GST electronic marketplace rules to accommodation and transportation services (clauses 109, 129 and others)

5.3 The Bill proposes to extend the GST electronic marketplace rules to accommodation and transportation services. These proposals are intended to address the mischief that suppliers of accommodation and transportation services who do not meet the GST-registration threshold are able to provide their services via electronic marketplaces with relative ease, while putting GST-registered suppliers of the same or substitutable services at a competitive disadvantage. Rather than targeting supplies made by such non-GST registered suppliers, the Bill proposes wholesale changes to how GST applies to accommodation and transportation services.

5.4 The Law Society is concerned that the proposals in the Bill represent a significant deviation to the orthodox GST treatment of services supplied in New Zealand. The proposals will also impose considerable compliance costs on GST-registered suppliers of listed services without any additional GST being collected.

5.5 For example, a hotel that offers its rooms through its own website and two intermediary websites will need to track the website through which each booking is made. Under the proposals in the Bill, GST on the accommodation supplied at the hotel will be paid to Inland Revenue by at least 3 entities: the hotel and each intermediary website (depending on how the booking is made). The complexity in this example increases if:

(a) the booking is made through an intermediary website but payment is collected by the hotel; and/or

(b) each individual hotel room is owned by a different investor, so where a booking is made, it is not known which underlying supplier will actually make the supply.

The complexity and additional compliance costs of the proposals could be avoided if GST-registered suppliers (i.e., suppliers who are not part of the mischief to which the proposals are aimed) could continue to operate under their existing GST compliance arrangements.

[9] *E tū Incorporated & Anor v Rasier Operations BV & Ors* [2022] NZEmpC 192.

This could be achieved by amending clause 129 and allowing any GST-registered supplier to enter into an opt-out agreement with a relevant electronic marketplace.

6 Information reporting for digital platforms

References to the model reporting standard for digital platforms (clause 139)

6.1 Clause 139 of the Bill defines:

(a) The term "extended model reporting standard for digital platforms" by reference to the *Model Reporting Rules for Digital Platforms: International Exchange Framework and Optional Module for Sale of Goods*,[10] and

(b) The term "model reporting standard for digital platforms" by reference to the *Model Rules for Reporting by Platform Operators with respect to Sellers in the Sharing and Gig Economy*,[11]

both of which are standards developed by the Organisation for Economic Co-operation and Development (**'OECD Model Rules'**).

6.2 These definitions do not include references to the dates of the OECD Model Rules. If these OECD Model Rules are to be incorporated by reference into New Zealand law, the Bill should clearly state which versions are being incorporated into New Zealand law by specifying the dates of the relevant document. We therefore suggest amending the definitions of "extended model reporting standard for digital platforms" and "model reporting standard for digital platforms" to include references to the dates of the relevant documents, in line with a static approach to incorporation by reference.

Requirements for reporting platform operators (clause 179)

6.3 Proposed new section 185S of the Tax Administration Act 1994 sets out which taxpayers must comply with the model reporting standards for digital platforms. In summary, the taxpayer must comply with the reporting standards when it is a "platform operator" that is resident in New Zealand, and carries on a business by way of a "digital platform" through which a seller of goods or services may operate in New Zealand.

6.4 The Bill does not define the terms "digital platform" or "platform operator". If the OECD Model Rules are incorporated into New Zealand law, we suggest defining these terms in the Bill so that it is clear on whom the new reporting standards are being imposed. It may be appropriate to model these definitions on the definitions of the terms "platform" and "reporting platform operator" provided in the OECD Model Rules.

Regulation-making powers (clause 180)

6.5 Clause 180 contains new section 226F of the Tax Administration Act, and empowers the Governor-General, by Order in Council, to make regulations which would amend the model reporting standards for digital platforms (and consequently, the application of the OECD Model Rules in New Zealand).

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10 Clause 139(4).

11 Clause 139(6).

6.6 The OECD Model Rules are largely developed without input from the New Zealand public. Before any changes are made to the application of these OECD Model Rules, the New Zealand public should therefore be given the opportunity to submit on such changes. This will not necessarily occur when a regulation-making power is exercised. Therefore, we suggest deleting this clause to ensure that any changes to the application of the OECD Model Rules in New Zealand are made by primary legislation. We note that the use of primary legislation in this context would also be consistent with the generic tax policy process.

6.7 If the select committee opts to retain new section 226F, and the proposed regulation-making power, the scope of that power should be limited to implementing changes made by the OECD to the OECD Model Rules. Any additional changes, which are unrelated to any changes made to the OECD Model Rules, should be made by primary legislation, and subject to public scrutiny before implementation, for the reasons set out above.

6.8 If the proposed regulation-making power allows changes to be made to the reporting standards, which are not changes to the OECD Model Rules, the Bill should provide statutory guidance as to the purpose of such a power, and specify parameters for the types of changes that may be made by exercising those powers.

The Commissioner should have the power to make a binding ruling on the application of the OECD Model Rules

6.9 The OECD Model Rules impose significant reporting obligations on reporting platform operators. Given the application of the OECD Model Rules may be complex, the Commissioner should be able to provide guidance and certainty to reporting platform operators regarding the application of the OECD Model Rules by way of a binding ruling.

6.10 As currently worded, section 91C of the Tax Administration Act would not permit the Commissioner to make a binding ruling regarding the OECD Model Rules (if they are incorporated into New Zealand law as proposed in the Bill). If the OECD Model Rules are incorporated into New Zealand law, we submit that the OECD Model Rules should also be added to the list of taxation laws on which the Commissioner may give a binding ruling under section 91C of the Tax Administration Act.

7 The income tax treatment of dual resident look-through companies

7.1 The Bill proposes various reforms to the income tax treatment of dual resident companies affected by changes to the interpretation of Australia's corporate tax residence rules. These proposed reforms do not, however, extend to dual resident look-through companies.

7.2 The definition of look-through company in section YA 1 of the Income Tax Act provides that a company that is treated under, or for the purposes of, a double tax agreement as not resident in New Zealand, is not eligible to be a look-through company. Given the changes to the interpretation of Australia's corporate tax residence rules following the decision in *Bywater Investments Limited v Commissioner of Taxation* (***Bywater* decision**),[12] a number of companies that were previously eligible to be look-through companies are no longer eligible.

[12] *Bywater Investments Limited v Commissioner of Taxation* [2016] HCA 45; 2016 ATC 20-589.

This gives rise to unexpected and unintended income tax implications under the residential land bright-line test.

7.3 The following examples illustrate how these unintended income tax implications can arise:

Example 1

H & W (New Zealand tax residents) form a look-through company to hold New Zealand residential rental properties. These rental properties were acquired in 2019, and are therefore subject to the 5-year bright-line test in section CZ 39 of the Income Tax Act. H & W then emigrate to Australia during the 2023 income year, and continue to manage the look-through company from Australia.

Based on the *Bywater* decision, the entity will become an Australian tax resident because it will be treated as carrying on business in Australia (even though its assets are situated in New Zealand), and the central management and control of the entity takes place in Australia. In addition, the entity will be treated as an Australian tax resident under the non-individual tax residence tie-breaker provision in the double tax agreement with Australia.[13]

The entity will cease to be eligible to be a look-through company from the beginning of the 2023 income year as it will no longer satisfy paragraph (c) of the definition of "look-through company" in section YA 1 of the Income Tax Act. As a result, H & W will be deemed to have disposed of their underlying interest in the look-through company's property at market value to a notional third party, and the company (no longer a look-through company) will be deemed to have acquired that property at market value.[14]

This deemed disposal and the reacquisition of the residential rental properties will trigger an income tax liability to H & W under the bright-line test, as the deemed disposal occurs within the 5-year bright-line period. In addition, the company will now hold the residential properties subject to the 10-year bright-line test in section CB 6A of the Income Tax Act, and will be subject to income tax on the disposal of any of those residential properties within 10 years from 1 April 2022 (i.e., the date the company is deemed to have acquired the residential properties). The recently enacted rollover relief provisions in section CB 6AB of the Income Tax Act do not apply in this situation to provide any relief.

Example 2

A, B and C (New Zealand tax residents) establish an ordinary company in 2001 to hold rural property as a long-term investment. In 2015, the property is rezoned residential, and the company decides to develop part of the property for sale and retain the balance of the property.

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13 As set out in the Double Taxation Relief (Australia) Order 2010.

14 Income Tax Act, section HB 4(6).

The company will be taxed on the development under section CB 13(1) of the Income Tax Act, which means the company will generate a tax-free capital gain equal to the difference between the cost of the property and the market value of the property at the time the development scheme commences.

A and B remain New Zealand tax residents, but C emigrates to Australia. The directors of the company are now B and C, but C (who now holds a majority of the shares) manages the development of the property from Australia.

A, B and C are considering converting the company to a look-through company, so they can extract the capital gain tax-free without winding up the company (because winding up the company would result in the balance of the property becoming subject to the 10-year bright-line test). The company may not, however, be eligible to become a look-through company as a result of the *Bywater* decision.

If the company does become a look-through company (for example, due to a benign interpretation of the Australian Tax Office's transitional position on corporate tax residency), and then Australia does not follow through with the proposed amendments to its corporate tax residency rules, the entity will cease to be a look-through company. While no income tax liability will arise on the deemed disposal of the balance of the property,[15] the balance of the property will end up being subject to the 10-year bright-line test due to the deemed disposal and reacquisition at market value.[16]

7.4 Given the other proposed changes to the Income Tax Act concerning dual resident companies, consideration should be given to whether the requirement in paragraph (c) of the definition of "look-through company" (i.e. that the entity is not treated under, or for the purposes of, a double tax agreement as not resident in New Zealand) is still appropriate. The Law Society also suggests that the effect of section HB 4(6) of the Income Tax Act on residential property is reconsidered. The residential land bright-line test did not exist when the look-through company regime was enacted. While the intended effect of section HB 4(6) is to crystallise any latent income tax liability when an entity ceases to be a look-through company, it goes much further than this in respect of residential property, and results in the bright-line period being reset, and residential property (including pre bright-line property) not previously subject to the 10-year bright-line test now being subject to that test.

7.5 This problem could be addressed by extending rollover relief from the bright-line test to situations where an entity ceases to be a look-through company (noting that rollover relief would override section HB 4(6) so far as it relates to residential property subject to the bright-line test). If officials were concerned about unintended consequences flowing from this change, then rollover relief could be restricted to situations where an entity ceases to be eligible to be a look-through company on the basis that it no longer meets paragraph (c) of the definition "look-through company".

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15 The conversion of an ordinary company to a look-through company does not reset the bright-line date.

16 Income Tax Act, section HB 4(6).

8 Aligning the foreign-sourced income exemption with the foreign trust disclosure rules (clauses 151, 152 and 153)

8.1 The Bill proposes to extend the ambit of the foreign trust disclosure rules in sections 59B, 59C and 59D of the Tax Administration Act to trusts that are not foreign trusts, but which:

(a) have a New Zealand-tax resident trustee, and

(b) are exempt (or have been exempt sometime in the past) from New Zealand income tax on foreign-sourced income because they no longer have a New Zealand-tax resident settlor (or because the New Zealand-tax resident settlor is a transitional resident).

8.2 Under proposed amendments to section HC 26 of the Income Tax Act, trusts that do not meet these registration and reporting requirements will be subject to New Zealand income tax on their worldwide income, even though they do not have (or no longer have) a New Zealand-tax resident settlor.

8.3 The Government appears to have formed the view that the amendments made to section HC 26 of the Income Tax Act in 2017, following its consideration of the *Report on the Government Inquiry into Foreign Trust Disclosure Rules* (**Shewan Report**),[17] are defective and did not achieve their objective.[18] This is because some trusts are not subject to the foreign trust disclosure rules, but are still exempt from New Zealand income tax on their foreign-sourced income, as they do not have a New Zealand-tax resident settlor in the income year concerned. The Law Society considers that the changes made to the taxation of foreign trusts in 2017 were a measured and appropriate response to the Shewan Report, and there is no need to extend the ambit of the foreign trust disclosure rules to trusts that are not, in fact, foreign trusts, or to subject such trusts to New Zealand income tax on their worldwide income in certain circumstances. The Law Society notes that many of these trusts will still be subject to the recently enacted domestic trust disclosure rules.

8.4 The rationale for New Zealand's settlor-based taxation regime is summarised in paragraphs 4.12 to 4.17 of the Shewan Report. Paragraphs 4.12 and 4.13 set out the pre-1988 position, when New Zealand taxed trusts based on the tax residence of the trustees, along with the problems associated with that system. Paragraph 4.14 notes that the way in which New Zealand taxes foreign-sourced income fundamentally changed in 1988 to protect the domestic tax base. This "reset" was based on the core principle that New Zealand residents should be taxed on their worldwide income, and non-residents should be taxed only on New Zealand-sourced income.[19] This reflected, and still reflects, orthodox international tax policy.

8.5 Paragraph 4.16 of the Shewan Report sets out how these international tax settings apply to trusts. The tax residence status of the settlor (and not the trustees) of the trust was chosen as the basis for determining whether trustees would be liable to New Zealand income tax on worldwide income, as the settlor was considered to be the 'power behind the throne'. The term "settlor" was deliberately defined very widely to ensure that any transfer of value by a New Zealand-tax resident person to a trust would result in that trust being subject to New

17 John Shewan *Government Inquiry into Foreign Trust Disclosure Rules* (June 2016).
18 Commentary on the Bill, pages 141-142.
19 Shewan Report, paragraph 4.15.

Zealand income tax on the trust's worldwide income. Paragraph 4.17 of the Shewan Report states that the Consultative Committee which recommended the settlor-based taxation regime "specifically recognised that one consequence of this approach would be that New Zealand would not tax the foreign source income of a resident who was the trustee of a trust with a non-resident settlor".

8.6 The Shewan Report recommended an enhanced registration and reporting regime for foreign trusts with one or more New Zealand tax resident trustees. The Shewan Report was concerned only with foreign trusts, as it was such trusts that gave rise to a reputational risk (as highlighted by the release of the Panama Papers). There is nothing in the Shewan Report which indicates that New Zealand's tax settings in relation to trusts (i.e. the settlor-based taxation system) needed to change, or that the enhanced registration and reporting regime should apply to all trusts that are not subject to New Zealand income tax on their worldwide income (rather than just "foreign trusts"). On the contrary, chapter 13 of the Shewan Report considered the scope of the income tax exemption on foreign-sourced income, and concluded that *"…* the exemption from tax on foreign source income, is based on design considerations that are entirely consistent with the coherent set of core principles that underpin New Zealand tax policy".[20]

8.7 The Law Society is concerned that the Government's proposal to extend the foreign trust disclosure rules to trusts that are not foreign trusts, and to subject such trusts to New Zealand income tax on their worldwide income if they do not comply with these disclosure and reporting rules, is not remedial in nature. Rather, it represents a fundamental shift in the tax settings relating to trusts.

8.8 Therefore, while the Law Society supports the introduction of the new definition of "foreign disclosing trust" for the purpose of the foreign trust disclosure rules, the Law Society submits that this definition should be limited to trusts which are "foreign trusts" (as defined) at the relevant time. We do not agree that the definition of "foreign disclosing trust" should be extended to trusts that are not "foreign trusts" but have applied the income tax exemption relating to foreign-sourced income derived by a New Zealand-tax resident trustee.

9 GST on investment management fees

9.1 While the proposed changes relating to GST on investment management fees were removed from an earlier version of the Bill, the Law Society considers this to be a topic which needs to be addressed. The lack of clarity in the legislation, and the resulting inconsistency in the treatment of GST across the funds management industry is undesirable. If a legislative change is no longer being considered, Inland Revenue should issue detailed guidance on this topic.

David Campbell
Vice-President

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[20] Shewan Report, paragraph 13.27.