NEW ZEALAND LAW SOCIETY

NZLS EST 1869

TAXATION (ANNUAL RATES, EMPLOYEE ALLOWANCES, AND REMEDIAL MATTERS) BILL

05/02/2014

SUBMISSION ON TAXATION (ANNUAL RATES, EMPLOYEE ALLOWANCES, AND REMEDIAL MATTERS) BILL

1. The New Zealand Law Society (Law Society) welcomes the opportunity to comment on the Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Bill (Bill). The Law Society's submission addresses the following aspects of the Bill:

   A. Land-related payments (clauses 7, 8, 9 and 53);

   B. Employee accommodation and accommodation allowances (clauses 11, 12, 20, 33, 34 and 35);

   C. Other employee expenditure and allowances (clauses 22 and 23);

   D. Trusts that are public and local authorities (clauses 25 and 26);

   E. Financial arrangements: foreign currency agreements for sale and purchase (clauses 60 to 67);

   F. Substituting Debenture Rules (clauses 83 and 184);

   G. Thin-capitalisation (clauses 87 to 98);

   H. Deregistration of charities (clauses 19, 27, 107, 108, and 110, and clause 123(6), (8), (28) and (44));

   I. Tax status of certain community housing entities (clauses 28, 29, 110, 159, 123(7)); and

   J. Foreign Account Information-Sharing Agreements (Clauses 2(23), 5, 6, 128(1), (2), (5), 123(15), 129, 150, 151, 152 and 158).

A Land-related payments (clauses 7, 8, 9 and 53)

2. Officials at Inland Revenue previously released an Officials' Issues Paper *The taxation of land-related lease payments* in April 2013 that proposed extensive changes to the taxation of leases. The Law Society submitted on the Officials' Issues Paper in a letter dated 5 June 2013, and recommended that the extent of the changes be reconsidered. It is pleasing to see there is a more limited set of proposals in the Bill.

3. The Law Society therefore generally supports the proposed changes in the Bill. However, there remain aspects of the proposed changes in the Bill that the Law Society considers could be improved.

4. Clause 7 introduces a new section CB 15B, to define the date on which a person acquires land as being the date on which the person first has an estate or interest in the land, alone or jointly or in common with another person. The Income Tax Act 2007 does not however define what an interest in land is for this purpose.

5. There appears to the Law Society to be the potential for uncertainty with the definition of "land" for the purposes of subpart CB. A tax liability can arise in relation to the "land" that is sold, and currently "land" is defined to include all types of interests in land. The issue which arises is where the "land" acquired is a different interest from the "land" being disposed of.

Recommendation

6. That consideration be given to clarifying the ambit of "land", where the interests acquired and disposed of are different.

Scope of exemption from tax in proposed new section CC 1B

7. The existing section CC 1B in the Income Tax Act 2007 was introduced with effect from 1 April 2013 by the Taxation (Livestock Valuation, Assets Expenditure, and Remedial Matters) Act 2013. Section DB 20B was also introduced by this Act. Together, sections CC 1B and DB 20B were intended to ensure that lease inducement payments were treated as income of the payee and deductible for the payer.

8. Section DB 20B provides that an amount paid for the transfer of a land right will be deductible to the payer if the payer owns either the land right or the estate from which the land right is granted, and the payee will obtain the land right. In circumstances outside these criteria, a lease inducement payment will not be deductible to the payer.

9. The scope of proposed new section CC 1B in the Bill does not mirror the criteria in section DB 20B. In contrast, a lease inducement payment for the transfer of land will only be exempt from tax if it is not sourced directly or indirectly from the owner of the estate from which the land right is granted, and the payer and payee are not associated with the owner of the estate from which the land right is granted.

10. It appears possible that some payments may be treated as income of the payee under proposed new section CC 1B, but not be deductible to the payer under section DB 20B. An example would be a lease inducement for the transfer of land that is sourced from the owner of the estate in land, but is paid by a third party (such as an agent) to the payee. This is likely to be income of the payee under proposed new section CC 1B (as amounts sourced indirectly from the owner of the estate), but not deductible to the owner of the estate or the third party (as the payer is not the owner of the estate or the land right). Accordingly, as currently drafted proposed new section CC 1B may cause mismatches between the income and deductibility treatment of some lease inducement payments.

Recommendations

11. The Bill should harmonise the income and deductibility treatment of lease inducement payments for the transfer of land rights. This could be done by amending the criteria in section DB 20B to reflect more closely the exemption criteria in proposed new section CC 1B (with the likely effect that deductions may be available in a slightly wider set of circumstances).

12. As a related matter, if a perpetually renewable lease is excluded from being depreciable property, as is proposed in clause 53 of the Bill, section CC 1 should be amended to exclude payments for the grant of a perpetually renewable lease from being income. That would ensure a symmetrical outcome for the payer and recipient and would also mean that the policy behind clause 53 (for example that perpetually renewable leases are treated similarly to freehold estates) is applied to the landlord as well as to the tenant.

B Employee accommodation and accommodation allowances (clauses 11, 12, 20, 33, 34 and 35)

13. The Law Society regards the proposed new framework for the taxation of accommodation and accommodation allowances provided to employees as generally appropriate. However, there are a number of smaller changes and clarifications that we consider would be appropriate to ensure the overall coherence of the proposed new regime.

Use of the defined term 'accommodation' in section CE 1

14. As section CE 1 is currently drafted, both accommodation and accommodation allowances are treated as employment income under subsection CE 1(1B). The term 'accommodation' is in turn defined in subsection CE 1(2) as including board or lodging. The current drafting of section CE 1 is important – in the absence of subsection CE 1(1B), the provision of accommodation directly by an employer would be regarded as a fringe benefit rather than employment income.

15. The proposed changes to sections CE 1 and YA 1 in clauses 11 and 123 of the Bill appear to alter the treatment of accommodation provided to employees as employment income. The proposed changes to section CE 1 remove any definition of 'accommodation' as employment income, and instead provide that 'board or lodging' (which are not defined terms) are employment income. The change to the definition of 'accommodation' in section YA 1 removes reference to 'board or lodging'.

16. This change is critical to the proposed new sections in clauses 12, 20, 33, 34 and 35. These sections use 'accommodation' as a defined term, and particularly the proposed new sections in clause 12 appear to proceed on the basis that accommodation provided to employees is employment income.

17. The proposed new sections in clauses 20 and 33 (sections CW 16B to CW 16F and CZ 29) provide that some accommodation or accommodation allowances are treated as exempt income. For clarity it may be useful to note that treating 'accommodation' as income under section CE 1 is subject to the proposed new sections.

Recommendations

18. Clause 11 of the Bill should be amended to clarify that 'accommodation' remains employment income under section CE 1, by retaining the current wording of section CE 1.

19. It should also be made clear that treating 'accommodation' as employment income under section CE 1 is subject to the proposed new sections CW 16B to CW 16F.

Guidance on the meaning of 'distant workplace'

20. A number of the proposed new sections in clauses 20, 33 and 34 rely on the definition of a 'distant workplace'. The term is defined in proposed new section CW 16B as "a new workplace that is not within reasonable daily travelling distance of their residence". However, no further guidance is provided in the Bill on what a 'reasonable daily travelling distance' may be, and only very limited guidance is provided in the Commentary on the Bill (with an example providing that the distance between Christchurch and Dunedin is beyond a reasonable daily travelling distance).

21. In order for taxpayers to apply the proposed new accommodation provisions, it would be very useful for additional guidance to be provided on what a 'reasonable daily travelling distance' means. This might be achieved by providing examples in the text of the legislation (similar to those used in subpart DG of the Income Tax Act 2007), or by a determination issued by the Commissioner (under a new section in the Tax Administration Act 1994).

Recommendation

22. That additional guidance be provided on the scope of the term 'reasonable daily travelling distance' through examples in proposed new section CW 16B or in a determination issued by the Commissioner.

Exceptional circumstances in the context of Canterbury earthquake relief

23. Proposed new section CW 16B in clause 20 provides that some accommodation or accommodation allowances provided to employees will be exempt income when the employee is at a distant

workplace or on an out-of-town secondment. Proposed new section CW 16C provides time limits for the period in which income will be treated as exempt, but includes a provision that these time limits will not apply if exceptional circumstances occur.

24. Proposed new section CZ 29 in clause 33 effectively mirrors the exempt income provisions in proposed new section CW 16B and CW 16C, with more concessionary time limits for employees engaged on the Canterbury rebuild. However, the proposed section does not contain any provision disregarding these time limits if exceptional circumstances occur. This seems an oversight, especially if another serious earthquake were to occur in the Canterbury region (it seems very likely that an earthquake of this type would be an exceptional circumstance justifying setting aside the time limits under section CZ 29).

Recommendation

25. That an exceptional circumstances provision be introduced into proposed new section CZ 29, modelled on the provision included in proposed new section CW 16C.

C Other employee expenditure and allowances (clauses 22 and 23)

26. Officials at Inland Revenue initially proposed changes to the tax treatment of employee meal allowances and employee clothing allowances in November 2012 in the Officials' Issues Paper *Reviewing the tax treatment of employee allowances and other expenditure payments*. The proposed new sections in the Bill adhere reasonably closely to the Officials' proposals, but the Law Society is of the view that some improvements to the proposed new sections are possible.

Employee meal allowances

27. Proposed new section CW 17CB in clause 22 provides that food and drink consumed by an employee as part of a working meal arranged as an alternative to a formal business meeting is exempt income. This approach to the scope of working meals is too narrow. Particularly in service based industries, a working meal with clients may not be in lieu of a formal business meeting but still directly relate to the firm's business activities. Attendance and participation at such working meals is often part of an employee's duties. Accordingly, the scope of the current proposed subsection CW 17CB(2)(a) appears overly restrictive.

28. Proposed new section CW 17CB also provides that light refreshments provided to employees will be exempt income if an employee normally works a minimum of 7 hours a day, their duties require them to be frequently away from their workplace, and the employer would normally provide light

refreshments at the workplace but it is not practical on a particular day to provide refreshments to the travelling employee. Light refreshments appear to be very restrictively defined as liquids, with examples given in the Bill of tea, coffee and water. However, many employers also provide light foods such as biscuits or fruit at the workplace (refreshments that would otherwise be a fringe benefit but fall within the on-premises exemption in section CX 23).

29. The Officials' Issues Paper suggested that private benefits provided to employees should be treated as non-taxable if they were low in value, hard to measure and/or did not give rise to a significant risk of salary and wages being recharacterised as non-taxable. Extending the concept of light refreshments in proposed subsection CW 17CB(2)(c) to include snack food items such as biscuits and fruit clearly meet the criteria to be treated as non-taxable.

Recommendations

30. The criteria for a working meal to be exempt income in proposed subsection CW 17CB(2)(a) should be broadened to capture all working meals that take place as part of an employer's business activities when an employee's duties require them to attend and participate.

31. The concept of light refreshments in proposed subsection CW 17CB(2)(c) should be extended to cover snack food items such as biscuits and fruit as well as fluids such as tea and coffee.

Allowances for work clothing

32. Proposed new section CW 17CC in clause 23 provides a general rule that allowances provided to employees to purchase distinctive work clothing will be exempt income. The rule also incorporates some allowances provided to purchase plain clothes into the new rule, subject to a stringent set of criteria. According to the Commentary on the Bill, these criteria are designed to allow a single employer (the New Zealand Police) to continue an existing policy of treating plain clothes allowances as partly exempt from tax.

33. The crafting of proposed new section CW 17CC to favour a single (government) employer in providing plain clothes allowances seems inappropriate when other employers have historically provided plain clothes allowances that were partly exempt from tax. The Law Society regards the limitation of this concession on plain clothes allowances to employers who provide a uniform to employees and who then require employees to wear plain clothes to be reasonable. However, the Law Society suggests that the rule should be altered to ensure that otherwise compliant employers who already had a policy of making plain clothes allowances partly taxable as at 1 July 2013 should

be covered by the rule (even if this policy was only evident in the employer's tax position and not expressly detailed in the employer's general terms and conditions of employment).

Recommendation

34. The scope of the plain clothes exception in proposed new section CW 17CC should be widened to ensure employers who adopted a policy that plain clothes allowances should be partly taxable and partly exempt, and otherwise meet the requirements of subsection CW 17CC(3), receive the benefit of this rule.

D Trusts that are public and local authorities (clauses 25 and 26)

35. Clauses 25 and 26 of the Bill would amend the existing exclusions from the public and local authority income tax exemptions that refer to income derived by a public or local authority "as a trustee" (section CW 38(3) and section CW 39(3)).

36. The amendments are included amongst the "remedial matters" dealt with in the Bill and the stated intent of the amendments is to "clarify" that income derived by a public or local authority as a trustee that is distributed as beneficiary income to a tax-exempt beneficiary is exempt.

37. The Law Society submits however, that:

- The proposed amendments are unnecessary, as the current position in relation to trust income distributed as beneficiary income is clear;
- The amendments are *ad hoc* amendments that potentially exacerbate existing uncertainty in relation to the interpretation and application of the exclusions from the public and local authority exemptions for income derived “as a trustee”; and
- If any amendments are to be made to the exclusions, they should only be made following a more comprehensive review of the underlying policy and intended scope of the exclusions.

Proposed amendments unnecessary

38. The proposed amendments in clauses 25 and 26 are unnecessary because it is already clear under the existing law that:

- the tax treatment of an amount distributed as “beneficiary income” under the trust rules in subpart HC of the Income Tax Act is ordinarily determined by the tax position of the beneficiary; and

- if a public or local authority that is, or is acting as, a trustee derives income in that capacity and distributes the income as "beneficiary income" to a tax-exempt beneficiary, that income will be exempt income.

39. Consequently, no amendment is required to confirm that the exclusions do not apply to "*an amount distributed [by a public/local authority that is, or is acting as, a trustee] as beneficiary income to a beneficiary who derives the amount as exempt income*".

40. This is also reflected in the drafting of the proposed amendments, as the amendments presuppose that the amount distributed as beneficiary income can be derived by the beneficiary as exempt income.

Ad hoc "remedial" amendments inappropriate

41. The Commentary on the Bill asserts that "*the policy is that [the public and local authority exemptions] should not extend to amounts that [a public or local authority] receives as a trustee*" and suggests that this applies even in relation to a public or local authority "*constituted as a trust*".

42. However, the underlying policy and intended scope of the exclusions for income derived "as a trustee" is not as clear-cut as the Commentary suggests:

- First, there are public and local authorities that are, as the Commentary puts it, "*constituted as a trust*", and it is not an obvious proposition that Parliament contemplated that the public and local authority exemptions would not apply to income derived by such entities, albeit that technically such income is derived "*in trust*" or "*as a trustee*". To the contrary, the specific inclusion of certain entities that are or may be structured as trusts within the public and local authority definitions in section YA 1 (for example, administering bodies of recreation scenic reserves under the Reserves Act 1977, various museum trusts etc.) suggests that the policy intent was that the exemptions would apply to income derived by such entities for their charitable or other public purposes, as part of their core function/role, without having to rely on some other exemption (for example, the exemptions for "tax charities" may be available in the case of a charitable entity, but this would require registration under the Charities Act and public and local authorities are already subject to sufficient reporting and accountability requirements).
- Secondly, there are various circumstances where public and local authorities (local authorities especially), *as part of their core function/role as public and local authorities*, hold assets for

particular charitable or other public purposes and may be viewed as holding such assets, and deriving any income therefrom, on trust for the relevant purposes (for example, technically, "*as a trustee*") (for example, the type of the statutory and other trusts discussed in *New Plymouth District Council v Waitara Leaseholders Association Incorporated* [2007] NZCA 80 (Court of Appeal)). Again, it is not an obvious proposition that Parliament contemplated that the public and local authority exemptions would not apply to income derived by public and local authorities in these circumstances, albeit that arguably such income is derived "in trust" or "as a trustee".

43. *Ad hoc* amendments to the exclusions for income derived "*as a trustee*" such as the proposed amendments in the Bill, and the associated Commentary, risk creating further uncertainty in relation to the interpretation and application of those exclusions, rather than clarifying the scope of the exclusions.

44. If any amendments are to be made to the exclusions, they should only be made following a more comprehensive review of the underlying policy and intended scope of the exclusions.

Recommendation

45. That the proposed amendments in clauses 25 and 26 not be made.

E Financial arrangements: foreign currency agreements for sale and purchase (clauses 60 to 67)

46. The Law Society makes the following comments in relation to the proposed rules in clauses 60-67 of the Bill which address the taxation treatment of foreign currency agreements or sale and purchase (referred to in the Bill as "ASAPs").

Complexity of the financial arrangements rules

47. While the Law Society generally supports the initiatives contained in clauses 60-67 of the Bill (subject to the comments below) it is becoming concerned at the increasing level of complexity exhibited by the financial arrangements rules.

48. Applying those rules now requires a detailed understanding of a large number of provisions which more often than not have complex inter-relationships with each other, as well as an appreciation of the position which might obtain applying NZ IFRS. Some of that complexity is attributable to the rules themselves but a large measure is attributable to drafting.

49. The continued piecemeal approach to amending the financial arrangements rules risks undermining the drafting improvements achieved under the recent rewrite of the Income Tax Act 1994 and Income Tax Act 2004.

Whether it is appropriate in policy terms for the lowest price mechanism to be removed for 12 month ASAPs entered into by non-IFRS preparers

50. While minimising the extent to which foreign exchange gains or losses are required to be recognised, the proposed rules deem an imputed interest amount to arise for tax purposes in connection with 12 month ASAPs entered into by non-IFRS preparers.

51. This is a significant change from the current position applying the lowest price rules (which typically result in there being no deemed interest component for tax purposes). The rationale for deeming an interest component to exist is that 12 month ASAPs are perceived to be loans in economic reality.

Recommendations

52. The Law Society is of the view that the lowest price concept should be retained for non-IFRS preparers with 12 month ASAPs. It is a well understood concept and results in the mitigation of compliance costs.

53. Non-IFRS preparers could borrow none of the work required to be performed in relation to the preparation of IFRS compliant financial statements and the proposed discounting and consequential tax treatment would represent an additional compliance burden.

The definition of 12 month ASAP

54. If the submission concerning the removal of the lowest price concept above is not accepted, the Law Society considers that the proposed definition of 12 month ASAP is too broad.

55. The assumption made in the Bill is that any 12 month ASAP is by nature a loan. The Law Society queries this assumption, and notes that an ASAP may become a 12 month ASAP because an earn out payment (expressed as an adjustment to the purchase price) is made 12 months after completion of the transaction. The deferral of payment in such a case occurs because of uncertainty regarding the value of the business, not because there is some imputed interest component as between the parties that ought to be recognised for tax purposes.

56. Similar issues may arise with warranty payments that are expressed as an adjustment to the purchase price, or working capital adjustments that take more than 12 months to determine. In those cases the ASAP may initially be regarded as not being a 12 month ASAP, but may subsequently become reclassified with the attendant requirement to recognise an interest component that no party intended to arise at the outset.

Recommendations

57. The definition of 12 month ASAP be amended to exclude ASAPs which incorporate certain deferral features (for example an earn out) but which do not have the underlying features of a loan.

58. Further, the definition of "foreign ASAP" should be clarified to confirm whether an ASAP will be a foreign ASAP where some (but not all) of the consideration is denominated in a foreign currency.

F Substituting Debenture Rules - clauses 83 and 84

59. Clause 83 provides a transition out of the existing substituting debenture rules, on the basis that they are considered to be redundant. Clause 84 of the Bill amends section FA 2, as part of removing the substituting debenture rule.

60. It has been brought to the Law Society's attention that the removal of the substituting debenture rule could have unintended consequences for those taxpayers which have treated debentures as substituting debentures, and that there could be considerable additional compliance costs and an unnecessary subsequent year tax effect, arising as a consequence of the repeal. The transitional provisions are intended to ensure that no adverse tax consequences arise for taxpayers, and (subject to the thin capitalisation and transfer pricing regimes) deductions may arise under the financial arrangements rules for the 2015-16 income year and following years. The Law Society considers that it would be appropriate to allow taxpayers the option to continue to treat substituting debentures as shares.

Recommendation

61. That an additional amendment be made to the Bill, so that taxpayers have the option of continuing to treat existing substituting debentures as shares for the purposes of the Act.

G Thin-capitalisation (clauses 87 to 98)

Clause 88

62. It is not clear to the Law Society why proposed section FE 2(1)(cc) is necessary. The language used means its scope is uncertain and it appears to extend the scope of the thin-capitalisation regime further than the policy behind the proposed changes indicates should be the case.

63. Proposed section FE 2(1)(cb) extends the scope of the thin-capitalisation rules to New Zealand companies that are controlled by a group of non-residents (where certain criteria are met), rather than by a single non-resident. That section, together with the associated definition of "non-resident owning body" in section FE 4, puts criteria around the scope of the extension to target it at situations where the group of non-residents are able to control the debt/equity mix and potentially substitute debt for equity. As indicated in the Commentary (at page 29), this level of detail was introduced to address concerns raised in submissions on the January 2013 Issues Paper that a reference in the legislation to "acting together", without further definition, would create a high degree of uncertainty.

64. However, section FE 2(1)(cc) (as well as proposed section FE 1(1)(a)(iii)) then further extends the scope of the regime to New Zealand companies that are owned to the extent of 50% or more, or controlled by any other means, by a group of entities that:

- themselves fall within certain paragraphs of section FE 2(1); and
- act together as a group.

65. As noted above, the phrase "acting together" was included in the original proposal set out in the Issues Paper. A number of submissions were made regarding the uncertainty that phrase would create if included in legislation and not specifically defined. This is acknowledged in the Commentary. Yet proposed section FE 2(1)(cc) uses the phrase "act together as a group" without further definition. For the same reasons given in the submissions on the original proposal, which the Law Society understood officials accepted, that phrase will result in an unacceptable level of uncertainty regarding the application of the regime.

66. As noted above, proposed section FE 2(1)(cb) appears to achieve the desired policy objective. There is no explanation in the Commentary regarding what section FE 2(1)(cc) is trying to achieve.

Recommendation

67. That proposed sections FE 2(1)(cc) and FE 1(1)(a)(iii) be deleted.

Clause 88 – "associated persons"

68. The current drafting is unclear as regards whether "associated person" is intended to refer to an associate of the trustee or an associate of the non-resident.

Recommendation

69. Proposed section FE 2(1)(d)(i) should be amended to read:

"a non-resident or an associated person of a non-resident"

70. It is unclear whether the reference to "the trustee" in subparagraphs (ii) and (iii) of proposed section FE 2(1)(d) is to the same trustee referred to in the opening words of section FE 2(1)(d) or to some other trustee (for example a trustee of a trust that makes a settlement on the first trust).

Recommendation

71. The drafting referred to above should be clarified in clause 88.

Clause 89

72. New paragraphs (f) and (g) of section FE 3(1) refer, respectively, to the New Zealand group of the members of a controlling body (paragraph (f)) and the worldwide group of the members of a group of trustees in a controlling body (paragraph (g)). It is unclear why it would be necessary to determine the New Zealand group or the worldwide group of members of a controlling body in a collective sense. A New Zealand group and worldwide group is determined for an entity, not a group of entities.

Recommendation

73. If it is intended that these paragraphs apply to each relevant entity, the drafting should be clarified to reflect that.

Clause 90

74. The reference to "funded" in paragraph (b) of the proposed definition of "non-resident owning body" should be clarified as a reference to being funded by way of debt (and not equity). Otherwise, a company with a shareholders agreement that refers to how the company will be capitalised with share capital, but that is silent as regards debt, would be caught contrary to the intended policy.

75. Paragraph (c) of the proposed definition of "non-resident owning body" should be amended to say that the members "must" exercise their rights in the way recommended by a person. Otherwise the paragraph is too broad and could potentially capture all companies where, even on one occasion, and notwithstanding that they can in fact do as they please, the shareholders approve a transaction upon the recommendation of a person (for example the chairman of the company). That cannot be the intended outcome.

76. Similarly, on the current drafting paragraph (d) of the proposed definition of "non-resident owning body" has the potential to apply in a wide range of situations outside the intended policy. For example, if two or more shareholders appoint the same proxy for a single meeting or resolution then the paragraph is arguably satisfied.

Recommendation

77. That the drafting issues referred to above be addressed.

Clause 94

78. There should be an exception to proposed section FE 18(3B)(b)(i) where the loan represents the on-lending of external (third party) debt. Section FE 18(3B)(b)(i) should also apply only when the owner provides funds under the financial arrangement, not when it is a party to the financial arrangement in some other capacity.

79. Shareholder guarantees for third party debt are extremely common, do not involve the provision of funds by the shareholder to the company and do not mean that the debt being guaranteed (for example a bank loan) is substitute for equity or in some way not genuine debt.

Recommendations

80. Subparagraph (i) of proposed FE 18(3B)(b) should be narrowed.

81. Subparagraph (ii) of proposed section FE 18(3B)(b) should be deleted.

H Deregistration of charities (clauses 19, 27, 107, 108, 110, and clause 123(6), (8), (28) and (44))

82. The proposed amendments relating to deregistration of charities (for example, removal of an entity from the charities register under the Charities Act 2005) deal with four matters:

1. Timing of the impact of deregistration on tax-exempt status as a “tax charity”.
2. Transition from tax-exempt status to taxpayer status.

3. Dealing with the accumulated assets of a deregistered entity.

4. The impact of deregistration on other tax concessions, namely:
   a. The limited exemption from fringe benefit tax (FBT) on non-cash benefits provider to employees, based on an employer entity's status as a "charitable organisation".
   b. Tax incentives for donations, based on a donee entity's status as a "donee organisation".

Timing of the Impact of Deregistration on Tax-exempt Status as a "Tax Charity" (clauses 27 and 123(8))

Intent of proposed amendments supported

83. The proposed amendments to the provisions relating to "tax charity" status under section CW 41 under clause 27 of the Bill are intended to be taxpayer-friendly:

- Currently, the impact of deregistration is immediate, for example as soon as an entity is deregistered it is no longer a "tax charity" as defined in section CW 41(5) and therefore cannot derive tax-exempt income under either section CW 41 (non-business income) or section CW 42 (business income), *and* the income tax impact of deregistration is potentially retrospective, for example although deregistration itself will not be retrospective, under the current terms of section CW 41 and CW 42 the implication of deregistration, if it relates to the charitable status of the entity, is that the entity has not qualified for tax-exempt status from some point in the past, because it did not satisfy the requirements set out in paragraph (a) or paragraph (b) of subsection CW 41(1).
- The intent of the proposed amendments is to clarify the point in time when a deregistered entity is no longer a tax charity *and* to ensure that an entity is not exposed to tax on a retrospective basis where the entity has effectively relied upon registration under the Charities Act in taking the position that it was tax-exempt.

84. The intended outcome of the proposed amendments is supported but a number of drafting changes are suggested, as outlined below. Consideration should also be given to amending section CW 41 to provide continuity of tax-exempt status for an entity whose "tax charity" status is affected by a short period of non-registration under the Charities Act.

Suggested alternative approach to the amendments to section CW 41 in clause 27

85. The intended effect of the proposed amendments in clause 27 of the Bill appears to be that a deregistered charity is to be treated as meeting the core requirements for tax exemption under section CW 41(1), for example in the case of a trust, the trustee or trustees derive income in trust for charitable purposes and, in other cases, the entity is a society or institution established and

maintained exclusively for charitable purposes and not carried on for private profit, from date of registration to the "day of final decision" *provided that* the entity has complied with its rules and other information supplied to the Charities Commission/Board when applying for registration.

86. However, the drafting of the proposed amendments in clause 27 is complicated and confusing, attempting to achieve that effect by way of amendments to section CW 41(1) and (5) (clause 27(1) and (3)), plus the addition of a new subsection (6) (clause 27(3), and a confusing provision relating to the application of the amendments (clause 27(5)).

Recommendations

87. A simpler and clearer way to achieve the intent of the proposed amendments would be for clause 27 of the Bill to amend section CW 41 by:

- amending the definition of "tax charity" to clarify the start and end dates for this status; and
- adding a new subsection (which could be new subsection (1A), or (2A), or (6)) that clearly states the intended effect outlined in paragraph 84 above.

88. The amendments should also apply with retrospective effect, given that the amendments are taxpayer-friendly and entities that have already been deregistered should be given the protection afforded by the amendment.

89. Drafting changes to section CW 41 and detailed drafting comments are set out below:

Drafting changes

90. The relevant parts of the "tax charity" definition in in section CW 41(5) would read:

> *(5) In this section and sections CW 42 and CW 43,* ***tax charity*** *means-*
>
> *(a) the trustee or trustees of a trust, a society or an institution that becomes, or become, registered as a charitable entity under the Charities Act 2005, such entity being a tax charity for the period, in relation to the registration:*
>
> *(i) starting with the earlier of the day on which the entity actually becomes registered as a charitable entity under the Charities Act 2005 and the day of the effective registration time for the registration under section 20 of the Charities Act 2005:*
>
> *(ii) ending with the day of deregistration:*

…

(c) the trustee or trustees of a trust, a society or an institution, that is, or are, non-resident and carrying out its or their charitable purposes outside New Zealand, and which is approved as a tax charity by the Commissioner in circumstances where registration as a charitable entity under the Charities Act 2005 is unavailable, such entity being a tax charity for the period, in relation to the approval:

(i) starting with the day that the approval is effective, as notified by the Commissioner to the entity at the time of approval:

(ii) ending with the day that the Commissioner notifies the entity of the Commissioner's revocation of the approval.

91. The new subsection protecting tax charities that have complied with their rules from exposure to tax on a retrospective basis (which, as noted above, could become a new section CW 41(1A), (2A) or (6)) could read:

"(1A) The trustee or trustees of a trust, a society or an institution, that is, or are, a tax charity on account of registration as a charitable entity under the Charities Act 2005 or approval by the Commissioner, as referred to in subsection (5), is, or are, treated as meeting the requirements set out in paragraph (a) of subsection (1) (in the case of the trustee or trustees of a trust) or paragraph (b) of subsection (1) (in the case of a society or an institution) for the period, in relation to the registration or approval:

(a) starting with the day on which the entity becomes a tax charity under subsection (5):

(b) ending with the earlier of the following days:

(i) the day on which the entity fails to act in accordance with the rules (as defined in section 4 of the Charities Act 2005) supplied by the entity:

(A) in the case of registration as a charitable entity under the Charities Act 2005, to the Charities Commission, or to the chief executive or the Board, under the Charities Act 2005:

(B) in the case of approval by the Commissioner, to the Commissioner for the purpose of obtaining the approval:

(ii) the day on which the entity ceases to be a tax charity under subsection (5)."

92. It may also be appropriate to state explicitly that a tax charity's non-compliance with its rules does not necessarily mean that it does not meet the requirements set out in section CW 41(1).

93. For the purpose of the provisions above, the definition of "day of final decision" in clause 123(8) would be replaced by a definition of "day of deregistration", which could read as follows:

> *"**day of deregistration** means, in relation to an entity's registration as a charitable entity under the Charities Act 2005, the later of-*
>
> *(a) the date of registration of the notice removal of the entity from the register of charitable entities under section 31 of the Charities Act 2005:*
>
> *(b) the effective date of removal of the entity from the register of charitable entities as specified by the Charities Commission or the Board under section 31 of the Charities Act 2005:*
>
> *(c) the effective date of removal of the entity as determined by any order of a court in relation to the entity's registration."*

94. Note that the suggested drafting changes above reflect the various detailed drafting comments set out below.

Detailed drafting comments in relation to clause 27 of the Bill

95. There does not appear to be any reason why the amendments should apply to entities that register under the Charities Act to become tax charities but not apply to entities that are required to obtain approval from the Commissioner. The suggested amendments above cover the position of both types of tax charity.

96. In relation to the start date for protecting entities from exposure to tax on a retrospective basis, currently described in clause 27 as "the day they are registered on the register", the drafting should recognise that under the Charities Act the effective date of registration may be either the time at which an entity actually becomes registered as a charitable entity or an earlier "effective registration time" (refer to section 20 of the Charities Act). In relation to the start date for entities approved by the Commissioner, this could be an effective date of approval as notified to the entity by the Commissioner.

97. In relation to the end date for protecting entities from exposure to tax on a retrospective basis:

Requirement for entity to "act in accordance with" its "constitutional documents"/"rules":

98. Rather than referring to "constitutional documents" (not defined in the Income Tax Act), it would seem more appropriate for the provisions to refer to an entity's "rules" as that term is defined in section 4 of the Charities Act.

99. It is unclear whether the relevant rules are intended to be limited to the rules filed by the entity as part of the Charities Act registration process, which will have been assessed by the Charities Commission or the chief executive/Board, or the rules as filed on the Charities Register from time to time, either as part of the registration process or subsequently (by way of notice of change or as part of an annual return), which may or may not have been assessed following their filing. The drafting in the Bill is ambiguous, although it appears to be intended that there be compliance with the rules filed as part of the registration process only (although this would include compliance with those rules in relation to any subsequent amendments thereto).

100. The correct policy position is unclear. On the one hand, there may be a concern to ensure that the relevant rules are ones that have been fully assessed by the Charities Commission or chief executive/Board, but on the other hand a deregistered entity would legitimately expect to be protected from exposure to tax on a retrospective basis if it has complied with its rules, including amendments thereto, that have been filed on the Charities Register from time to time. On balance, it would seem appropriate to refer to the rules filed on the Charities Register from time to time.

101. In relation to tax charities approved by the Commissioner, given that there is no statutory framework for filing amendments to rules and other information with the Commissioner on an ongoing basis (although the Commissioner might require this), it would seem appropriate to refer to the rules as provided to the Commissioner for the purpose of obtaining the approval.

102. If the relevant rules were to be limited to the rules filed by the entity as part of the Charities Act registration process, the reference to those rules being supplied "at the time of applying for charitable status" in the current drafting of clause 27 is unclear.

103. First, an application for registration is in reality a process that does not occur at one point in time. Instead of referring to material supplied "at the time of applying", it would be preferable to refer to material supplied "for the purpose of" obtaining registration or approval, or similar language.

104. Secondly, any reference to "applying for charitable status" should be replaced with “applying to *become a tax charity, either by registering as a charitable entity under the Charities Act 2005 or by obtaining the Commissioner’s approval*", or similar language.

105. Subject to the above comments, the requirement for an entity to "act in accordance with" its “rules” in order to be protected from exposure to tax on a retrospective basis would seem appropriate.

Additional requirement for an entity to "act in accordance with… / information supplied to the Charities Commission or Board”

106. This additional requirement is too broad and uncertain. All entities registering under the Charities Act will have supplied a copy of their rules to the Charities Commission or to the chief executive/Board, but various levels of information may be supplied as part of the registration process in relation to the activities or proposed activities of an entity, depending on the way in which their application for registration has been dealt with. Some entities will have filed little or no information in addition to their rules, others will have filed substantial submissions and other supporting documents, many will have referred to their websites as a source of further information, and some will have had discussions with registration analysts in relation to their applications.

107. Requiring an entity to "act in accordance with" such "information" would create considerable uncertainty in a number of situations, for example where:

- an entity has provided a summary of its actual or proposed activities as part of the registration process, but the exact details of those activities change over time;
- an entity has provided information relating to certain activities as part of the registration process and then post-registration undertakes other activities in furtherance of the purposes set out in its rules; or
- an entity has provided a reference to its website as part of the registration process, but its website has changed as its activities have changed over time.

108. It should be sufficient that the entity has complied with its rules, as already discussed above. Accordingly, an entity should only be required to "act in accordance with" its “constitutional documents/rules” in order to be protected from exposure to tax on a retrospective basis.

Definition of "day of final decision" (clause 123(8))

109. It might be clearer if the term used was simply day of deregistration or day of effective deregistration, or similar, and as it is not used elsewhere, the term could be defined in section CW 41, rather than section YA 1.

110. Presumably the reference in paragraph (a) of the proposed definition to the day the entity "is removed from the register of charitable entities" is intended to refer to the effective date of removal specified by the Charities Commission or Board under section 31 of the Charities Act, rather than the date the notice of removal is registered in the register under that section. This seems appropriate, *provided that* the effective date of deregistration cannot be set retrospectively. If the effective date of deregistration could be set retrospectively, then it may be appropriate to refer to the date the notice of removal is registered in the register under section 31.

111. In relation to paragraph (b) of the proposed definition, which would effectively allow an entity to remain a tax charity, and to be protected from exposure to tax on a retrospective basis, until any appeals or proceedings "in relation to… charitable status" (ie, "in relation to maintaining the entity's registration as a charitable entity under the Charities Act 2005"), are finalised or exhausted, it is unclear why this should be used as an appropriate end date:

- If such appeals or proceedings are successful, the entity should not be removed from the register at all, and note that the Courts can make interim and final orders for an entity to be restored to the register from a specified date and to remain on the register (refer to sections 60 and 61 of the Charities Act).
- If such appeals or proceedings are unsuccessful, there does not seem to be any reason why the effective date of removal specified by the Charities Commission or Board, or effective date of removal as determined by the Court (refer to section 61 of the Charities Act) should not stand.

Additional amendments to provide for continuity of tax-exempt status despite short periods of non-registration

112. The proposed amendments in clause 27 do not cover the position of an entity whose "tax charity" status, and therefore tax-exempt status, is affected by a short period of non-registration under the Charities Act, even though the entity's assets and income may be held, or distributed/applied, exclusively for charitable purposes at all times.

113. For example, it is not uncommon for entities to opt for seeking re-registration under the Charities Act, rather than bearing the cost of disputing/appealing the Charities Commission or Board's decision to deregister an entity, but unless the effective date of re-registration precedes or matches the effective date of deregistration (for example, by way of backdating under section 31 of the Charities Act), there will be a period of non-registration during which the entity is not a tax charity as defined in section CW 41,, even under the amended definition of that term. This will often be in circumstances where there has not been any material breach of the requirements for tax-exempt status under section CW 41, and the potential complexity and cost of having to deal with a short period of non-registration (including the application of the new rules in the Bill) would seem unwarranted.

Recommendation

114. Consideration should be given to amending section CW 41 to provide for continuity of tax exempt status in certain circumstances where an entity that is a tax charity is deregistered but then re-registers (for example, applies for and obtains a new registration) under the Charities Act.

115. For example, successive registrations of an entity under the Charities Act might effectively be treated as a single registration for the purpose of the "tax charity" definition in section CW 41(5), for example the period of non-registration should be ignored, where, following deregistration:

- the entity takes reasonable steps in the process of preparing and completing an application for registration as a charitable entity under the Charities Act;
- the entity is re-registered within a specified timeframe, for example 12 months from the day of deregistration (or such other period as may be sufficient to allow for the preparation, completion and processing of the application for registration); and
- in the interim, all of the assets of the entity are retained, or distributed or applied, exclusively for charitable purposes and not for the private pecuniary profit of any individual.

Transition from Tax-exempt Status to Taxpayer Status

116. The proposed amendments in clauses 104 and 107 of the Bill relate to a deregistered charity's transition from being tax-exempt as a tax charity to being a taxpayer and in particular the determination of such entity's initial tax base in relation to property, financial arrangements and prepayments.

117. The provisions are substantially modelled on existing and longstanding provisions for trusts, including previously tax-exempt charitable trusts, coming into the tax base, set out in section HC 31 of the Income Tax Act.

Recommendations

118. The proposed amendment to section HC 31 in clause 104 of the Bill should mirror the drafting used in new section HR 11(1) in relation to the circumstances in which section HR 11 will apply, for example instead of referring to a charitable trust "losing its charitable status", new section HC 31(1B) should refer to a charitable trust "ceasing to meet the requirements to derive exempt income under section CW 41 or CW 42", or similar, or simply include a cross-reference to section HR 11.

119. The proposed provisions in new section HR 11 in clause 107 of the Bill could potentially be broadened to apply not only to deregistered charities but also to other entities that are eligible for a general exemption from income tax and then become ineligible because they no longer meet the requirements of that exemption.

120. Assuming that section HR 11 will remain limited to charities, in the heading to the section, "Former Tax Charities" would be a more accurate heading than "Ceased Charities".

121. The application provision in section HR 11(1) should arguably be amended so that the section would only apply to an entity if:

- the entity "*ceases to meet the requirements to derive exempt income under section CW 41 or CW 42*"; and
- the entity is not eligible for any other general exemption from income tax, for example a deregistered charity may be eligible for an exemption that is not dependent upon registration under the Charities Act (such as the existing exemptions for public and local authorities, local and regional promotion bodies and amateur sports promotion bodies, and the proposed new exemption for community housing providers).

122. Consequential amendments would also then need to be made, for example in section HR 11(2) and (5) the words "if section CW 41 or CW 42 never applied" would need to be amended.

123. It may be the case that an entity that no longer meets the requirements to derive exempt income under section CW 41 or CW 42 is partially exempt, for example in relation to non-business income,

and partially taxable, for example in relation to some or all of its business income. It may be appropriate for new section HR 11 to deal expressly with the allocation/apportionment of the entity's initial tax base in this type of scenario.

Dealing with the Accumulated Assets of a Deregistered Charity (clauses 19 and 108)

Treatment of accumulated net asset amount as income is a blunt instrument that may have unintended and inappropriate consequences

124. The stated intent of the proposed amendments in clauses 19 and 108 of the Bill is to "encourage" a deregistered charity to distribute its accumulated assets and income for charitable purposes.

125. The potential application of the proposed amendments to a range of entities needs to be carefully considered. The amendments do not attempt to "claw-back" accurately or in a scientific way the benefits of tax-exempt status to the entity in relation to accumulating assets and income. Instead, they seek to impose a potentially significant tax cost (28% of the value of a company's net assets, 33% for trusts) on deregistered charities that do not distribute their accumulated assets and income for charitable purposes within 12 months of deregistration. This is a blunt instrument that may have unintended and inappropriate consequences.

126. For many deregistered charities, these provisions may not have any material impact, for example:

- despite the entity's deregistration under the Charities Act its purposes are, or include, charitable purposes to which its assets/income can be distributed (or applied) and the entity will be able to distribute (or apply) a sufficient amount of assets/income for charitable purposes within the 12 month period, or to settle a sufficient amount on trust for such purposes (assuming this would be permitted) so that the provisions would not apply;
- the entity will be tax-exempt at the time of derivation of any amount of income under the proposed provisions, either under the exemptions for tax charities (for example, because the entity has re-registered under the Charities Act) or under another exemption (for example, the existing exemptions for local/regional promotion bodies and amateur sports promotion bodies or the proposed exemption for community housing providers) – which is presumably an intended outcome.

127. For other deregistered charities, the "encouragement" to distribute accumulated assets and income for charitable purposes provided by the provisions may be warranted. (Although note that for deregistered charities that have not complied with their rules, Inland Revenue would already be able to revisit their tax-exempt treatment as "tax charities" on a retrospective basis.)

128. However, for many other deregistered charities, these provisions could have significant and inappropriate consequences, and those consequences do not appear to have been fully considered.

129. For example, there are entities that have been deregistered because the Charities Commission or Board reviews an entity's rules and decides that the entity's stated purposes are not charitable, and the entity cannot (or would not, in light of its core purposes) amend the purposes for which it is established in order to render them charitable, according to the view of the Commission or Board. Such an entity cannot distribute its assets for charitable purposes post-deregistration, as such a distribution would be *ultra vires*. The entity would not necessarily qualify for any other general exemption from income tax.

130. The Law Society considers that such an entity should not be subject to the proposed amendments. The provisions would not "claw-back" accurately or in a scientific way the benefits of tax-exempt status to the entity; instead, they would impose a potentially significant tax cost, crudely calculated, in order to "encourage" the entity to do something it cannot do.

131. While the apparent simplicity of the proposed amendments may seem attractive, the potential application of the amendments to a wide range of deregistered charities needs to be carefully considered.

Recommendation

132. The proposed amendments in clauses 19 and 108 should not be made, pending a thorough review of the potential consequences of the amendments.

Specific comments on the drafting of the proposed amendments in clauses 19 and 108

133. If, notwithstanding the points made above, the proposed amendments in clauses 19 and 108, adding new sections CV 17 and HR 12 respectively, are to proceed, substantial changes should be made to the drafting of the amendments.

Recommendations

134. In the headings to the sections, "Former Tax Charities" would be more accurate than "Ceased Charities".

135. Section CV 17 need not deal with the timing of derivation of the relevant income as this is dealt with in section HR 12.

136. The provisions relating to application of the provisions in section HR 12(1) should be consistent with section CW 41, as amended under clause 27 as discussed above. Section HR 12 would apply to an entity "on and after the day on which the entity ceases to be a tax charity" under section CW 41 (covering both entities registered under the Charities Act and approved by the Commissioner). Arguably, the provisions in section HR 12 should not apply in relation to a deregistered entity that is exposed to tax on a retrospective basis, at least where the benefits of tax-exempt status are clawed back in that way.

137. The provisions relating to the calculation of the amount of income to be recognised in section HR 12(2) and (3) need to be carefully reviewed and should be more closely aligned with the concept of clawing back the benefits of tax-exempt status:

- The exclusion of gifted assets, and potentially other items, should be dealt with as part of the "net assets" calculation in subsection (3), and the amount of income to be recognised under subsection (2) would then be the net assets value less the value of assets distributed (or applied – see below) for charitable purposes in the relevant 12 month period.
- In relation to the exclusion of items from the net assets calculation, gifts of money, or at least certain gifts of money, should arguably be excluded from the calculation, as tax incentives will not necessarily have been claimed by donors in relation to such gifts, and there are other items that should also be excluded from the calculation, for example possibly capital gain amounts, assets acquired prior to becoming tax-exempt etc.
- In relation to the allowance for assets distributed for charitable purposes, to provide flexibility it would seem appropriate to refer to assets "distributed *or applied*" for charitable purposes within the relevant 12 month period and possibly also to clarify that this would include the entity settling, or declaring that it holds, assets on trust for charitable purposes within the 12 month period.

138. The rationale for the proposed split application date for section HR 12 should also be reviewed, as it would be preferable for there to be a single application date. In light of the potential significance of the new rules, the deferred April 2015 application would seem preferable, and this would not necessarily result in a rush of voluntary deregistrations bearing in the mind the other tax consequences of deregistration and the fact that voluntary deregistrations would presumably be tracked during the period.

Impact of Deregistration on Other Tax Concessions (clauses 110 and 123(6))

Inappropriate linkage of "donee organisation" and "charitable organisation" status to Charities Act registration

139. The proposed amendments in clauses 110 and 123(6) of the Bill, which imply that there is a direct link between registration/deregistration under the Charities Act and these other tax concessions, are potentially misleading and inappropriate, and this may provide sufficient grounds for deleting both amendments, in their current form, from the Bill.

140. This is because Charities Act registration is *not* a prerequisite for the other tax concessions under the Income Tax Act 2007, including tax incentives that can be claimed by donors in relation to "charitable or other public benefit gifts", being gifts to entities commonly referred to as "donee organisations" (for example, entities falling within the categories set out in section LD 3(2) or listed in Schedule 32) and the limited exemption from FBT for "charitable organisations " (under section CX 25).

141. When the Charities Bill was first introduced, it was proposed that donee organisations would be required to register with the Charities Commission, but a deliberate policy decision was made to limit registration to charities, as a prerequisite for income tax exemptions and the former gift duty exemption for charitable gifts, not other tax concessions.

142. However, the general intent of each of the proposed amendments is supported and further comments are set out below.

Specific comments on the amendment relating to tax incentives for gifts to "donee organisations" in clause 110

143. The proposed amendment to section LD 3(2) in clause 110, adding a new paragraph (ab) that refers to registered charities, is intended to be taxpayer-friendly, by protecting donors in relation to tax incentives that have been claimed in respect of monetary gifts to registered charities that have subsequently been deregistered – presumably on the basis that donors should be able to rely upon Charities Act registration as evidence of donee organisation status.

144. The general intent of the proposed amendment is supported, but the way in which the amendment seeks to achieve that intent is confusing and needs to be revisited:

- On its face, the addition of new paragraph (ab) to section LD 3(2) would suggest that tax incentives can be claimed for monetary gifts to all charities registered under the Charities Act. However, this is not the current position, as a registered charity must fall within one of

the existing categories of donee organisations in section LD 3(2) or it must be listed in Schedule 32 and not all registered charities will do so (in particular because they apply funds overseas and are not listed in the schedule), nor is this the apparent intent of the amendment.

- The proposed application provisions in clause 110(4) appear to be intended to limit the effect of the new paragraph (ab), but if so the drafting of clause 110(4) is unclear and, in any event, it is not appropriate for the application provisions, which would not appear in the principal legislation, to be used in this way.
- In addition, the proposed amendment does not provide any protection to donors in relation to tax incentives claimed for monetary gifts to entities included on the list of approved donee organisations maintained on Inland Revenue's website. Although it does not currently have statutory recognition, this list, unlike the Charities Register, is supposed to provide a public record of entities that Inland Revenue has accepted as falling within the existing categories of donee organisations in section LD 3(2) (as well as those listed in Schedule 32), whether or not they are charities registered under the Charities Act.

Recommendation

145. A simpler and clearer approach to achieve the general intent of the proposed amendment would be to provide specific protection for donors in relation to taking the position that an entity to which they have donated is a donee organisation. In this context, an entity's registration under the Charities Act and/or listing with Inland Revenue could be specified as a sufficient, or relevant, ground for concluding that an entity is a donee organisation.

146. For example, a new subsection could be added to section LD 3 to provide that a gift of $5 or more to a society, institution, association, organisation, trust or fund is *treated as* a charitable or other public benefit gift if the donor has reasonable grounds for concluding that the donee is a donee organisation, including where, at the time of the gift:

- the donee is listed with Inland Revenue as an approved donee organisation; and
- the donee is registered under the Charities Act and the donor has no grounds for concluding that the donee does not apply its funds mainly for charitable purposes in New Zealand.

Specific comments on amendment relating to the limited exemption from FBT for "charitable organisations" in clause 123(6)

147. The proposed amendment to the definition of "charitable organisation" in section YA 1, by adding a new paragraph (ab) that refers to deregistered charities, is intended to be taxpayer-friendly, by protecting organisations that have relied upon registration under the Charities Act in taking the position that the limited exemption from FBT for charitable organisations can be utilised.

148. Again, the general intent of the proposed amendment is supported but the way in which the amendment seeks to achieve that intent is confusing and needs to be revisited:

- On its face, the addition of new paragraph (ab) to the "charitable organisation" definition suggests that all charities registered under the Charities Act can utilise the limited exemption from FBT. However, this is not the current position, as a registered charity must fall within one of the existing categories of donee organisations in section LD 3(2) or it must be listed in Schedule 32 and not all registered charities will do so, nor is this the apparent intent of the amendment.
- The fact that paragraph (ab) would only apply to an entity once it has been deregistered, coupled with the application provisions in clause 123(44), appear to be intended to limit the effect of the new paragraph (ab), but if so the drafting is unclear and, in any event, it is not appropriate for the application provisions, which would not appear in the principal legislation, to be used in this way.
- In addition, the proposed amendment does not provide any protection to entities in relation to utilisation of the limited exemption of FBT for entities included on the list of approved donee organisations on Inland Revenue's website, even though this list, unlike the Charities Register, is supposed to provide a public record of entities that Inland Revenue has approved as donee organisations, whether or not they are charities registered under the Charities Act.

Recommendation

149. A simpler and clearer approach to achieve the general intent of the proposed amendment would be to provide specific protection, under either the Income Tax Act or the Tax Administration Act, for an entity that has taken the position, on reasonable grounds, that it is a “charitable organisation” and in this context provide that an entity's registration under the Charities Act and/or listing with Inland Revenue is a sufficient ground for taking such a position.

I Tax Status of certain Community Housing Entities (clauses 28, 29, 110, 159, 123(7))

150. The proposed amendments in the Bill relating to the tax status of community housing entities deal with two matters:

- A new exemption from income tax for community housing entities; and
- "Donee organisation" status for community housing entities, so that tax incentives can be claimed for donations to such entities.

New Exemption from Income Tax for Community Housing Entities (clauses 28, 29, 123(7) and 159)

Proposed new section CW 42B and related amendments to section CW 42

151. The proposed new section CW 42B for community housing entities refers to income derived by an entity "*from a business of providing new houses*", and the new section would also effectively incorporate certain requirements that also apply in relation to the "business" income tax exemption for "tax charities" in section CW 42.

152. The term "*business*" as defined in section YA 1 principally includes "*any profession, trade or undertaking carried on for profit*". Technically, the term "business" may not be an appropriate term to cover the full range of community housing activity undertaken by the target community housing entities and it may be preferable to use a wider or more neutral term, such as "enterprise" or "activity", throughout section 42B. (An "enterprise" or "activity" can still generate income that might otherwise be assessable, and both terms would encompass a "business".)

153. If the term "enterprise" or "activity" were to be used in new section CW 42B, this would not affect the incorporation of requirements from the "business" income tax exemption for "tax charities" and the cross-references to certain provisions in section CW 42. (It is assumed that the incorporation of those requirements had not been based solely on the proposed use of the term "business" in the section.) However, it may be appropriate to clarify that, for the purpose of section CW 42B, the term "business" in the relevant provisions of section CW 42 is to be read as a reference to the "enterprise" or "activity" of the community housing entity.

154. As currently drafted, the new section would also be limited to a community housing entity's income "*from*" that enterprise/activity. In relation to this limitation:

- The limitation may not matter if the expectation is that a target entity's sole enterprise/activity would be the relevant community housing enterprise/activity – but in that case, that expectation should be reflected in the definition of "community housing entity" in section CW

42B(2), rather than section CW 42B(1), for example the definition should clarify the permitted scope of the targeted entities' operations.

- If the relevant housing enterprise/activity is not expected to be a targeted entity's sole enterprise/activity, the limitation might create some uncertainty in relation to income, for example interest or other 'passive' income, that is derived by a target entity "*in relation to*"/"*in respect o*f"/"*for the benefit of*" the enterprise/activity, but not directly "*from*" the enterprise/activity. Presumably such income is intended to be covered by the exemption, but if so this should be clarified.

155. In relation to the "beneficiaries"/"clients" of a community housing entity, as described in new section CW 42B(1):

- Trusts utilising this exemption could potentially be either private trusts, for a class of beneficiaries, or charitable trusts, for charitable purposes. As a matter of trust law, a charitable trust will not have "beneficiaries" as such, but it can have "beneficiaries" as ordinarily defined for tax purposes, for example *persons who are eligible to benefit, or who have benefitted, under the trust*. However, a trust can also have "clients". Conversely, in this context, a company (including a society) operating as a community housing entity might be viewed as having "clients" and/or "beneficiaries". It may be preferable for section CW 42B(1) to refer to "*the only beneficiaries and/or clients of the entity, as the case may be…*".

- New section 42B(1)(a) refers to "*community housing entities that derive exempt income under this section*". The Law Society queries whether this should simply refer to "*community housing entities*", or to "*community housing entities that are eligible to derive exempt income*", and also whether it may be possible for a beneficiary/client community housing entity to derive exempt income under either the new section 42B or another exemption, for example the tax charity exemptions in section CW 41 and CW 42.

156. In relation to the definition of "community housing entity" in new section 42B(2), in addition to the points noted above relating to clarifying the permitted scope of an entity's operations and use of the term "business", the Law Society queries whether the requirement that "*all profit of the [enterprise/activity] is reinvested into the [enterprise/activity]"* might preclude the distribution or application of such profit for community housing purposes that should be permitted, for example a distribution or application of such profit to or for the benefit of a parent or beneficiary/client community housing entity.

Recommendation

157. The drafting of proposed new section CW 42B, and in particular the use of the term "business", should be reviewed and amended in light of the drafting comments above.

Regulation-making power in relation to qualifying beneficiaries/clients (clause 159)

158. Clause 159 of the Bill proposes a new section 225D in the Tax Administration Act that would enable regulations to be made specifying the persons, or classes of persons, who may be the beneficiaries/clients of a community housing entity that is tax-exempt under new section CW 42B, and section 225D(2) sets out the factors upon which such specifications may be based.

Recommendation

159. It would be appropriate for this regulation-making power to be "framed" by a purpose provision that makes it clear that the factors referred to in section 225D(2) are to be used to ensure that the operations of tax-exempt community housing entities are targeted at the provision of new housing for the benefit of individuals and families who are on relatively low incomes and who could not otherwise afford housing without government assistance.

"Donee Organisation" Status for Community Housing Entities (clause 110)

160. The proposed amendment to section LD 3(2) in clause 110, adding a new paragraph (ac) that refers to community housing entities, is intended to enable donors to claim tax incentives in respect of monetary gifts to such entities – where such entities would not otherwise fall within the existing categories of donee organisations in section LD 3(2) (and would not be listed in Schedule 32).

Recommendations

161. As currently drafted, the proposed new paragraph (ac) would apply only if "*the gift is made in a tax year that the entity derives exempt income under section CW 42B*". It may be preferable for the provision to refer to the donee entity as being an entity that is "*eligible to derive*" exempt income under that section.

162. As noted in relation to the proposed amendment to section LD 3(2) relating to deregistered charities, it would be appropriate to protect donors in relation to taking the position that an entity to which they have donated is a qualifying "community housing entity". In this context, in due course, an entity's registration under the Housing Restructuring and Tenancy Matters Act 1992 could be specified as a sufficient, or relevant, ground for concluding that an entity qualifies.

Other Matters Raised by the *Queenstown Lakes Community Housing Trust* Decision

163. The proposed changes in the Bill relating to community housing entities appear to have been significantly influenced by the High Court decision confirming that the Queenstown Lakes Community Housing Trust (Trust) is not charitable (*Re Queenstown Lakes Community Housing Trust* [2011] 3 NZLR 502 (High Court).

164. However, neither the community housing entity changes nor the changes in the Bill relating to deregistered charities appear to address the issue of continuity of tax-exempt status for an entity such as the Trust if there has been a period of non-registration under the Charities Act (and no other general income tax exemption is available) prior to the community housing entity exemption coming into effect. As noted in the submissions on the changes relating to deregistered charities, it may be appropriate for additional amendments to be made to section CW 41 to provide for continuity of tax-exempt status in this type of situation, and similar amendments might be appropriate to provide for continuity of tax-exempt status for community housing entities pending availability of the new community housing entity exemption.

Recommendation

165. Consideration should be given to including amendments in the Bill to provide for continuity of tax-exempt status for community housing entities if continuity of tax-exempt status would otherwise be affected by deregistration under the Charities Act.

J Foreign Account Information-Sharing Agreement (Clauses 2(23), 5, 6, 128(1), (2), (5), 123(15), 129, 150, 151, 152 and 158)

166. The Bill provides for amendments to New Zealand domestic law, to authorise information to be obtained and provided to Inland Revenue under a proposed inter-governmental agreement (IGA) with the United States. The amendments are drafted in a broad manner, and do not specifically address the question of which entities would be subject to these information-gathering and provision obligations. The proposed amendments apply to "a person, as described in a foreign account information-sharing agreement" and require such persons to, among other things, apply the due diligence procedures and obtain and provide to Inland Revenue the information described in or contemplated by the IGA.

Clarification that provisions do not apply to solicitors' trust accounts

167. In the context of FATCA and the IGA that is currently being negotiated with the United States (and, any future similar agreements with other countries), the Law Society understands that the provisions

apply only to New Zealand financial institutions as those concepts are defined in the IGA. The Law Society considers that solicitors are not "financial institutions" as defined in the IGA in respect of their relationship with their clients and in particular in relation to solicitors' trust accounts. However, given the potential breadth of term "a person as described in a foreign account information-sharing agreement" and the onerous implications of being such a person, the Law Society seeks clarification that the proposed amendments are not intended and do not apply to solicitors in respect of solicitors' trust accounts.

Provisions should also authorise the provision of information to New Zealand financial institutions

168. The proposed amendments explicitly authorise New Zealand financial institutions to obtain and provide certain information to Inland Revenue in respect of their account holders, in order to overcome concerns that such collection and provision would be in breach of the Privacy Act 1993 in the absence of legislative authorisation. The proposed amendments do not, however, extend to the provision of information by account holders to New Zealand financial institutions and do not protect them against potential Privacy Act breaches.

169. To comply with their obligations under the proposed amendments, New Zealand financial institutions will have to obtain information from account holders that includes whether they are holding funds on behalf of other persons and, if so, the personal details (including name, address and tax identification numbers) of such persons. Account holders could potentially be in breach of the Privacy Act by providing the requested information to financial institutions. Given that the provision of such information is necessary to enable New Zealand financial institutions to comply with their obligations under the proposed amendments and the New Zealand Government to comply with its obligations under the IGA and other foreign account information-sharing agreements, the Law Society considers that account holders should be afforded the same legislative protection against potential Privacy Act breaches that are given to financial institutions.

Recommendations

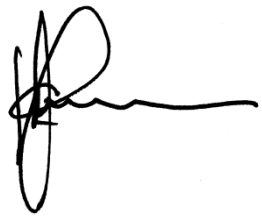
170. The Law Society requests that the status of solicitors' trust accounts be confirmed by officials by way of clarification or specifically addressed by legislation.

171. To cater for the possibility that information could be required from solicitors (which would be the case where, for example, amounts are placed on interest bearing deposit outside of the trust account on behalf of clients) and other account holders, consideration be given to an appropriate amendment to the effect that the provision of information by a person to a New Zealand financial

institution to enable the institution to provide information to the IRD should also not be a breach of Privacy Act or any other confidentiality obligation.

Conclusion

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



Chris Moore
President
5 February 2014