NEW ZEALAND LAW SOCIETY

NZLS EST 1869

TAXATION (ANNUAL RATES FOR 2015-2016, RESEARCH AND DEVELOPMENT, AND REMEDIAL MATTERS) BILL

1/5/2015

SUBMISSION ON THE TAXATION (ANNUAL RATES FOR 2015-2016, RESEARCH AND DEVELOPMENT, AND REMEDIAL MATTERS) BILL

1. The New Zealand Law Society (Law Society) welcomes the opportunity to comment on the Taxation (Annual Rates for 2015-2016, Research and Development, and Remedial Matters) Bill (Bill). The Law Society's submission addresses the following aspects of the Bill: Research and Development; Controlled Foreign Company (CFC) and Foreign Investment Fund (FIF) Remedials; and the Property Transfer Rules. The submission also addresses an issue that arises from transitional rules relating to the treatment of dwellings under the GST Act 1985.

PART 3 – Amendments to Income Tax Act 2007

Research and Development Tax Losses – sections MX2, MX3, MX6 (clause 192)

2. The Commentary on the Bill states that look-through companies (LTCs) and qualifying companies are excluded from the proposals. The Bill does exclude qualifying companies (proposed section MX 2(e)), but not LTCs. It is assumed that this is an oversight. If so, then a reference to LTCs should also be included at proposed section MX 2.

3. Proposed section MX 2(a) appears too restrictive in denying eligibility to a company if it is part of a group of companies that includes a foreign company (or one that is treated as a resident of a foreign country under a double tax agreement). A better alternative would be to disregard any such foreign company in the group for the purposes of determining whether the wage intensity and other criteria are satisfied.

4. For clarity, the Law Society suggests inserting in proposed section MX 3(1), after the phrase "*or for the part of the income year for which the person exists if that is not the whole income year*", the words "*(the **part of the income year**)*". This would remove any doubt as to the meaning of the phrases "*the part of the income year*" in the section MX 3 definitions of "*total R&D labour expenditure*" and "*total labour expenditure*".

5. The definition of "*contractor R&D consideration*" refers to "*R&D material*" provided by an external contractor. The definition of "*R&D material*", while encompassing "*goods and services to the extent to which they relate to providing a service of research and development*", excludes goods and services to the extent to which they relate to an activity described in proposed schedule 22 (Proscribed R&D activities) – as does the proposed definition of "*R&D expenditure*". The list of proscribed R&D activities in Schedule 22 includes acquiring intellectual property or know-how. The

Bill's proposed definition of "*intellectual property*" includes "*anything that results from research or development*" while "*know-how*" is defined as "*includes trade secrets, confidential information, and information with commercial value*". Given the breadth of the definitions of "*intellectual property*" and "*know-how*", the current definitional approach could make the provisions uncertain in application, or even unworkable, because it is difficult to envisage what "*R&D material*" could be provided by an external contractor that would not be proscribed by schedule 22 as the "acquisition" by the principal of anything that results from the contractor's research or development service. The Law Society considers that it should therefore be made clear that "acquiring", as used in clause 3 of schedule 22, does not include the development of new intellectual property or know-how from carrying out research and development. The same clarification should be made in paragraph (f) of the definition of "R&D expenditure".

6. In the definition of "*R&D material*" the Law Society recommends inserting in (b) after "*are used*" the words "*by the recipient or, if the recipient is a member of a group of companies, by a member of the group*".

7. Section MX 6(1) does not address the consequences of the company becoming an LTC.

8. In section MX 6(2)(a)(i) and (ii), the phrase "*before or including*" is used. This phrase is not used elsewhere in legislation (except with a different effect in section EI 4B(4)(c)(i) and (5)(c)(i)). It is recommended that it is replaced with "*up to and including*".

9. In section MX 6, R&D repayment tax may be repayable on a disposal of intangible property, core technology, intellectual property, or know-how. The Commentary accompanying the Bill states that the cashed out losses should be repaid when the company "*makes a return on their investment*". This seems to presuppose that the intangible sold was created by R&D expenditure for which a tax credit was paid. However, it is possible that the intangible was the product of R&D that occurred before the 2015-16 tax year. In that case, it is not appropriate that the tax credit is clawed back. Accordingly, section MX 6(1)(a)(i) should read "disposes of or transfers intangible property, core technology, intellectual property, or know-how *for which a tax credit for R&D tax losses has been paid*:"

10. The term "*intangibles' market value*" is used (and defined) in determining the amount of the repayment where section MX 6(1)(a)(i) applies. There is an inconsistency between this market value approach and the "consideration" approach in proposed section CG 7C upon the disposal of a non-

depreciable intangible asset that has been "derecognised" or written off under proposed section DB 34.

Recommendation

11. The Law Society recommends that proposed sections MX2, M3 and MX6 be amended as described in the foregoing paragraphs.

CFC and FIF Remedials

Fair dividend rate methods (clause 137)

12. The Law Society does not support the proposal to restrict a taxpayer, using the fair dividend rate calculation method (FDR method), from changing between the "usual method" and the "unit-valuing funds" method no more than once every four years. A similar policy objective could be achieved by requiring a global change across the full portfolio when an election to change method is made. This is because:

- It would align the FDR method rules with the rule in section EX 46 requiring a global portfolio change when choosing which calculation method to apply under section EX 44; and

- It would not lock the taxpayer into one form of calculation method for a period of four years, which it is submitted is likely to be regarded by taxpayers as unacceptably long, there being no self-evident reason for such a lengthy restrictive period.

Recommendation

13. The Law Society recommends that clause 137 be amended to remove the four year period in proposed sections EX 51B (2)(b)(i) and EX 51B (3)(c)(i) , and to require a global change across the full portfolio when an election to change method is made.

Part year exemptions for Australian FIFs (clause 134)

14. The proposed remedial change at clause 134 of the Bill addresses the situation where no shares are held for part of the year. However, the Law Society considers that the proposed solution may give rise to further inconsistencies. For example:

- a taxpayer who held no income interest in a Foreign Investment Fund (FIF) for the first 6 months of the year and a 15% income interest in the FIF for the final 6 months of a year would meet the 10% threshold; but

- a taxpayer who holds a 4% income interest for the first 6 months in a year and a 15% income interest in a FIF for the second half of the year, would not meet the 10% threshold.

15. In the second situation, the taxpayer has held a greater interest in the company over the entire period of the year, which (as the Commentary states) is the general basis for calculating interests in CFCs.

Recommendation

16. The Law Society recommends that further thought be given as to whether an alternative test, for example one that focuses on whether the 10% threshold was met for a minimum period of time (such as the lesser of three months or the period during which the shares are held), might better address the policy concerns.

Property Transfer Rules

Meaning of "settlement of relationship property" (clause 149)

17. Clause 149 amends the definition of "settlement of relationship property" so that the transaction is no longer required to be between parties to a relationship property agreement. The proposed amendment fixes what appears to have been an unintended change arising from the rewrite process.

18. The Commentary to the Bill provides that the reference to "between parties" is to be deleted so that transfers of property between one of the parties to the agreement and a third party (such as a family trust) are included. However, the proposed definition of "settlement of relationship property" goes further than that, in that neither the transferor nor the transferee need to be parties to the relationship property agreement. The consequence of this approach appears to be that transactions between two trusts (such as a resettlement) made pursuant to a relationship property agreement will be subject to the concessionary treatment in subpart FB.

19. The Law Society agrees that the concessionary treatment should extend to such situations (as was the case prior to the rewrite), but is concerned that Inland Revenue may "read down" the new definition, given that the Commentary to the Bill implies that the transferor must be a party to the relationship property agreement.

Recommendation

20. The Law Society recommends that officials clarify in a forthcoming Taxation Information Bulletin that the change in the meaning of "settlement of relationship property" means that neither the transferor nor the transferee need to be a party to the relationship property agreement and, as such, subpart FB will apply to the resettlement of trust property made pursuant to a relationship property agreement.

Effective date of proposed changes

21. Clause 149(2) states that the proposed changes to subpart FB apply to the 2008-09 and later income years. The proposed change to the definition of "settlement of relationship property" will affect whether the transferor or the transferee bears the income tax liability arising from the transfer of property (such as depreciable property) pursuant to a relationship property agreement. These tax implications would (or at least should) have been taken into account by the parties in determining a fair split of relationship property. If the change to the definition of "settlement of relationship property" is enacted with retroactive effect, this could have a significant impact on the financial position of parties who have settled relationship property in good faith, prior to the date of enactment.

Recommendation

22. The Law Society recommends that the proposed changes to subpart FB and, in particular, the definition of "settlement of relationship property" in proposed section FB 1B, apply from the date of enactment and not from the 2008-09 income year.

Suggested remedial amendment to address an issue arising from the transitional rules relating to the treatment of dwellings

23. Section 21HB of the Goods and Services Tax Act 1985 was amended by the Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Act 2014 to enable persons affected by the change in the definitions of "dwelling" and "commercial dwelling" to elect not to treat a supply of accommodation, in certain circumstances, as a taxable supply.

24. The enactment of the transitional rule arose from concerns raised in the issues paper, *GST remedial issues* (18 December 2012). Chapter 6.12 of the issues paper proposed changes to section 21HB to deal with situations such as where a sole trader acquired a holiday home in their own name prior to 1 April 2011. The Law Society is concerned that the changes to section 21HB do not achieve the

desired effect, because it appears that section 21HB(4) requires that the property previously treated as a "dwelling" is now treated as a "commercial dwelling".

25. In the case of holiday homes, while the change to the definition of "dwelling" means that the holiday home will no longer be treated as a "dwelling", such a property is unlikely to be treated as a "commercial dwelling", as it will not generally be treated as a "serviced apartment" or any of the other items listed in the definition of "commercial dwelling". The owner of the holiday home in this situation will not be able to apply the transitional rule in section 21HB(4) and will be required to account for GST on the supply of accommodation (as that supply will not be an exempt supply under section 14(1)(c) of the GST Act), even though the supply will not be made in respect of a commercial dwelling.

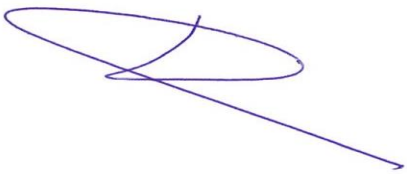
Recommendation

26. The Law Society recommends that section 21HB(4) of the GST Act be amended as follows:

> "**21HB(4) [Treatment of supply of accommodation in a dwelling]**
> A person who is no longer able to treat a dwelling as a dwelling because of the amendment to the definition of **dwelling** made by section 4(4) of the Taxation (GST and Remedial Matters) Act 2010 may choose not to treat a supply of accommodation in a dwelling affected by the amendment as a taxable supply."

Conclusion

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



Mark Wilton
Vice President

1 May 2015