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TAX INFORMATION Bulletin

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Inland Revenue
Te Tari Taake

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YOUR OPPORTUNITY TO COMMENT

Inland Revenue regularly produces a number of statements and rulings aimed at explaining how taxation law affects taxpayers and their agents. Because we are keen to produce items that accurately and fairly reflect taxation legislation and are useful in practical situations, your input into the process, as a user of that legislation, is highly valued.

You can find a list of the items we are currently inviting submissions on as well as a list of expired items at **taxtechnical.ird.govt.nz** (search keywords: public consultation).

Email your submissions to us at **public.consultation@ird.govt.nz** or post them to:

Public Consultation
Tax Counsel Office
Inland Revenue PO Box 2198
Wellington 6140

You can also subscribe at **taxtechnical.ird.govt.nz/subscribe** to receive regular email updates when we publish new draft items for comment.

Your opportunity to comment

Ref	Draft type	Title	Comment deadline
ED0240	Standard practice statement	Disputes process	24 June 2022
ED0242	Determination	Tax depreciation rates for hydrofraise rigs	17 June 2022

IN SUMMARY

New legislation

Taxation (Annual Rates for 2021–22, GST, and Remedial Matters) Act 2022 3

On 30 March 2022, the Taxation (Annual Rates for 2021–22, GST, and Remedial Matters) Act was granted Royal assent and passed into law.

The new legislation includes measures to:

- limit the deductibility of interest incurred for residential property investments, and
- updates the residential property bright-line test.

The new legislation also includes a range of improvements and maintenance measures to ensure the smooth functioning of the tax system, including to:

- modernise the GST invoicing rules
- introduce specific rules for the GST treatment of cryptoassets
- set penalties for the sale and acquisition of sales suppression software, and
- set the annual income tax rates for the 2021–22 tax year.

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Question we've been asked

QB 22/02: Donations - what is required to establish and maintain a "public fund" under s LD 3(2)(d) of the Income Tax Act 2007? 306

A person who donates money to a donee organisation can receive a donations tax credit or deduction. A donee organisation includes a "public fund" established and maintained exclusively for the purpose of providing money for one or more specified purposes within New Zealand. This question we've been asked considers what is required to establish and maintain a public fund.

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GST - input tax deductions; Income tax - deductions, understated income; Tax Administration Act - shortfall penalties.

NEW LEGISLATION

This section of the *TIB* covers new legislation, changes to legislation including general and remedial amendments, and Orders in Council.

Taxation (Annual Rates for 2021–22, GST, and Remedial Matters) Act 2022

Overview

The Taxation (Annual Rates for 2021–22, GST, and Remedial Matters) Act was introduced on 8 September 2021. It received its first reading on 23 September 2021, its second reading on 8 March 2022 and its third reading on 29 March 2022.

The new Act received Royal assent on 30 March 2022. It amends the Goods and Services Tax Act 1985, the Income Tax Act 2007 and the Tax Administration Act 1994.

The new legislation includes measures to:

- limit the deductibility of interest incurred for residential property investments, and
- updates the residential property bright-line test.

The new legislation also includes a range of improvements and maintenance measures to ensure the smooth functioning of the tax system, including to:

- modernise the GST invoicing rules
- introduce specific rules for the GST treatment of cryptoassets
- set penalties for the sale and acquisition of sales suppression software, and
- set the annual income tax rates for the 2021–22 tax year.

GST Policy Issues

Taxation of cryptoassets

Sections 2(1), 3 and 20H of the Goods and Services Tax Act 1985; sections EW 5 and YA 1 of the Income Tax Act 2007

Cryptocurrencies have been excluded from GST. GST will continue to apply to supplies of non-fungible tokens (NFTs).

Cryptoassets (including NFTs) are excluded from the financial arrangements rules, but other income tax rules will continue to apply. In most cases, cryptoassets will be subject to income tax on disposal.

Background

Cryptoassets are digital assets (commonly known as coins or tokens) that use cryptography to secure transactions and verify the transfer of the coins or tokens. Instead of relying on a financial institution to verify transactions, cryptoasset transactions are confirmed by computers operating on the currency's network (distributed ledger technology).

Prior to these amendments, the tax rules in New Zealand did not contemplate cryptoassets. Cryptoassets did not fit well into existing definitions that were designed for other investment products such as currency, shares, debt or equity securities. Because of their innovative nature, they will often have different features to these other investment products.

The application of GST to cryptoassets would vary depending on the facts, the features of the cryptoasset and the residency of the parties to the transaction. The supply of a cryptoasset could be subject to GST at 15%, an exempt financial service, or a zero-rated supply to a non-resident. This uncertain and variable GST treatment made investing in or using cryptoassets less attractive than investing in other financial assets. Moreover, because of the complexity of the GST treatment, the GST rules were impractical or difficult to comply with.

Legislative amendments have been made to exclude cryptocurrencies from GST and allow businesses who raise capital through issuing cryptocurrency to claim input tax deductions on their capital-raising costs. Taken together, these changes make it easier

for people to buy and sell cryptocurrency in New Zealand and ensures that businesses are not disadvantaged from selling tokens or raising capital through cryptoassets in New Zealand. These changes are not intended to provide concessionary treatment for cryptoassets, but rather provide a similar tax treatment to other investment products (for example, both money and shares are not subject to GST in New Zealand). This could help facilitate investment, business growth and technology development in cryptoassets and provide certainty for cryptoasset users in New Zealand.

Key features

The amendments have made the following key changes:

- Definitions of "cryptoasset", "cryptocurrency" and "non-fungible token" have been included in the Income Tax Act 2007 (ITA) and Goods and Services Tax Act 1985 (GST Act).
- Cryptocurrencies have been excluded from GST. GST will continue to apply to supplies of goods and services bought with cryptocurrencies, related services (for example, mining) and NFTs.
- GST-registered businesses that raise funds by issuing cryptocurrencies with features similar to debt or equity securities will still be able to claim input tax deductions on their capital-raising costs.
- Cryptocurrencies have been excluded from the financial arrangements rules, except where they are economically equivalent to debt arrangements.

Application date

The amendment to allow input tax deductions for capital-raising costs through cryptocurrencies applies for taxable periods starting on or after 1 April 2017, as this was the date that the capital-raising deduction rule took effect.

All other amendments apply retrospectively from 1 January 2009, the date the first cryptocurrency, bitcoin, was launched.

Detailed analysis

Definitions of cryptoasset, cryptocurrency and non-fungible token

A definition of "cryptoasset" has been inserted into section 2(1) of the GST Act and section YA 1 of the ITA.

A "cryptoasset" is a digital representation of value that exists in a database that is secured cryptographically and contains ledgers that record transactions and is maintained in a decentralised form. A digital representation of value that exists in another application of the same technology performing an equivalent function will also be a cryptoasset.

This "cryptoasset" definition is very broad and is intended to encompass all forms of assets that are secured cryptographically and use distributed ledger technology, such as cryptocurrencies and NFTs.

A definition of "cryptocurrency" has also been introduced in both Acts. It is defined as a cryptoasset that is not an NFT. The purpose of introducing the "cryptocurrency" definition is because cryptocurrencies are excluded from GST, but GST will continue to apply to supplies of NFTs.

A "non-fungible token" is a cryptoasset that contains unique distinguishing identification codes or metadata. An NFT is therefore unique and not directly substitutable for another equivalent asset.

Example 1: Cryptoassets, cryptocurrencies and NFTs

Kraymondcoin is a digital currency that is secured cryptographically via the blockchain and has a circulating supply of 10,000,000 tokens. Each token currently has a value of approximately NZ$5.

To commemorate the ten-year anniversary since the Kraymondcoin whitepaper was first published, the founders of Kraymondcoin introduced Krayliens. Krayliens are a set of unique artworks that depict the coin's famous founder in various outfits and holding random household objects. A total of 100 Krayliens have been minted and introduced onto the blockchain.

For the purposes of the New Zealand legislation, both Kraymondcoin and Krayliens meet the definition of a "cryptoasset". By virtue of their unique features and distinguishing metadata, Krayliens are "non-fungible tokens" and do not fit within the definition of "cryptocurrency".

Kraymondcoin is both a "cryptoasset" and a "cryptocurrency", but it is not a "non-fungible token". Each Kraymondcoin is identical to any other and can easily be substituted as such.

Excluding cryptocurrencies from GST

The definitions of both "goods" and "services" in section 2(1) of the GST Act have been amended to exclude cryptocurrency. This means that the supply of cryptocurrency is not subject to GST.

This brings the law for cryptocurrency into line with similar products (such as money and shares), which are also not subject to GST.

GST will continue to apply to supplies of goods and services bought with cryptocurrency, supplies of NFTs, and supplies of related services that are not themselves supplies of cryptocurrency, such as bitcoin mining or providing software services in exchange for utility tokens or other cryptocurrency.

Consider the following examples:

Example 2: Cryptocurrencies and GST

Exchange of cryptocurrencies

Ben is an avid cryptocurrency investor. He owns 14,000 Kraymondcoin tokens that he purchased for a total of $2000 via a cryptocurrency exchange not long after their initial release.

Throughout the period he has held Kraymondcoin, Ben has sold portions of his Kraymondcoin holdings and bought into various other tokens. In 2023, Ben decides to cash out of cryptocurrency altogether and use that money to buy a house.

Ben sells his cryptocurrency holdings for $120,000 and puts this towards his house deposit. Although Ben's sale of his cryptocurrency holdings is well above the $60,000 threshold for GST registration, Ben is not required to register for GST or account for GST on the sale of any of his cryptocurrency holdings. This is because cryptocurrencies are excluded from GST under section 2(1) of the GST Act.

Mining cryptocurrency

Graeme commences a business of bitcoin mining. Graeme registers for GST and buys specialised computer equipment for $92,000 (including GST) to undertake this mining activity. As his mining activity involves making taxable supplies of mining services (services to a blockchain that is outside New Zealand will be zero-rated exported services), Graeme claims the GST component of his mining set-up costs as an input tax deduction of $12,000. He can also claim the GST component of the other purchases used in his mining business, such as electricity or commercial rent. Graeme's mining activity generates Bitcoin. Because Bitcoin is a cryptocurrency, the supply of Bitcoin is not subject to GST when Graeme exchanges the Bitcoin for money or other types of cryptocurrency.

Staking cryptocurrency

Graeme hears from his friend Ben that he can stake Kraymondcoin. Kraymondcoin uses a proof of stake consensus mechanism.

To stake Kraymondcoin, Graeme must purchase the cryptocurrency and then lock it in a staking pool for 12 consecutive months. These staking pools provide a 10 percent return on investment.

Graeme purchases 2,000 Kraymondcoin tokens for $10,000. Although Graeme is using the Kraymondcoin in his taxable activity, he is unable to claim a GST input tax deduction, as the Kraymondcoin he purchased was not subject to GST (cryptocurrencies are not subject to GST). He is also unable to claim a secondhand goods input tax deduction, as cryptocurrencies are not a good.

One year later, Graeme redeems his Kraymondcoin from the staking pool. Given his 10 percent return, he now has 2,200 Kraymondcoin. Just like Bitcoin, the network for Kraymondcoin is located outside New Zealand, and so the supply of staking services that Graeme made in return for his staking reward is zero-rated.

It is noted that if the network for Kraymondcoin was in New Zealand, Graeme would need to account for output tax based on the value of the 200 Kraymondcoin he received as a staking reward at the time he receives it. This is because, although the supply of cryptocurrency is not subject to GST, the supply of staking services is.

Buying goods and services with cryptocurrency

Happy with the profits he has made from staking Kraymondcoin, Graeme decides to do some shopping. Kraymondcoin has become a success worldwide and is now accepted by some retailers.

Graeme purchases a new TV from his local technology retailer for $1,150 (including GST). He elects to pay for his purchase with Kraymondcoin and pays the GST-inclusive price. This is because goods and services purchased with cryptocurrency remain subject to GST, just the same as if Graeme had paid for the purchase with New Zealand dollars.

Purchasing NFTs

Buoyed by his recent success staking Kraymondcoin, Graeme decides to spend some of his Kraymondcoin to purchase NFTs. Graeme browses an online NFT exchange and finds a Kraylien that he likes the look of. It depicts the founder of Kraymondcoin wearing a tweed cap. Graeme purchases this NFT for 300 Kraymondcoin (approximately NZ$2,400 at the time of purchase).

The sale of NFTs is subject to GST in New Zealand. This means that if the online NFT exchange is registered for NZ GST under New Zealand's remote services rules, it must account for NZ GST on the sale to Inland Revenue.

Input tax deductions for capital-raising costs

The GST rules were amended in 2017 to allow GST-registered persons to claim input tax deductions for GST paid on supplies used in the making of financial services to raise capital using (see section 20H of the GST Act).

One consequence of excluding cryptocurrency from GST is that, on the face of it, GST registered persons are unable to claim input tax deductions for certain costs. By being excluded from GST, GST is not charged on the value of the cryptocurrency supply, but also the supplier cannot claim input tax deductions in relation to that supply.

To ensure that businesses who choose to raise capital through issuing cryptocurrency are not disadvantaged, an amendment has been made to section 20H(1)(d) of the GST Act to include "a cryptocurrency with similar features and function" to a debt security, participatory security or equity security. This allows GST-registered businesses to claim input tax deductions for their capital-raising costs when they raise funds through issuing cryptocurrency with features that are similar to debt, equity or participatory securities.

Example 3: GST input tax deductions for capital-raising costs

Nicole is the founder of a cryptoasset called Econo-coin, which is a revolutionary blockchain-based project that aims to create efficiencies in manufacturing production chains using RFID chip technology. These supply chain efficiencies result in saved manufacturing costs for businesses.

Nicole prepares a white paper setting out the purpose of Econo-coin and the technology that will be implemented to achieve its goals to persuade investors to back the project. Investors who buy an Econo-coin are entitled to a share of the profits made by the project, and the Econo-coin has similar features or functions to a participatory security.

In issuing the white paper, Nicole spends $23,000 (including GST) on legal and consultant fees. Nicole claims an input tax deduction of $3,000, being the GST component of the costs she incurred to raise capital (with the whitepaper being the promotional tool to achieve this capital-raising aim).

It is noted that this amendment applies to "cryptocurrency" and not "cryptoassets" (that is, it excludes NFTs). Although it is highly unlikely that an NFT issuance would take on the characteristics of a debt, equity or participatory security, NFTs remain subject to GST and therefore costs associated with the production of NFTs (such as paying for services or IP provided by artists) are generally already claimable as an input tax deduction.

GST treatment of derivatives over cryptocurrency

Derivatives are a type of financial contract, usually between two parties, whose value is dependent on an underlying asset. This means that a derivative over a cryptocurrency is not a cryptocurrency itself, but rather an agreement that tracks that underlying asset.

Consider the following example, which sets out a simple futures contract for cryptocurrency:[1]

[1] A futures contract is a legal agreement between two parties to purchase or sell an underlying asset at a specified price and date in the future. They allow traders to speculate on the future value of an asset.

Example 4: Futures contract over cryptocurrency

Kraymondcoin is $8 per token. Graeme is bullish on Kraymondcoin and believes it will rise in the future. Graeme enters into a futures contract assuming a long position, at 10 times leverage, with an expiration period of 3 months.

The value of Kraymondcoin begins to rise rapidly and Graeme cashes in on his long position for a profit.

Throughout this process, no Kraymondcoin tokens change hands. This is because the futures market is based on a contract on the *underlying* price of Kraymondcoin.

GST does not apply to this transaction as a futures contract over cryptocurrency is a financial service (see amended section 3(1)(k) of the GST Act), and financial services are GST exempt.

The GST Act has been amended to ensure that the act of providing futures and options contracts over cryptocurrency is an exempt financial service. This brings the law for options and futures contracts over cryptocurrency into line with options and futures over shares, which are a broadly equivalent asset that are also an exempt financial service. Specifically, section 3(1)(k)(iii), which provides exempt financial services treatment for the provision of a futures contract, now includes contracts that provide for the delivery of cryptocurrency. Similarly, new section 3(1)(kaab) provides that the provision or transfer of ownership of an option over cryptocurrency is also an exempt financial service.

Existing section 3(1)(ka) provides that the payment or collection of any amount of interest, principal, dividend, or other amount whatever in respect of, among other things, a financial option or futures contract is a financial service. Although not expressly amended legislatively, the reference to "financial option" and "futures contract" in section 3(1)(ka) refers to financial options and futures contracts generally and includes options and futures contracts over cryptocurrency.

GST treatment of brokerage services provided for cryptocurrency

Section 3(1) of the GST Act has also been amended to ensure that brokerage services provided for cryptocurrency, including those provided by a cryptocurrency exchange, are an exempt financial service. This brings the law into line with share or currency brokering services (which are GST exempt).

This has been achieved by inserting new section 3(1)(lb), which provides that arranging the provision, or transfer, of ownership of cryptocurrency is an exempt financial service.

Taxation of cryptoassets – financial arrangements rules

The financial arrangements rules are a set of rules that require all returns on "financial arrangements" to be accounted for, for tax purposes, on an accrual basis over the term of the financial arrangement using a spreading method. Financial arrangements are broadly defined, and this means that some types of cryptoassets could have been financial arrangements. However, the application of the financial arrangements rules to cryptoassets could require accrual-based taxation on large unrealised gains and losses from cryptoasset values. These can be very volatile and difficult to apply a spreading method to.

Amendments have therefore been made to exclude cryptocurrency and options over cryptocurrency from the financial arrangement rules. However, an exception applies where the arrangement is economically equivalent to a debt arrangement.

Excluding cryptocurrency from the financial arrangements rules

New section EW 5(3BA) of the ITA provides that a cryptocurrency is an excepted financial arrangement unless it meets the requirements set out in new section EW 5(3BAB).

New section EW 5(3BAB) provides that a cryptocurrency is not an excepted financial arrangement if ownership means the owner is entitled to receive, during the period of ownership, amounts that are determined by reference to the quantity or value of the cryptocurrency, on a basis that is known by the owner in advance, and not by reference to the profits of a business activity.

This exclusion ensures that cryptocurrencies that are economically equivalent to debt arrangements are still taxed under the financial arrangements rules.

In addition, a financial arrangement may involve a person receiving payment in the form of cryptocurrency instead of money. This still qualifies as a financial arrangement. Consider the following example:

NEW LEGISLATION

Example 5: Financial arrangement involving payment of a fixed return in cryptocurrency

Gordon has 2 Bitcoin that he invests via a platform called blockgrowth.co.nz. Blockgrowth is a spread business that makes money by borrowing capital at a certain rate (the interest it pays to users) and lending it at a higher rate.

When Gordon invests his Bitcoin on the blockgrowth platform, his Bitcoin is locked in for a set period, and Gordon is paid a guaranteed fixed return in Bitcoin for the period that his investment remains locked in to the blockgrowth platform.

Gordon invests via blockgrowth for a year and is provided with a 5% fixed return, which is equivalent to interest. During this time, Gordon is unable to sell, trade, exchange or otherwise make any use of his Bitcoin.

After the expiration of the yearly period, Gordon withdraws 2.10 Bitcoin from blockgrowth. Although Gordon's underlying investment of 2 Bitcoins is not subject to the financial arrangements rules (as buying or selling cryptocurrency is not a financial arrangement), the 5% fixed return, or 0.1 Bitcoin, was derived from a financial arrangement that is subject to the financial arrangements rules. As Gordon is a cash basis person, this means that Gordon must undertake a base price adjustment on the maturity of this arrangement and pay tax accordingly.

Options over cryptocurrency and the financial arrangements rules

An amendment has also been made to ensure that options over cryptocurrency receive the same treatment under the financial arrangements rules as options over shares, which are a broadly equivalent asset.

New section EW 5(13B) provides that an option to acquire or dispose of cryptocurrency is an excepted financial arrangement. This ensures that options over cryptocurrency receive an equivalent treatment to the treatment of options over shares, which are an excepted financial arrangement under existing section EW 5(13).

NFTs and the financial arrangements rules

The amendment to exclude cryptocurrencies from the financial arrangements rules does not apply to NFTs. This is because NFTs meet the definition of "cryptoasset" but not "cryptocurrency". However, although NFTs have not been expressly excluded from these rules, it is unlikely in most cases that holding an NFT would give rise to a financial arrangement in accordance with section EW 3.

Example 6: NFTs

Gareth becomes interested in cryptoassets and decides to purchase an NFT on his local exchange. He purchases a Kraylien NFT depicting Kraymondcoin's famous founder wearing some magical-looking sneakers for 200 Kraymondcoin tokens ($1,600).

The purchase of this NFT is not a financial arrangement.

Taxable income

Although cryptocurrencies are excluded from the financial arrangements rules, amounts that an individual or business receives from selling, trading or exchanging cryptocurrency are taxable income in most cases.

An individual or business may have to pay tax on cryptoassets, including NFTs, for one or more of the following reasons:

- Acquiring cryptoassets for the purposes of disposal (for example selling or exchange)
- Trading in assets
- Using cryptoassets for a profit-making scheme.

GST – ability to agree an apportionment method with Inland Revenue

Sections 20(3EB) and 21(4B) of the Goods and Services Tax Act 1985

The $24 million turnover threshold for agreeing an apportionment method with the Commissioner of Inland Revenue has been removed. This allows any registered person to apply to the Commissioner to agree to an apportionment method, irrespective of their turnover.

Background

The apportionment and adjustment rules apply when a GST-registered person uses or intends to use goods and services for both taxable and non-taxable purposes. Following the acquisition of an asset, the apportionment rules require the GST-registered person to annually compare the intended taxable use of an asset with the actual taxable use of an asset. If there is a difference the person must make an adjustment to either claim extra input tax credits or pay output tax to reflect the actual taxable use of the asset.

As an alternative to applying the apportionment formula in section 20 and sections 21A to 21H of the Goods and Services Tax Act 1985 (GST Act), section 20(3EB) and section 21(4B) of the GST Act allow a registered person to apply to the Commissioner of Inland Revenue to agree to an apportionment method. The proposed method will usually be easier for the registered person to calculate or apply, as a way of reducing their compliance costs.

Prior to 30 March 2022, this ability to apply to agree an apportionment method was limited to registered persons who were expected to make supplies of goods and services with a value of more than $24 million in a 12-month period. This turnover threshold has been removed so any registered person can now apply.

Application date

The amendments apply from 30 March 2022.

GST – disposal of asset with taxable and non-taxable use

Sections 5(18) and 21F of the Goods and Services Tax Act 1985

The limitation on the amount of additional input tax deduction that can be claimed on disposal of an asset that had some non-taxable use has been removed. However, a limitation is retained if the disposal is of land that a property developer uses in the course or furtherance of their taxable activity of developing land or dividing land into lots.

Background

Section 21F of the Goods and Services Tax Act 1985 (GST Act) applies when a GST registered person disposes of an asset they have partly used to make taxable supplies and also partly used for a non-taxable use (such as a private or exempt use). It allows them to claim an additional input tax deduction (known as a final adjustment) in respect of their non-taxable use of an asset. This deduction offsets the output tax they return on disposal of the asset.

Section 21F previously limited the additional input tax deduction to the tax fraction of the price paid when the registered person acquired the asset. This limitation meant that in cases where an asset, such as land, increased in value, all the appreciation in value was treated as being connected to the asset's taxable (business) use, rather than its private or exempt use.

Key features

The key changes made by the amendments are as follows:

- The formula used to calculate the section 21F final adjustment has been simplified.
- If the disposal is of land that a property developer uses in the course or furtherance of their taxable activity of developing land or dividing land into lots, then the final adjustment is limited to the tax fraction of the price paid when the property developer acquired the land.
- In all other cases, the final adjustment is not limited to the tax fraction of the purchase price and section 21F allows an additional input tax deduction to reflect the non-taxable use of the asset.
- Section 5(18) has been repealed, as this provision has become redundant because of the amendments to section 21F.

Application date

The amendments apply from 24 February 2020.

Detailed analysis

Simplified formula for section 21F final adjustment

The formula used to calculate the section 21F final adjustment has been simplified.

The formula in section 21F(4) is used when a GST-registered person disposes of an asset that they have partly used to make taxable supplies and also partly used for a non-taxable use (such as a private or exempt use). The formula provides an input tax deduction or final adjustment equal to the tax fraction × consideration × (1 – previous use).

The more complex formula in section 21F(2) has been repealed, as the same amount of adjustment is now provided by the simpler formula in section 21F(4).

Disposal of land that a property developer has developed or divided into lots

If the disposal to which section 21F applies is of land that a property developer uses in the course or furtherance of their taxable activity of developing land (such as erecting new buildings, renovating existing buildings, or other improvements) or dividing land into lots (such as a subdivision), then the final adjustment is limited to the tax fraction of the price paid when the property developer acquired the land.

This is achieved by section 21F(6) limiting the amount of the final adjustment under section 21F(4). How the limitation is calculated depends on whether the land was acquired as a zero-rated supply of land.

If the property developer acquired the land as a zero-rated supply (such as from another registered person who has used the land to make taxable supplies), section 21F(6)(a) applies to limit the maximum input tax deduction under section 21F to 15% of the consideration paid when the developer acquired the land (the amount calculated under section 20(3J)(a)(iii) with a 15% GST rate).

For other types of land, including land acquired as a secondhand good, section 21F(6)(b) applies to limit the maximum input tax deduction for a property developer under section 21F(4) to the full input tax deduction (3/23rds) of the consideration the developer paid when they acquired the land.

The limit on input tax deductions for property developers is illustrated in the following example.

Example 7: Property developer disposing of land with partly exempt use

House Co is a GST-registered property developer that purchases a house on a large section of land for $2.3 million from an unregistered person. The land was subject to an existing residential tenancy and continues to be rented out as an exempt supply of accommodation in a dwelling for three months following the purchase. Three months later, the residential tenancy ends, and House Co begins the process of demolishing the house, subdividing the land and constructing five new houses on the land. Two years after acquiring the land, House Co sells the five new houses for a total price of $5.75 million (including GST) and returns output tax of $750,000.

House Co uses the land in their taxable activity of developing land or dividing it into lots. As such, the limit on adjustments in section 21F(6) would apply to the disposal of the land.

Section 21F(6)(b) caps the maximum input tax deduction to the tax fraction of the purchase price that House Co paid when they acquired the land, which is $300,000 (3/23 × $2.3 million = $300,000). Over the period House Co owned the land, their taxable use was 87.5%, so they had previously claimed an input tax deduction of $262,500.

House Co's additional input tax deduction under section 21F would therefore be limited to $37,500, as this is the remainder of the $300,000 tax fraction on the $2.3 million purchase price.

Disposal of other types of assets

In all other cases, the final adjustment is not limited to the tax fraction of the purchase price and section 21F allows an additional deduction to reflect the non-taxable use of the asset.

This includes cases where the asset was sold for a higher amount of consideration than what it was acquired for. For example, a registered person may have used a holiday home for short-term commercial accommodation and private use and then sold the land for more than their purchase price. Section 21F(4) would allow an additional input tax deduction to reflect their private use. This is illustrated by the following example.

Example 8: Short-term commercial accommodation and private use

Sally purchases a holiday house for $690,000. The holiday house is used to supply short-term commercial accommodation and, because the expected revenues from this activity will exceed $60,000 per annum, Sally registers for, and charges GST on, the short-term accommodation.

As Sally has also stayed in the holiday home for long periods over the winter months, her private (non-taxable) use of the house has been 20%.

Because the taxable use of the holiday home is 80%, Sally has already claimed an input tax deduction of $72,000 during her period of ownership ($72,000 is 80% of the tax fraction (3/23rds) of the $690,000 purchase price of the house).

After many years, she sells the holiday home for $1,150,000 (including GST). As Sally is GST registered and disposing of an asset that was used in the course or furtherance of her taxable activity of supplying short-term commercial accommodation, she is required to return $150,000 of GST output tax.

Applying the formula in section 21F(4) to Sally's holiday home:

Tax fraction × consideration × (1 – previous use)

= 3/23 × $1,150,000 × (1 – 0.8) = $30,000

Sally returns $150,000 of GST output tax and claims an additional input tax deduction of $30,000 in her next GST return.

The $120,000 of net GST she returns reflects 80% of the output tax charged on the sale of the holiday home, which is consistent with the fact that 80% of the holiday home was used to make taxable supplies.

Consequential repeal of section 5(18)

Section 5(18) has been repealed as this provision has become redundant because of the amendments to section 21F. A registered person who sells a dwelling will generally return the same net GST on sale from applying section 21F as they would have if section 5(18) had applied instead.

Prior to its repeal, section 5(18) operated by limiting the output tax liability to the extent that the dwelling was used to make taxable supplies. Section 5(18) was a targeted rule that had much more limited application than the general rule in section 21F, which applies to all goods and services (including but not limited to dwellings) that have some taxable and non-taxable use. Section 5(18) only applied to certain dwellings for which a person claimed a partial input tax deduction at the time the dwelling was acquired (as opposed to a taxable use that began after the dwelling was acquired).

Domestic transport services supplied as part of the international transport of goods

Section 11A(1)(c) of the Goods and Services Tax Act 1985

Domestic transport suppliers can zero-rate their domestic transport services where they relate to the international transport of goods.

Background

Under the previous GST rules, for a zero rate of GST to apply, the supplier that transported the goods into or out of New Zealand had to be the same supplier that transported the goods within New Zealand before they were transported into or out of New Zealand. This was achieved by the words "to the extent that the services are supplied by the same supplier" contained within section 11A(1)(c) of the Goods and Services Tax Act 1995 (GST Act). The 'same supplier' rule was interpreted strictly, meaning commercial arrangements, such as subcontracting or even a wholly owned subsidiary of the international transport supplier, were outside the scope of the zero-rating rule.

A common commercial practice in the freight industry involves an international transport supplier (transporting the goods outside New Zealand) subcontracting the domestic transport component to a New Zealand-based transport supplier (for example, a courier company). This subcontracting arrangement meant the domestic transport service was not performed by the same supplier as the international transport service.

Where the international transport supplier was not registered for New Zealand GST, they were not able to claim back the 15% GST charged to them by their subcontractor. Circumstances arose where goods transporters would incorrectly zero-rate their domestic transport service due to a lack of understanding of the rules or potentially due to commercial pressure to remain competitive in the marketplace.

Key features

The amendment to section 11A(1)(c) of the GST Act allows for the supply of transport services for goods to be zero-rated when an international transport supplier has subcontracted the domestic leg of the international transport to a different supplier (such as a New Zealand courier). This has been achieved by replacing the words "to the extent that the services are supplied by the same supplier as part of the supply of services" with "to the extent that the services are part of a supply of services, relating to the same goods".

Application date

The amendment came into force on 30 March 2022.

Detailed analysis

Removal of "to the extent that the services are supplied by the same supplier"

The amendment results in subcontracting arrangements and other common commercial arrangements being able to qualify for the zero-rating rule. The amendment means all domestic transport services supplied to another transport supplier (usually the primary transport supplier / international transport supplier) to enable the transport of goods to or from New Zealand can be zero-rated.

Goods transported into New Zealand

Consistent with the existing policy intent of section 11A(1)(a), if the international transport supplier is contracted to deliver goods from point A outside New Zealand to point B in New Zealand, then the transporter can zero-rate the entire supply.

Any domestic transport services contractually supplied to enable the movement of goods within New Zealand to fulfil the pre-arranged whole transport service to the customer, can also be zero-rated.

Example 9: Goods being transported from a place outside New Zealand to a place in New Zealand

Edmonds-Transport, an international transport supplier of luxury kitchen cabinetry, is contracted by a customer to transport their French-made cabinetry from Paris, France to Lower Hutt, Wellington. Edmonds-Transport transports the cabinetry from France to Auckland and then subcontracts Smittys Transport Services (STS) to provide the domestic transport service between Auckland and Lower Hutt. Under the previous rules, STS would have charged 15% GST on its supply to Edmonds-Transport.

Under the new rules, STS would zero-rate (0% GST) its supply of domestic transport services, because the transport service is part of a supply of transport services that is transporting the goods along its pre-arranged journey from outside New Zealand to its ultimate destination in New Zealand.

Goods transported out of New Zealand

Consistent with the policy intent of section 11A(1)(a), if the international transport supplier is contracted to transport goods from point A in New Zealand to point B outside New Zealand, they can zero-rate the entire supply.

Any domestic transport services contractually supplied to enable the movement of goods within New Zealand to fulfil the pre-arranged whole transport service to the customer can also be zero-rated.

Example 10: Goods being transported from a place in New Zealand to a place outside New Zealand

Rose's Shipping is contracted by a customer to transport goods from Wellington to New York City. Rose's Shipping subcontracts to Chamberlain's Couriers, a domestic courier company based in Wellington, to transport the goods from Wellington to Auckland. From Auckland, Rose's Shipping then transports the goods to New York City.

Under the previous rules, Chamberlain's Couriers would have charged 15% GST on its supply to Rose's Shipping.

Under the new rules, Chamberlain's Couriers would zero-rate (0% GST) its supply of domestic transport services, because the transport service is part of a supply of transport services that is transporting the goods along its pre-arranged journey from within New Zealand to its destination outside New Zealand.

Evidence to determine the origin or destination of the goods

To determine the GST treatment of a particular supply of transport services and whether a transport service is part of a supply of services relating to goods being transported into or out of New Zealand, taxpayers should rely on existing documentation that usually accompanies a particular shipment. This includes intermodal freight transport, such as Bill of lading (shipping lines) or Airway Bills (airlines), or other relevant transport documents, including "track and trace" and other digital-based shipping documentation tools. Many of these documents are required for Customs purposes.

There may also be circumstances where the New Zealand customer, or domestic transport supplier (as part of a subcontracting arrangement), is billed for the domestic transport service, rather than the primary transport supplier. The particular entity billed for the service, by itself, is not determinative of the GST treatment of a particular transport service. This is because the billing is occurring under a contract for the international transportation of goods.

It is important to note the International Commercial Terms (known as the INCO terms), widely used in the freight industry, will not be determinative of the GST treatment of a particular transport service.

Example 11: Goods being transported from a place outside New Zealand to a place in New Zealand

Continuing example 9 above, Smittys Transport Services (STS) is aware the origin of the luxury kitchen cabinetry is outside New Zealand because Edmonds-Transport has contracted STS to transport the goods after they arrive in New Zealand, and the transport documents attached to the goods show they originated from France and their final destination is New Zealand.

STS can rely on this information to treat the domestic transport service as a zero-rated service.

Alternatively, where the domestic transport provider has received other information that the pre-arranged transport service will end at a destination that is outside New Zealand, then this information can be used to determine the GST treatment of the domestic supply of transport services.

Example 12: Goods being transported from a place in New Zealand to a place outside New Zealand

Continuing example 10 above, Rose's Shipping has been contracted by the customer to provide a transport service from Wellington to New York City. Rose's Shipping has subcontracted the domestic transport services portion of this service to Chamberlain's Couriers. Chamberlain's Couriers knows their transport service is part of a supply of services to move goods outside New Zealand because the shipping information attached to the goods outlines its pre-arranged journey is from Wellington to New York City.

Chamberlain's Couriers can rely on this information to treat the domestic transport service as a zero-rated service.

Determine when an eligible domestic transport service has been supplied

A service to transport goods is considered to be zero-rated when the "services are part of a supply of services, relating to the same goods". This is where that particular transport service is part of a series of pre-arranged transport services. These transport services would be arranged before the goods begin their transport journey.

For goods in New Zealand, this would mean goods for export being transported from their place of origin in New Zealand to their last place in New Zealand before export, and likewise goods for import would be transported from their first place in New Zealand after importation to their ultimate destination in New Zealand.

Example 13: A transport service not subject to 0% GST

ABC Shipping was contracted to arrange for priceless artifacts to be transported from Dunedin, New Zealand to Sydney, Australia. ABC Shipping arranged for XYZ Movers to transport the goods from Dunedin to Auckland, and for the goods to be securely stored in an Auckland warehouse for two months, as ABC Shipping's client's gallery was not ready to receive them until after their current exhibition ended. At the end of this period, ABC Shipping would then arrange shipping from the Auckland warehouse to Sydney.

The domestic transport service would not qualify for zero-rating because, while there are two transport services being supplied, they are not connected to each other and the transport documents for XYZ Movers show the goods' final destination was actually a warehouse in Auckland, not the client's gallery in Sydney.

Example 14: Shipping involving Customs clearance depots

The customer has arranged for their goods to be shipped from Amsterdam, Netherlands to Wellington, New Zealand. The customer has contracted VZ shipping to ship the goods from Amsterdam to Ports of Auckland. From there, the customer has separately arranged for Mike's Moving Company to perform the customs clearance services and to deliver the goods to their final destination in Wellington.

In this situation, the domestic transport service performed by Mike's Moving Company would not be zero-rated, as these services are being performed under a separate contract from the contract that delivered the goods to New Zealand.

Where there is a 'break' in the transport journey, this needs to be carefully considered in the context of the transport journey – for example, changing transport suppliers due to the sudden unavailability of a pre-arranged transport supplier.

Example 15: Where there is a break in the transport

Using the facts in example 9 above, assume that Edmonds-Transport had originally arranged for Smittys Transport Service to transport the luxury kitchen cabinetry from Auckland, New Zealand to Lower Hutt, New Zealand. However, Smittys Transport Service had not prioritised regular maintenance of their haulage vehicles and, consequently, when the time came to transport the goods, they were in the unfortunate situation of not having a usable vehicle available to transport the goods.

Edmonds-Transport instead contracted Lucy's e-Lorries (an all-electric trucking company) to complete the domestic transport service. While this transport service was not contracted until after the goods were in transit, the purpose was to replace a transport service that was required to deliver the goods to their pre-arranged destination.

This domestic service would be treated as a zero-rated service.

Other Policy Issues

COVID-19 information sharing – removal of time limit

Schedule 7 of the Tax Administration Act 1994

The expiration clause has been removed from schedule 7, clause 23B of the Tax Administration Act 1994, which enables information sharing between government agencies for COVID-19 related initiatives.

Background

Schedule 7, clause 23B enables information sharing between government agencies for COVID-19 purposes and includes a sunset clause, meaning it ceases to be in effect once 24 months have passed from the date the clause commenced (17 March 2020). This time limit can be extended by an Order in Council, which must be made before the expiry of the 24-month period.

The amendment has removed the time limit from clause 23B so that it remains in effect without the need for extensions to be made by Order in Council. This future proofs these powers, ensuring agencies can share needed information throughout the entire life cycle of the pandemic and the initiatives that support New Zealand's recovery.

Having an open-ended time limit on these provisions does not remove current limitations on information sharing. The ability to share information continues to be tied specifically to the delivery and administration of relevant COVID-19 related initiatives.

Application date

The amendment came into force on 30 March 2022.

Offences relating to electronic sales suppression

Sections 3, 139B(2B), 141EE, 141FB, 141GB, 142B, 143BB, 143BC of the Tax Administration Act 1994

A number of new measures have been introduced to prevent the spread of electronic sales suppression tools (suppression tools) within the New Zealand tax base. An electronic sales suppression penalty (ESS penalty) has been established for the acquisition or possession of suppression tools. The offences of manufacturing or distributing suppression tools and acquiring or possessing suppression tools have also been established.

Background

Electronic sales suppression tools are software programs, devices, or other tools that systematically alter point-of-sale data collected by a business to understate or completely conceal revenues, which facilitates tax evasion. These tools can work in a variety of ways, such as targeting the integrity of transactions, software, internal memory, external filing, or reporting to delete, change, or simply not record select sales data and transactions.

The spread of electronic sales suppression poses risks to the integrity of the tax system. Unlike a number of other jurisdictions, including Australia, the UK and Canada, electronic sales suppression was not previously specifically considered in New Zealand law. While using a suppression tool constitutes tax evasion and can be penalised under existing anti-evasion provisions, it was not previously illegal to manufacture, sell, buy, or possess such tools.

The new civil penalty and offences allow Inland Revenue to specifically target suppliers and taxpayers possessing suppression tools.

Key features

A definition of "electronic sales suppression tool" has been introduced in section 3 of the Tax Administration Act 1994 (TAA), and the new ESS penalty in section 141EE has been added to the definition of "civil penalty".

A new civil penalty and two offences have been introduced, as follows:

- New section 141EE establishes the ESS penalty of $5,000 for the acquisition or possession of a suppression tool.
- New section 143BB establishes an offence of manufacturing or supplying a suppression tool. A person convicted of such an offence is liable to a fine of up to $250,000.
- New section 143BC establishes an offence of acquiring or possessing a suppression tool. A person convicted of such an offence is liable to a fine of up to $50,000.

The following amendments have also been made to ensure the penalty regime works as intended:

- New section 139B(2B)(f) ensures that the ESS penalty is not subject to incremental late payment penalties.
- New section 141FB(6) removes the 50 percent reduction of shortfall penalties for no prior history in the case of evasion where the use of a suppression tool contributed to that evasion and an ESS penalty is imposed.
- New section 141GB reduces the ESS penalty when possession of the suppression tools is voluntarily disclosed.
- New section 142B(3) ensures that the due date for payment of the ESS penalty is determined under section 142B(1)(a) as if it were an amount of unpaid tax.

Application date

The new provisions apply from 30 March 2022.

Detailed analysis

Section 3 amendments

Two amendments have been made to section 3, which defines terms used elsewhere in the TAA.

The first amendment introduces a definition of "electronic sales suppression tool". An "electronic sales suppression tool" means a software program, device, tool, or other thing, part of a thing, or combination of things or parts that satisfies both the following two criteria:

- It can modify, falsify, destroy, conceal, hide, or prevent the creation of a record a person is required to make or keep under a tax law and that is, or would be, created by an electronic point of sale system.
- A reasonable person would conclude that one of its principal functions is to facilitate the modification, falsification, destruction, concealment, or prevention of the creation of a record.

The definition is broad and encompasses both physical and digital tools.

The use of a reasonable person test avoids the issues inherent in using a highly specific definition of a suppression tool (for example, accidentally capturing software that modifies sales data for legitimate reasons, such as correcting input errors or training staff). It allows for the targeting of tools intended for sales suppression while avoiding similar tools that are not used for malicious purposes.

The second amendment to section 3 adds the ESS penalty for acquiring or possessing suppression tools under new section 141EE to the definition of "civil penalty".

Electronic sales suppression penalty (section 141EE)

New section 141EE of the TAA establishes the ESS penalty. This is a civil penalty for taxpayers who knowingly acquire, possess or control a suppression tool, or have the right to use the suppression tool, with the purpose of evading their own, or some other person's, assessment or payment of tax. A person is treated as meeting the purpose test if they have used the suppression tool to evade the assessment or payment of tax.

An exception exists for taxpayers who acquire a business whose operations include the use of a suppression tool if the taxpayer could not reasonably have known of the tool's existence and has not used the tool. This ensures taxpayers who accidentally acquire a tool in this way are not penalised for this unintentional acquisition.

The ESS penalty amount is set at $5,000.

If the section applies, a taxpayer is only liable to pay a single penalty for all related tax types and periods. However, a further penalty may be imposed for a later period of time for the continued possession or control of, or right to use, the tool.

Offence of manufacturing or providing suppression tools (section 143BB)

New section 143BB of the TAA establishes that it is an offence to:

- Manufacture, develop, or publish a suppression tool that is provided to a person who is liable for an ESS penalty, who commits an offence under section 143BC, or who commits an offence under section 143BB(2) (subsection (1)), or
- Knowingly supply, make available for use, or otherwise provide a suppression tool, or the right to use a suppression tool, to a person resident in New Zealand, or knowingly provide a service to a person resident in New Zealand that includes the use of a suppression tool (subsection (2)).

The penalty for committing any of these offences is a fine up to a maximum of $250,000.

Offence of acquiring or possessing suppression tools (section 143BC)

New section 143BC of the TAA establishes the criminal equivalent of the civil ESS penalty in new section 141EE. Section 143BC provides that it is an offence for a taxpayer required to keep records under a tax law to knowingly acquire, possess or control a suppression tool, or have a right to use the suppression tool, with the purpose of evading their own or some other person's assessment or payment of tax.

The penalty for committing this offence is a fine of up to a maximum of $50,000. Similar to the ESS penalty, a taxpayer who is convicted of an offence under this section is treated as committing a single offence in relation to all tax types and periods, so that only one fine is imposed. However, a further penalty may be imposed for a later period of time if the taxpayer continues to possess, control or have the right to use the tool.

Example 16: Single penalty

In October 2023, Inland Revenue identifies that a taxpayer has acquired a suppression tool with the intention of using it to evade the payment of tax. Although the taxpayer acquired it in 2021, its possession was only an offence from 30 March 2022.

Between 30 March 2022 and October 2023 there are 20 GST periods (including part periods) and 3 income tax periods (including part periods). However, if convicted, the taxpayer will be treated as having committed only a single offence between these dates and will be liable for only a single penalty of up to $50,000.

However, if a subsequent review in 2024 revealed that the taxpayer still possessed the suppression tool, they could be convicted of a further offence and liable for a further penalty of up to $50,000.

No incremental late payment penalties for ESS penalty (section 139B)

Section 139B of the TAA imposes an initial late payment penalty on the day after the due date and the seventh day after the due date where a taxpayer has not paid an amount of tax by the due date. Further incremental late payment penalties are then imposed at monthly intervals on any amount still unpaid. Section 139B(2B) prevents incremental late payment penalties from applying for specified tax types and periods, including GST, income tax, and civil penalties for the specified tax types and periods.

The ESS penalty is intended to function similarly to other shortfall penalties. New section 139B(2B)(f) therefore ensures that incremental late payment penalties do not apply to the civil ESS penalty.

Reduction of penalty for previous behaviour denied (section 141FB)

Section 141FB of the Act provides a 50 percent reduction of tax shortfall penalties imposed under various other sections of the TAA where the taxpayer has no prior history of incurring the relevant shortfall penalties. This is intended to provide leniency in situations where a taxpayer has no prior history of non-compliance. However, evasion involving a suppression tool requires the taxpayer to acquire the tool (itself a premeditated act of non-compliance) and therefore establishes a history of intended non-compliance.

New subsection 141FB(6) therefore denies the 50 percent reduction in a shortfall penalty for evasion or a similar act where an ESS penalty has been imposed on the taxpayer under section 141EE and the use of the suppression tool contributed to the evasion or similar act.

Voluntary disclosure (section 141GB)

Section 141G of the TAA allows certain shortfall penalties payable by a taxpayer to be reduced if the Commissioner concludes that the taxpayer has made a full voluntarily disclosure of the tax shortfall. A disclosure can be either pre-notification (where the disclosure was made before the taxpayer was notified of a pending audit or investigation) or post-notification (where it was made after the taxpayer was notified of the audit or investigation). The level of reduction for a pre-notification disclosure is higher than for a post-notification disclosure.

New section 141GB allows a reduction in an ESS penalty where the taxpayer makes a full voluntary disclosure of all the details relating to the suppression tool. The penalty is reduced by 100 percent for a pre-notification disclosure or 40 percent for a post-notification disclosure. Section 141GB operates in a similar way to section 141G, except that the new section requires disclosure of the details of the suppression tool, rather than a tax shortfall.

Due date for ESS penalty (section 142B)

The due date for shortfall penalty payments is set out in section 142B of the TAA. Section 142B(1)(a) provides that where the tax shortfall is an amount of unpaid tax, the due date for payment of the shortfall penalty shall be not less than 30 days after the date on which a notice of assessment is issued for the penalty (unless a new due date has been set). Payments of all other shortfall penalties are covered by section 142B(1)(b), which provides that the payment is due on the date the Commissioner notifies the taxpayer is the due date for payment of the penalty.

New section 142B(3) clarifies that the due date for payment of the ESS penalty is to be determined under section 142B(1)(a), as if the ESS penalty were an amount of unpaid tax. This is in line with other shortfall penalties. Without this provision, the due date would have to be calculated according to section 142B(1)(b), which would be contrary to the policy intent.

Local authority taxation – dividends and deductions

Sections CW 10, CW 10B, CW 39, DB 41, FM 8, OP 12, OP 30 and RE 2 of the Income Tax Act 2007

The following changes have been introduced to improve the income tax settings for local government:

- Dividends derived by a local authority from a council-controlled organisation (CCO), port company, or energy company are exempt income.
- Dividends derived by a holding company CCO from a CCO with 100% public ownership are exempt income.
- Local authorities are no longer allowed a deduction for charitable or other public benefit gifts made to donee organisations.
- A credit does not arise to a consolidated group's imputation credit account (ICA) for imputation credits attached to a dividend derived by a local authority.

Background

The current tax policy settings for local authorities stem from local government reforms of the late 1980s. Since these reforms, broadly speaking, the tax settings for local authorities have been as follows:

- A local authority is generally tax-exempt on income derived from its core services (for example, rates, parking fees).
- However, a local authority is taxable on all income (for example, rent, management fees and dividends) derived from a CCO, an energy company or a port company (trading subsidiaries of a local authority). A CCO itself is taxable.

The changes introduced improve the consistency of the tax treatment of dividends with other exempt entities and the integrity of local government taxation.

Key features

Dividends

Dividends derived by local authorities are exempt from income tax. This improves the coherence of the tax system by aligning the tax treatment of dividends for local authorities with that of other exempt entities.

Dividends derived by a holding company CCO from a CCO with 100% public ownership are also exempt from tax. This ensures local authorities that use a CCO as a holding company are not disadvantaged.

Corporate gift deduction

A local authority can no longer access the corporate deduction for a charitable or other public benefit gift.

Imputation credit accounts

A local authority that is a member of a consolidated group is not able to make a credit entry to the group's imputation credit account (ICA) for dividends received from a group member. This is consistent with the legislative settings for a local authority not being allowed to maintain an ICA on its own account.

Application date

The amendments apply for the 2022–23 and later income years.

Detailed analysis

Dividends

Before the current amendments, the income of a local authority was exempt from income tax except for income earned from a CCO, a port company or an energy company.

The purpose of taxing income derived by a local authority from these types of entities is to prevent profit shifting from these taxable entities to exempt local authorities. Without taxing income from such entities, it could be extracted tax-free by the local authority charging the entity above-market rental or management fees, which would be deductible to the entity but not taxable to the local authority due to its tax-exempt status.

Taxing local authorities on dividends derived from their CCOs, port companies and energy companies is inconsistent with the tax treatment of other similar entities, such as the Crown and State enterprises, or charities. Inter-corporate dividends paid between New Zealand resident companies are also exempt where there is 100% common ownership. However, this exemption did not apply to dividends derived by local authorities from their CCOs, port companies or energy companies.

As a dividend is not a deductible expense of a CCO, port company or energy company, there are no profit-shifting concerns with treating the dividend as exempt income of the local authority. Therefore, all dividends derived by CCOs, port companies or energy companies have been made exempt from tax. This improves the coherence of the tax system by providing consistency with the rules for other entities.

CCO holding companies

Some local authorities have structures where a CCO is used as a holding company. Dividends derived by a CCO holding company from a wholly-owned subsidiary are exempt income due to the inter-corporate dividend exemption.

Dividends derived by a holding company CCO (where a local authority holds 100% of the voting interests in the CCO) from a CCO, port company or energy company with no non-public ownership have also been made exempt from income tax. To be exempt, all of the voting interests in the payer of the dividend must be held by:

- two or more local authorities, or
- a combination of one or more Ministers of the Crown, on behalf of the Crown, and one or more local authorities.

This ensures local authorities that use a CCO as a holding company are not disadvantaged. Dividends from CCOs that are jointly owned by multiple local authorities, or a mix of local authorities and the Crown, to a holding company CCO are exempt from tax.

Dividends derived by a CCO holding company from a CCO with some non-public ownership remain subject to tax. Exempting these dividends would be an integrity risk and could result in taxable income being streamed to the exempt local authority part-owner and capital gains to the taxable non-public part-owner. That is, this structure could be used to shelter profits from tax. This situation could also result in the streaming of imputation credits to the non-public part-owner.

Corporate gift deductions

Changes to the application of the corporate gift deduction provision from the 2008–09 income year allowed companies a deduction for charitable donations to donee organisations, subject to the deduction not exceeding the company's net income. It was not clear that specific consideration was given at the time to whether local authorities should have access to this provision. However, as current law treats a local authority as a company, the corporate gift deduction was available to a local authority, even though it was not intended to be available for primarily exempt entities like local authorities.

The corporate gift deduction tax rule can distort the spending decisions of local authorities by providing a deduction for some donations made by local authorities as part of their ordinary community support function. The tax system should not incentivise a local authority to outsource its community support function to a third party, through the corporate gift deduction, instead of directly conducting that activity (which would not give rise to a deduction).

Before these amendments, local authorities could offset corporate gift deductions against dividend income from their CCOs. This resulted in imputation credits attached to those dividends being unused, and these were then converted to a tax loss and used to reduce the taxable income of the local authority's CCOs under the loss grouping rules. This arrangement could result in local authorities transferring the benefit of their exempt status to their taxable CCOs, contrary to the policy intent.

A local authority is no longer able to access the corporate deduction for a charitable or other public benefit gift.

Imputation credit accounts

A local authority is not allowed to maintain an imputation credit account (ICA). However, local authorities in consolidated tax groups could previously credit imputation credits attached to dividends it derives from a CCO to the group's ICA. These credits were then available for use by CCOs within the group.

The amendments ensure that a local authority that is part of a consolidated group is not able to make such credit entries to the group's ICA. This means that all local authorities are treated similarly for imputation credit purposes.

Fair dividend rate foreign currency hedges

Sections EM1, EM 2, EM 3, EM 4, EM 5, EM 5B, EM 6, EM 7, EM 8 of the Income Tax Act 2007

Technical amendments have been made to the rules for hedging of foreign currency movement in Australian non-attributing shares and attributing FDR method interests (the FDR FX hedges rules) in subpart EM of the Income Tax Act 2007 to improve their functionality from a practical perspective and to reduce compliance costs for investors with large numbers of hedges.

Background

When a person invests into an offshore asset, changes in the exchange rate can affect the value of the person's investment when it is converted back to New Zealand dollars (NZD). Therefore, many people who invest offshore enter arrangements to protect themselves from exchange rate changes. These arrangements are referred to as foreign currency hedges. Changes in the hedge's value due to movements in the exchange rate are intended to offset changes in the value of the hedged foreign assets due to those same exchange rate movements. This allows an investor to gain exposure to the economic performance of the hedged asset only, without a corresponding exposure to the currency that asset is denominated in.

A tax mismatch arises when a person hedges an investment taxed under the fair dividend rate (FDR) method. This is because, under the FDR method, changes in an asset's value are not taxed. Instead, FDR assets are deemed to return income equal to five percent of the asset's market value at the start of the period. Conversely, changes in a hedge's value are fully taxed under the financial arrangements rules. This mismatch in tax treatment means that a hedge that is effective in removing the impact of unexpected currency fluctuations before tax ceases to be effective after tax.

While taxpayers can attempt to hedge effectively on an after-tax basis, this is often not practical, especially when the taxpayer is taxed based on its investors' marginal rates (for example, portfolio investment entities (PIEs), which are prevalent in the managed funds industry). It also increases the hedging transaction costs for an investor.

The FDR FX hedges rules in subpart EM of the Income Tax Act 2007 were introduced in 2013 with the policy intent of eliminating this mismatch in the tax treatment of foreign currency hedges and hedged offshore assets. The rules are optional and allow a taxpayer to calculate tax on a foreign currency hedge on the same basis as the hedged offshore asset – by imputing taxable income of five percent of a hedge's opening market value.

The FDR FX hedges rules were designed both to ensure that FDR treatment is not available for currency speculation or hedges of non-eligible assets and to prevent manipulation. These risks were addressed by including appropriate restrictions in the rules. However, these restrictions imposed burdensome compliance costs on taxpayers with large numbers of hedges, and this resulted in the rules being unfeasible to apply. Further, some practical issues had been identified that needed to be addressed.

Amendments have therefore been made to the FDR FX hedges rules to reduce compliance costs for investors with large numbers of hedges and to improve their functionality.

Note, this only discusses the amendments made to the rules by the Taxation (Annual Rates for 2021-22, GST and Remedial Matters) Act 2022. Please refer to *Tax Information Bulletin Vol 25, No 9*, October 2013, pp 47-51 for a full discussion of the rules.

Key features

The amendments to the FDR FX hedges rules:

- modify the second hedge-by-hedge method for determining the extent to which foreign currency hedges can be subject to FDR treatment (FDR hedge portions) in section EM 5

NEW LEGISLATION

- specify how the hedge-by-hedge methods for determining FDR hedge portions apply to a hedge of a hedge[2]
- update the quarterly testing timing requirements for the hedge-by-hedge methods
- introduce an optional new method (the portfolio method) for determining FDR hedge portions to allow taxpayers with significant hedging activity to apply the rules from a practical perspective
- allow eligible hedges to continue to be subject to FDR treatment when there is a transfer of ownership of the assets of a fund or investor class
- allow eligible hedges to have no NZD leg, subject to certain requirements
- introduce an optional look-through rule to allow taxpayers who hedge indirectly owned eligible assets to apply the rules
- specify how the formula for calculating FDR income from eligible hedges is applied to hedges entered and settled within a valuation period, and
- update the definition of "non-eligible assets" by excluding from the definition eligible hedges, certain foreign cash assets, and New Zealand securities listed on foreign exchanges and denominated in foreign currencies to the extent that no foreign currency hedges have been entered to hedge these assets.

Application date

The amendments apply from 1 April 2022.

Detailed analysis

Amendments have been made to the FDR FX hedges rules to reduce compliance costs for taxpayers that enter large numbers of hedges and to improve the functionality of the rules from a practical perspective. The specific changes are detailed below.

Modification to second hedge-by-hedge method (sections EM 5(9)–(10D))

Section EM 5 includes two alternative methods that a taxpayer can choose from to determine the maximum[3] FDR hedge portion on a hedge-by-hedge basis. The FDR hedge portion is the amount of an eligible foreign currency hedge that is subject to FDR treatment. Both these methods ensure the amount of a taxpayer's eligible hedges that can be subject to FDR treatment does not exceed the value of their hedged eligible assets.

The second of these two hedge-by-hedge methods for calculating FDR hedge portions is now contained in sections EM 5(9) to EM 5(10D). The amended method now ensures that its application does not always result in an FDR hedge portion of less than 100% when a taxpayer's non-eligible assets are already fully hedged.

The second hedge-by-hedge method uses the following formula in section EM 5(9) to calculate the maximum FDR hedge portion for a person's eligible hedge (the calculation hedge):

$$\text{FDR gross amount} \times \left(\frac{\text{apportioned current hedge amount}}{\text{calculation hedge amount}} \right)$$

The result of this calculation, expressed as a percentage, is the maximum (or minimum for a hedge of a hedge) FDR hedge portion for the person's eligible hedge.

All calculations for this method must be performed in NZD. It can be broken down into three steps.

Step 1 – calculate the apportioned current hedge amount

The first step is to calculate the "apportioned current hedge amount". If the apportioned current hedge amount is zero, the FDR hedge portion will be zero and no further action is required.

The purpose of this step is to allocate a hedge to non-eligible assets first.

[2] A hedge of a hedge is a hedge that effectively cancels out another hedge of a foreign currency to NZD. A hedge of a hedge can also be referred to as a negative hedge.

[3] When the methods are applied to a hedge of a hedge, an amendment has been made so that they now calculate the minimum FDR hedge portion. This amendment is discussed below.

Under section EM 5(10D), the "apportioned *current hedge amount*" is one of the following amounts:

- If the calculation hedge is not a hedge of a hedge, or is a hedge of a hedge and the second bullet point below does not apply, then the apportioned current hedge amount is the lesser of the following amounts:
  - the amount of foreign currency hedged by the calculation hedge, and
  - the amount of foreign currency that is hedged by a person's hedges including the calculation hedge less the amount of foreign currency that is hedged by a person's FDR hedge portions excluding the calculation hedge less the total market value of a person's non-eligible assets, treating a negative result as zero.
- If the calculation hedge is a hedge of a hedge and the amount of foreign currency that is hedged by a person's FDR hedge portions excluding the calculation hedge plus the calculation hedge (treating a hedge of a hedge as a negative amount) equals less than zero, then the apportioned current hedge amount is the negative of the amount of foreign currency that is hedged by a person's FDR hedge portions excluding the calculation hedge.

Example 17: Apportioned current hedge amount of zero because hedge is allocated to non-eligible assets

At the beginning of 1 April 2023, Sterling Cooper Fund (Sterling Cooper) has a portfolio of:

- US$35,000 of shares in US-based companies (eligible assets, worth NZ$70,000)
- US$15,000 of share options (non-eligible assets, worth NZ$30,000)
- A hedge of USD to NZD, with a foreign amount hedged of US$36,000 (equivalent to NZ$72,000). This hedge has an FDR hedge portion of 100%.

On 1 April 2023, Sterling Cooper enters into an eligible hedge for US dollars, with a foreign amount hedged of US$15,000 (equivalent to NZ$30,000).

The second hedge-by-hedge method is applied to the hedge entered on 1 April 2023 by Sterling Cooper below.

First step

The apportioned current hedge amount is NZ$0 as it equals the lesser of:

- the amount of foreign currency hedged by the calculation hedge (NZ$30,000), and
- the amount of foreign currency that is hedged (including by the calculation hedge) less the amount of foreign currency that is hedged by Sterling Cooper's FDR hedge portions excluding the calculation hedge less the total market value of Sterling Cooper's non-eligible assets (NZ$102,000 – NZ$72,000 – NZ$30,000 = NZ$0).

The apportioned current hedge amount is zero, so the FDR hedge portion will be zero and no further action is required.

Step 2 – calculate the FDR gross amount

The second step is to calculate the "FDR gross amount". This is the portion of the apportioned current hedge amount that hedges eligible assets and is therefore eligible for FDR treatment.

Under sections EM 5(10B) and (10C), the "FDR gross amount" is the lesser of 1 and the amount resulting from the following formula:

$$\frac{(1.05 \text{ x eligible currency assets = FDR hedge amount})}{\text{apportioned current hedge amount}}$$

Where:

Eligible currency assets is the total market value of a person's eligible assets owned directly and, if the person chooses and is an investor in a multi-rate PIE (either directly or indirectly through one or more multi-rate PIEs), their interest in the eligible assets that are owned by the multi-rate PIE.

FDR hedges amount is the amount of foreign currency hedged by a person's FDR hedge portions but excluding the portion for the calculation hedge.

Apportioned current hedge amount is the amount calculated under the first step.

If the denominator is zero (that is, the apportioned current hedge amount), the formula result is to be treated as zero.

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Step 3 – convert the FDR gross amount into a portion of the calculation hedge

The third step is to convert the FDR gross amount into a portion of the calculation hedge by applying the formula in section EM 5(9):

$$\text{FDR gross amount} \times \left(\frac{\text{apportioned current hedge amount}}{\text{calculation hedge amount}} \right)$$

Where:

FDR gross amount is the amount calculated for the second step.

Apportioned current hedge amount is the amount calculated for the first step.

Calculation hedge amount is the amount of foreign currency that is hedged by the current hedge.

The result of this step, expressed as a percentage, is the maximum (or minimum for a hedge of a hedge) FDR hedge portion for a person's hedge. A negative percentage must be treated as zero.

Example 18: Hedging on hand not subject to FDR treatment equals non-eligible assets, new hedging equals eligible assets4

At the beginning of 1 June 2023, Sterling Cooper Fund (Sterling Cooper) has a portfolio of:

- US$35,000 of shares in US-based companies (eligible assets, worth NZ$70,000)
- US$15,000 of share options (non-eligible assets, worth NZ$30,000)
- A hedge of USD to NZD, with a foreign amount hedged of US$15,000 (equivalent to NZ$30,000). This hedge has an FDR hedge portion of zero.

On 1 June 2023, Sterling Cooper enters into an eligible hedge for US dollars, with a foreign amount hedged of US$35,000 (equivalent to NZ$70,000). The second hedge-by-hedge method is applied to this hedge below.

First step

The apportioned current hedge amount is NZ$70,000 as it equals the lesser of:

- the amount of foreign currency hedged by the calculation hedge (NZ$70,000), and
- the amount of foreign currency that is hedged (including by the calculation hedge) less the amount of foreign currency that is hedged by Sterling Cooper's FDR hedge portions excluding the calculation hedge less the total market value of Sterling Cooper's non-eligible assets (NZ$100,000 – NZ$0 – NZ$30,000 = $70,000).

Second step

The FDR gross amount is 1 as it equals the lesser of 1 and the amount under the formula:

$$\frac{(1.05 \times \text{eligible currency assets} = \text{FDR hedge amount})}{\text{apportioned current hedge amount}}$$

$$\frac{(1.05 \times \text{NZ\$70,000} - 0)}{\text{NZ\$70,000}} = 1.05$$

Third step

Applying the formula in section EM 5(9):

$$\text{FDR gross amount} \times \frac{\text{apportioned current hedge amount}}{\text{calculation hedge amount}}$$

$$1 \times \frac{\text{NZ\$70,000}}{\text{NZ\$70,000}} = 100\%$$

This means that the maximum FDR hedge portion that can be applied to the hedge of US$35,000 is 100%.

[4] In examples 18 to 21, the fund only holds foreign assets denominated in the same foreign currency. This has been done for simplicity purposes and to highlight the modifications to the second hedge-by-hedge method. When applying this method in practice, the formulae in the second hedge-by-hedge method are not applied on a currency-by-currency basis – that is, they are applied taking into account the values of all foreign currency assets and hedges, converted to New Zealand dollars.

Example 19: Hedging on hand not subject to FDR treatment is less than non-eligible assets

At the beginning of 1 August 2023, Sterling Cooper Fund (Sterling Cooper) has a portfolio of:

- US$35,000 of shares in US-based companies (eligible assets, worth NZ$70,000)
- US$15,000 of share options (non-eligible assets, worth NZ$30,000)
- A hedge of USD to NZD, with a foreign amount hedged of US$10,000 (equivalent to NZ$20,000). This hedge has an FDR hedge portion of zero.

On 1 August 2023, Sterling Cooper enters into an eligible hedge for US dollars, with a foreign amount hedged of US$40,000 (equivalent to NZ$80,000). The second hedge-by-hedge method is applied to this hedge below.

First step

The apportioned current hedge amount is NZ$70,000 as it equals the lesser of:

- the amount of foreign currency hedged by the calculation hedge (NZ$80,000), and
- the amount of foreign currency that is hedged (including by the calculation hedge) less the amount of foreign currency that is hedged by Sterling Cooper's FDR hedge portions excluding the calculation hedge less the total market value of Sterling Cooper's non-eligible assets (NZ$100,000 – NZ$0 – NZ$30,000 = $70,000).

Second step

The FDR gross amount is 1 as it equals the lesser of 1 and the amount under the formula:

$$\frac{(1.05 \text{ x eligible currency assets} = \text{FDR hedge amount})}{\text{apportioned current hedge amount}}$$

$$\frac{(1.05 \text{ x NZ\$70,000} - 0)}{\text{NZ\$70,000}} = 1.05$$

Third step

Applying the formula in section EM 5(9):

$$\text{FDR gross amount} \quad \text{x} \quad \frac{\text{apportioned current hedge amount}}{\text{calculation hedge amount}}$$

$$1 \quad \text{x} \quad \frac{\text{NZ\$70,000}}{\text{NZ\$80,000}} = 87.5\%$$

This means that the maximum FDR hedge portion that can be applied to the hedge of US$40,000 is 87.5%.

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Example 20: Hedging on hand not subject to FDR treatment is less than non-eligible assets, FDR hedge portions on hand

At the beginning of 1 October 2023, Sterling Cooper Fund (Sterling Cooper) has a portfolio of:

- US$35,000 of shares in US-based companies (eligible assets, worth NZ$70,000)
- US$15,000 of share options (non-eligible assets, worth NZ$30,000)
- A hedge of USD to NZD, with a foreign amount hedged of US$20,000 (equivalent to NZ$40,000). This hedge has an FDR hedge portion of 50%.

On 1 October 2023, Sterling Cooper enters into an eligible hedge for US dollars, with a foreign amount hedged of US$30,000 (equivalent to NZ$60,000). The second hedge-by-hedge method is applied to this hedge below.

First step

The apportioned current hedge amount is NZ$50,000 as it equals the lesser of:

- the amount of foreign currency hedged by the calculation hedge (NZ$60,000), and
- the amount of foreign currency that is hedged (including by the calculation hedge) less the amount of foreign currency that is hedged by Sterling Cooper's FDR hedge portions excluding the calculation hedge less the total market value of Sterling Cooper's non-eligible assets (NZ$100,000 – NZ$20,000 – NZ$30,000 = $50,000).

Second step

The FDR gross amount is 1 as it equals the lesser of 1 and the amount under the formula:

$$\frac{(1.05 \text{ x eligible currency assets = FDR hedge amount})}{\text{apportioned current hedge amount}}$$

$$\frac{(1.05 \text{ x NZ\$70,000–NZ\$20,000})}{\text{NZ\$50,000}} = 1.07$$

Third step

Applying the formula in section EM 5(9):

$$\text{FDR gross amount} \quad \text{x} \quad \frac{\text{apportioned current hedge amount}}{\text{calculation hedge amount}}$$

$$1 \quad \text{x} \quad \frac{\text{NZ\$50,000}}{\text{NZ\$60,000}} = 83.33\%$$

This means that the maximum FDR hedge portion that can be applied to the hedge of US$30,000 is 83.33%.

Example 21: Hedging on hand not subject to FDR treatment equals non-eligible assets, new hedging exceeds 105% of eligible assets

At the beginning of 1 December 2023, Sterling Cooper Fund (Sterling Cooper) has a portfolio of:

- US$35,000 of shares in US-based companies (eligible assets, worth NZ$70,000)
- US$15,000 of share options (non-eligible assets, worth NZ$30,000)
- A hedge of USD to NZD, with a foreign amount hedged of US$15,000 (equivalent to NZ$30,000). This hedge has an FDR hedge portion of zero.

On 1 December 2023, Sterling Cooper enters into an eligible hedge for US dollars, with a foreign amount hedged of US$37,500 (equivalent to NZ$75,000). The second hedge-by-hedge method is applied to this hedge below.

First step

The apportioned current hedge amount is NZ$75,000 as it equals the lesser of:

- the amount of foreign currency hedged by the calculation hedge (NZ$75,000), and
- the amount of foreign currency that is hedged (including by the calculation hedge) less the amount of foreign currency that is hedged by Sterling Cooper's FDR hedge portions excluding the calculation hedge less the total market value of Sterling Cooper's non-eligible assets (NZ$105,000 – 0 – NZ$30,000 = NZ$75,000).

Second step

The FDR gross amount is 0.98 as it equals the lesser of 1 and the amount under the formula:

$$\frac{(1.05 \text{ x eligible currency assets = FDR hedge amount})}{\text{apportioned current hedge amount}}$$

$$\frac{(1.05 \text{ x NZ\$70,000–0})}{\text{NZ\$75,000}} = 0.98$$

Third step

Applying the formula in section EM 5(9):

$$\text{FDR gross amount} \quad \text{x} \quad \frac{\text{apportioned current hedge amount}}{\text{calculation hedge amount}}$$

$$0.98 \quad \text{x} \quad \frac{\text{NZ\$75,000}}{\text{NZ\$75,000}} = 98\%$$

This means that the maximum FDR hedge portion that can be applied to the hedge of US$37,500 is 98%.

Hedge of a hedge (sections EM 5(1), (4) and (9))

The two hedge-by-hedge methods for calculating FDR hedge portions in section EM 5 have been amended so that they work as intended when applied to a hedge of a hedge. These two methods now identify the minimum, rather than the maximum, FDR hedge portion when applied to a hedge of a hedge.

A taxpayer can choose an FDR hedge portion for a hedge of a hedge between the minimum identified by the method applied and 100%. The purpose of identifying the minimum FDR hedge portion is to require a taxpayer's total FDR hedge portions to be reduced by a new hedge of a hedge where the existing FDR hedge portions on hand (not counting the new hedge of a hedge) exceed 105% of eligible assets.

When applying these methods to a hedge of a hedge, the hedge of a hedge should be treated as a negative amount in the formulae.

If the FDR hedge portion calculated is less than zero, this must be treated as a minimum FDR hedge portion of 0%.

Example 22: Minimum FDR hedge portion results in combined FDR hedge portions equal to 105% of eligible assets

At the beginning of 1 June 2023, Dunder Mifflin Fund (Dunder Mifflin) has a portfolio of:

- US$45,000 of shares in US-based companies (eligible assets, worth NZ$90,000)
- US$5,000 of share options (non-eligible assets, worth NZ$10,000)
- A hedge of USD to NZD, with a foreign amount hedged of US$50,000 (equivalent to NZ$100,000). This hedge has an FDR hedge portion of 90% (calculated under the second hedge-by-hedge method). Therefore, the total FDR hedge portions coverage of eligible assets is 100%.

By the beginning of 10 June 2023, the value of Dunder Mifflin's US shares has dropped to US$35,000 (NZ$70,000). To adjust the foreign currency hedge exposure as result of this drop, Dunder Mifflin enters into a hedge of a hedge for US$10,000 (NZ$20,000) on 10 June 2023. Applying the second hedge-by-hedge method in sections EM 5(9)–(10D), the minimum FDR hedge portion for this hedge of a hedge is calculated as follows:

First step

The apportioned current hedge amount is –NZ$20,000 as it equals the lesser of:

- the amount of foreign currency hedged by the calculation hedge (–NZ$20,000), and
- the amount of foreign currency that is hedged (including by the calculation hedge) less the amount of foreign currency that is hedged by Dunder Mifflin's FDR hedge portions excluding the calculation hedge less the total market value of Dunder Mifflin's non-eligible assets, treating a negative result as zero (NZ$80,000 – NZ$90,000 – NZ$10,000 = –NZ$20,000, which is treated as NZ$0).

(Section EM 10D(b) does not apply because the amount of foreign currency that is hedged by Dunder Mifflin's FDR hedge portions excluding the calculation hedge plus the calculation hedge (treating a hedge of a hedge as a negative amount) does not equal less than zero.)

Second step

The FDR gross amount is 0.825 as it equals the lesser of 1 and the amount under the formula:

$$\frac{(1.05 \times NZ\$70{,}000 - NZ\$90{,}000)}{-NZ\$20{,}000} = 0.825$$

Third step

Applying the formula in section EM 5(9):

$$0.825 \times \frac{-NZ\$20{,}000}{-NZ\$20{,}000} = 82.5\%$$

This means that the minimum FDR hedge portion that can be applied to the hedge of a hedge of –US$10,000 is 82.5%. Dunder Mifflin can choose an FDR hedge portion for the hedge of a hedge from 82.5% to 100%.

A minimum FDR hedge portion of 82.5% for the hedge of a hedge (–NZ$20,000 x 82.5% = –NZ$16,500) would result in the total FDR hedge portions equalling 105% of eligible assets ((NZ$90,000 existing FDR hedge portion on hand – NZ$16,500 FDR hedge portion for the new hedge of a hedge) / NZ$70,000 of eligible assets = 1.05) which is the maximum allowed.

Example 23: Minimum FDR hedge portion of 0%

At the beginning of 1 October 2023, Ark Investment Fund (Ark) has a portfolio of:

- US$45,000 of shares in US-based companies (eligible assets, worth NZ$90,000)
- US$5,000 of share options (non-eligible assets, worth NZ$10,000)
- A hedge of USD to NZD, with a foreign amount hedged of US$30,000 (equivalent to NZ$60,000). This hedge has an FDR hedge portion of 100% (calculated under the second hedge-by-hedge method).

On 10 October 2023, Ark enters into a hedge of a hedge for US$10,000 (NZ$20,000). Applying the second hedge-by-hedge method in sections EM 5(9)–(10D), the minimum FDR hedge portion for this hedge of a hedge is calculated as follows:

First step

The apportioned current hedge amount is −NZ$20,000 as it equals the lesser of:

- the amount of foreign currency hedged by the calculation hedge (−NZ$20,000), and
- the amount of foreign currency that is hedged (including by the calculation hedge) less the amount of foreign currency that is hedged by Ark's FDR hedge portions excluding the calculation hedge less the total market value of Ark's non-eligible assets, treating a negative result as zero (NZ$40,000 – NZ$60,000 – NZ$10,000 = −NZ$30,000, which is treated as NZ$0).

Second step

The FDR gross amount is −1.725 as it equals the lesser of 1 and the amount under the formula:

$$\frac{(1.05 \times NZ\$90{,}000 - NZ\$60{,}000)}{-NZ\$20{,}000} = -1.725$$

Third step

Applying the formula in section EM 5(9):

$$-1.725 \times \frac{-NZ\$20{,}000}{-NZ\$20{,}000} = -172.5\%, \text{ treated as } 0\%$$

This means that the minimum FDR hedge portion that can be applied to the hedge of a hedge of −US$10,000 is 0%. Ark can choose an FDR hedge portion for the hedge of a hedge from 0% to 100%.

Quarterly testing (section EM 7)

Under section EM 7, a taxpayer that uses one of the hedge-by-hedge methods must calculate a quarterly FDR hedging ratio to ensure that their FDR hedge portions for eligible hedges remain appropriate. This requirement has been amended to allow taxpayers to choose the day in a quarter on which the testing is performed, provided the testing is done on the same day of each quarter in an income year.

If a taxpayer chooses to change the calculation day for an income year, this may increase or decrease the number of days between the quarterly testing for the last quarter of the income year before the change and the quarterly testing for the first quarter in the income year of the change.

The portfolio method (section EM 5B)

Where taxpayers hold a significant number of hedges at any point in time, and they turnover hedges regularly, the requirement to apply the rules on a hedge-by-hedge basis can impose burdensome compliance costs that result in the rules being impractical to apply.

To address this issue, section EM 5B introduces a new method for calculating FDR hedge portions for eligible hedges on a portfolio basis. This method sits alongside the two hedge-by-hedge methods, and taxpayers have the option of selecting their preferred method (subject to eligibility criteria detailed below).

The quarterly testing requirements in section EM 7 do not apply to taxpayers using the portfolio method. This is because FDR hedge portions for all eligible hedges are reset periodically under this method.

Eligibility criteria and elections (sections EM 4(6) and (7))

Only taxpayers with a unit valuation period of one month or less for section EX 53 can elect to use the portfolio method. This election can be made at any time. The exception to this is a re-election, which may only be made after 12 months have passed since a previous election to use the portfolio method was revoked.

Once an election to use the portfolio method has been made, taxpayers are required to apply the method for a minimum of 24 months to all existing eligible hedges on hand (regardless of whether they are subject to an existing hedge-by-hedge method) and any hedges entered into post-election.

The Commissioner may agree to reduce the election and re-election time periods prospectively when there are genuine commercial reasons that require a change in method for calculating FDR hedge portions. Where the Commissioner agrees, taxpayers can revoke an election to apply the portfolio method within 24 months or re-elect within 12 months. Genuine commercial reasons that warrant a change in method include where a taxpayer changes service provider and the new service provider only supports one of the methods for calculating FDR hedge portions.

Periodic basis for calculating FDR hedge portions (section EM 5B(3))

Taxpayers can elect their own periodic basis for calculating FDR hedge portions, up to a maximum period of one month. The periodic basis chosen must be applied for an income year.

Portfolio FDR hedge portion (sections EM 5B(1) and EM 5B(3))

The FDR hedge portion must be calculated at the start of each period and applied to the entire portfolio of eligible hedges for that period.

Where a taxpayer enters into a new eligible hedge within a period, the FDR hedge portion calculated for the portfolio at the start of the period applies to that hedge until the end of the period, at which point the FDR hedge portion calculated for the portfolio for the next period applies.

Formulae (sections EM 5B(2) and EM 5B(4)–(7))

The approach for calculating FDR hedge portions under this method involves two formulae, with the portfolio FDR hedge portion being set at the lower of the two results. This is different to the hedge-by-hedge methods, which calculate the maximum (or minimum for a hedge of a hedge). Setting FDR hedge portions based on the results of the formulae under the portfolio method is intended to address concerns that taxpayers could otherwise gain a tax advantage by choosing the tax treatment of hedges on a periodic basis.

The purpose of the first formula is to allocate hedges to non-eligible assets first, while the second formula is intended to ensure that the amount of hedging subject to FDR treatment does not exceed 105% of eligible assets.

All amounts must be calculated in NZD.

The first formula is:

$$1 - \left(\frac{\text{non-eligible assets}}{\text{portfolio hedges amount}} \right)$$

Where:

Non-eligible assets is the total market value of a person's foreign currency assets excluding eligible assets, certain cash assets, eligible hedges and certain New Zealand securities denominated in a foreign currency.

Portfolio hedges amount is the total amount of foreign currency that is hedged by a person's hedges.

The second formula is:

$$\frac{(1.05 \text{ x eligible assets})}{\text{portfolio hedges amount}}$$

Where:

Eligible assets is the total market value of a person's eligible assets owned directly and, if the person chooses and is an investor in a multi-rate PIE (either directly or indirectly through one or more multi-rate PIEs), their interest in the eligible assets that are owned by the multi-rate PIE.

Portfolio hedges amount is as above.

Example 24: The portfolio method

Gekko & Co Fund (Gekko) is a daily unit valuer who elects to use the portfolio method and chooses a periodic basis of one month.

At the beginning of 1 September 2023,[5] Gekko holds:

- UK£25,000 of shares in UK-based companies (eligible assets, worth NZ$50,000)
- UK£10,000 of UK bonds (non-eligible assets, worth NZ$20,000)
- Hedges of GBP to NZD with a foreign amount hedged of UK£30,000 (equivalent to NZ$60,000).

Gekko's FDR hedge portion for September 2023 is the lower of the amounts calculated under the following two formulae:

First formula

$$1 - \frac{\text{NZ\$20,000}}{\text{NZ\$60,000}} = 67\%$$

Second formula

$$\frac{(1.05 \times \text{NZ\$50,000})}{\text{NZ\$60,000}} = 87.5\%$$

The FDR hedge portion for Gekko's hedges for September 2023 is therefore 67%. This FDR hedge portion is applied to **all** hedges on hand at the start of the month. It also applies to any new hedges or hedges of hedges entered into within September 2023, regardless of any changes in the holdings of eligible or non-eligible assets.

At the beginning of 1 October 2023, Gekko holds:

- UK£15,000 of shares in UK-based companies (eligible assets, worth NZ$30,000)
- UK£30,000 of UK bonds (non-eligible assets, worth NZ$60,000)
- Hedges of GBP to NZD with a foreign amount hedged of UK£40,000 (equivalent to NZ$80,000).

Gekko's FDR hedge portion at the start of October 2023 is calculated as the lower of the following two amounts:

First formula

$$1 - \frac{\text{NZ\$60,000}}{\text{NZ\$80,000}} = 25\%$$

Second formula

$$\frac{(1.05 \times \text{NZ\$30,000})}{\text{NZ\$80,000}} = 39.375\%$$

The portfolio hedge portion for Gekko for October 2023 is therefore 25%. This portfolio FDR hedge portion is applied to **all** hedges on hand at the start of the month. It also applies to any new hedges or hedges of hedges entered into within October 2023, regardless of any changes in the holdings of eligible or non-eligible assets.

Transfer of eligible hedges (sections EM 3(1)(d), EM 4(2), (3) and (5) and EM 5(3), (4) and (9))

The FDR FX hedges rules have been amended so that they can be applied to eligible hedges that are acquired via a transfer between funds or sub funds. Before these amendments, it was not clear whether the rules could be applied in these circumstances because an eligible hedge was required to have a fair value of zero when first entered into. An election to apply the rules also had to be made before a hedge was first entered into, and FDR hedge portion calculations had to be performed when a hedge was first entered into.

These issues have been addressed by amending the definition of an "eligible hedge" to include a hedge that is entered into or acquired at its fair value. In addition, elections for the rules to apply are now allowed to be made before a hedge is first entered into or acquired, and FDR hedge portion calculations can be performed when an eligible hedge is first entered into *or acquired*.

[5] Note, for practical purposes the opening values on 1 September 202X are the closing values on 31 August 202X

Certain eligible hedges may have no NZD leg (section EM 3(2))

Taxpayers with large portfolios of hedges often rebalance their hedging of eligible assets denominated in two foreign currencies to NZD by hedging one foreign currency to the other – that is, by entering a hedge with no NZD leg. The rules have been amended to allow eligible hedges to have no NZD leg provided these hedges are entered into to adjust the hedging position of existing hedges on hand that have one leg in NZD.

This change to the eligible hedge requirements only applies to taxpayers that use the second hedge-by-hedge method or the new portfolio method for calculating FDR hedge portions. It does not apply when the first hedge-by-hedge method is used because amounts must be calculated in the calculation hedge's foreign currency for that method, rather than converted to NZD, and this is not practical where a hedge has two legs in a foreign currency.

Optional look-through rule (sections EM 5(5) and (10C), EM 5B(7) and EM 8)

An optional look-through rule has been introduced to allow taxpayers to include indirectly owned eligible assets in their calculation of eligible assets in certain circumstances.

This optional rule is available to "qualifying hedge funds", as defined in section EM 8. These are taxpayers that invest in a multi-rate PIE, either directly or indirectly through one or more multi-rate PIEs, and have income from eligible assets held by the multi-rate PIE attributed to them.

In applying this new look-through rule, a taxpayer will need to determine the value of their interest in the eligible assets held by the multi-rate PIE by reference to the proportion of the units they hold in the PIE or investor class. A taxpayer will therefore need to have access to sufficient information from the multi-rate PIE to comply with the requirements if they wish to apply this optional rule.

Hedges entered and settled within a valuation period (section EM 6)

Section EM 6 calculates the FDR income or expenditure from eligible hedges. The formula in section EM 6 has been amended to ensure that an amount of income or expenditure is calculated for hedges that are entered into and settled within a valuation period.

The amended formula has added the items 'period gain' and 'period loss' as follows:

$$\frac{(\text{FDR portions' value} + \textit{period gain} - \textit{period loss}) \times 0.05 \times \text{valuation period}}{\text{days in the year}}$$

Where:

Period gain is the net gain multiplied by the FDR hedge portion for relevant eligible hedges that are entered into and settled within the preceding valuation period.

Period loss is the net loss multiplied by the FDR hedge portion for relevant eligible hedges that are entered into and settled within the preceding valuation period.

As a result of this change, the net gain or loss on the FDR hedge portion of eligible hedges that are entered and settled within a preceding valuation period is now subject to FDR treatment.

Example 25: Hedge entered and settled within valuation period

M. Burns Asset Management Fund (Burns) has a one-month valuation period. Its hedging activity during March 2023 is:

- On 4 March 2023, it enters into an eligible hedge for US$100,000 (equivalent to NZ$140,000 at acquisition). This hedge has an FDR hedge portion of 50%.
- On 15 March 2023, it enters into an eligible hedge for US$50,000 (equivalent to NZ$75,000 at acquisition). This hedge has an FDR hedge portion of 100%.
- On 27 March 2023, the hedge for US$50,000 is settled. At settlement, US$50,000 is equivalent to NZ$70,000.
- At the end of 31 March 2023, the hedge entered into on 4 March 2023 is still on hand and US$100,000 is equivalent to NZ$125,000. There are no other hedges on hand.

Applying the updated formula in section EM 6, Burns' FDR income from its eligible hedges on 1 April 2023 is:

$$\frac{((NZ\$125{,}000 \times 50\%) + 0 - NZ\$5{,}000) \times 0.05 \times 30}{365} = \$236$$

Period gain is zero on 1 April 2023 because there was no net gain on the hedge of US$50,000 that was entered and settled within the preceding valuation period.

Period loss is NZ$5,000 on 1 April 2023 (being (NZ$70,000 – NZ$75,000) × the 100% FDR hedge portion) because there was a net loss of $5,000 on the hedge of US$50,000 that was entered and settled within the preceding valuation period.

Definition of "non-eligible assets" (section EM 8)

The definition of "non-eligible assets" in section EM 8 has been amended to improve the accuracy of FDR hedge portion calculations. Eligible foreign currency hedges are now excluded from the definition of "non-eligible assets". Also excluded are New Zealand securities listed on a foreign exchange and denominated in a foreign currency to the extent that no foreign currency hedge has been entered into to hedge the shares.

Certain foreign currency cash assets are also excluded from non-eligible assets. There are two different approaches for taxpayers to calculate this exclusion – the *de minimis cash exclusion* and the *relational cash exclusion*. The de minimis cash exclusion approach is the default approach. However, either approach can be applied each time an FDR hedge portion is being calculated (but only one approach can be applied per FDR hedge portion calculation).

De minimis cash exclusion approach

Under the de minimis approach, foreign currency cash assets totalling less than 5% of the market value of eligible assets are excluded from non-eligible assets. This means that if a taxpayer's foreign currency cash assets equal less than 5% of eligible assets when calculating an FDR hedge portion, all the foreign currency cash assets will be excluded from non-eligible assets. If a taxpayer's foreign currency cash assets equal 5% or more of eligible assets, then the maximum allowed (that is, 4.99%) will be excluded.

Example 26: Foreign currency cash assets equal less than 5% of eligible assets

At the beginning of 1 November 2023, Basil US Equity Fund (Basil) has a portfolio of:

- US$50,000 of shares in US-based companies (eligible assets, worth NZ$100,000)
- US$2,000 of foreign currency cash assets (worth NZ$4,000)

At the beginning of 1 November 2023, Basil's foreign currency cash assets equal less than 5% of its eligible assets, so all NZ$4,000 of the foreign currency cash assets are excluded from non-eligible assets under the de minimis approach.

Example 27: Foreign currency cash assets equal more than 5% of eligible assets

At the beginning of 1 November 2023, Thyme US Equity Fund (Thyme) has a portfolio of:

- US$50,000 of shares in US-based companies (eligible assets, worth NZ$100,000)
- US$20,000 of foreign currency cash assets (worth NZ$40,000)

At the beginning of 1 November 2023, Thyme's foreign currency cash assets equal greater than 5% of its eligible assets, so NZ$4,999.99 of the foreign currency cash assets (that is, the maximum allowed) are excluded from non-eligible assets under the de minimis cash exclusion approach. NZ$35,000.01 of the foreign currency cash assets will be treated as non-eligible assets under this approach.

Relational cash exclusion approach

If a taxpayer does not wish to use the de minimis cash exclusion approach, they can elect to adopt the relational cash exclusion approach. Under this approach, foreign cash assets that relate directly to eligible assets or FDR hedge portions can be excluded from non-eligible assets. Examples of foreign cash assets that relate directly to eligible assets or FDR hedge portions include cash held:

- for investment or reinvestment in eligible assets
- for settling eligible hedges, to the extent of the FDR hedge portions, or
- to provide liquidity for redemption purposes, to the extent the fund invests in eligible assets.

Example 28: Relational cash exclusion where fund invests in eligible assets

Assume the same facts as in example 27.

NZ$30,000 of Thyme's foreign currency cash is due to a subscription for units and is to be invested in US equities. NZ$6,000 of the cash is due to a sale of shares and is to be reinvested in US equities. The remaining NZ$4,000 is held to provide liquidity for redemption purposes.

All of Thyme's foreign cash assets relate directly to eligible assets, so the full NZ$40,000 cash is excluded from non-eligible assets under the relational cash exclusion approach.

In some cases, foreign cash assets can relate to a mix of eligible assets and other assets. Taxpayers will need to determine the extent to which cash may be excluded from non-eligible assets on a reasonable basis in these circumstances. For example, this could be based on a proportional allocation of the cash (that is, based on the proportion of eligible assets to total assets, excluding cash balances) or on a direct attribution basis where foreign cash assets that relate solely to eligible assets are held in separate earmarked accounts.

Example 29: Relational cash exclusion, on a proportional allocation basis, where fund invests in a mix of eligible assets and other assets

At the beginning of 1 November 2023, Parsley US Investments Fund (Parsley) has a portfolio of:

- US$40,000 of shares in US-based companies (eligible assets, worth NZ$80,000)
- US$10,000 of share options (non-eligible assets, worth NZ$20,000)
- US$15,000 of foreign currency cash assets (worth NZ$30,000)

NZ$20,000 of Parsley's foreign currency cash is due to a subscription for units and is to be invested in US equities and share options. NZ$4,000 of the cash is due to rebalancing investment interests and is to be invested in US equities and share options. The remaining $NZ6,000 is held for liquidity purposes.

NZ$24,000 of cash is excluded from non-eligible assets on a proportional basis under the relational cash exclusion approach (NZ$80,000 of eligible assets / NZ$100,000 of assets excluding cash balances x NZ$30,000 of foreign currency cash).

Use of tax pooling to satisfy a backdated tax liability

Section RP 17B of the Income Tax Act 2007

In certain circumstances, taxpayers can use tax pooling to satisfy a liability arising from a voluntary disclosure where there is no existing assessment.

NEW LEGISLATION

Background

Under previous settings, tax pooling could not be used where there is no existing assessment or quantified obligation. The only exception was certain voluntary disclosures for income tax and resident withholding tax (RWT) where no prior return was filed, and the return was provided as part of the voluntary disclosure. In those situations, use of tax pooling is subject to the Commissioner's discretion measured against specific legislative criteria.

In some circumstances, a taxpayer may have unintentionally not filed a tax return for a particular tax type and tax period. For example, a small business may be unaware that an employee benefit it provides is subject to fringe benefit tax and so does not provide an FBT return. Where these omissions have been made in good faith, it is disproportionally punitive not to allow taxpayers to use tax pooling.

The amendments allow the use of tax pooling to satisfy tax obligations in these instances

Key features

The amendments allow a person to use tax pooling, and thereby mitigate their exposure to UOMI, for voluntary disclosures related to tax types other than RWT and income tax, provided certain requirements are met. The additional tax types covered are PAYE, ESCT, RSCT, NRWT, GST and FBT.

Application date

The amendment came into force on 30 March 2022.

Detailed analysis

The requirements to be met to be able to use tax pooling are as follows:

- The person must make a voluntary disclosure of a "new liability", not being a liability that arose from a return by the person, or an assessment of the person, made before Inland Revenue has made any contact with the person or their agent.
- The person must notify the Commissioner, which results in an assessment of, or obligation to pay, the new liability.
- The voluntary disclosure must be made within a reasonable time after the earliest time the person or their agent became aware of the new liability, and before the date of notification of the Commissioner or the person is notified of a pending tax audit or investigation or that a tax audit or investigation has started.
- The Commissioner must be satisfied that the new liability did not arise as a result of a choice by the person not to comply with the person's obligations under the Inland Revenue Acts or as a result of a failure by the person to take reasonable care to comply with those obligations.

There are two aspects of these requirements that could create some uncertainty:

- the voluntary disclosure must be made "within a reasonable time" after the earliest time that the person or the person's agent is aware of the person's new liability, and
- the new liability must not arise as a result of a choice by the person not to comply with the person's obligations under the Inland Revenue Acts or as a result of a failure by the person to take "reasonable care" to comply with those obligations.

Both these tests will be fact dependant, but some guidance is provided below.

Within a reasonable time

Generally, "within a reasonable time" will be within a period of less than three months. However, the circumstances of the specific taxpayer will also be considered. Inland Revenue considers the phrase means that provided the taxpayer applies at the earliest opportunity after they or their agent becomes aware of the liability, then the test will be met.

There are limited situations where a request for relief outside this time frame may still have been made "within a reasonable time". Ultimately it will depend on the circumstances of the particular case. However, the circumstances of the taxpayer would need to be such that they could not have reasonably advised Inland Revenue within three months. For example, sickness or injury that extended beyond the three-month period and made them unable to make a voluntary disclosure may still satisfy "within a reasonable time".

Reasonable care

The "reasonable care" test is similar to that used when applying shortfall penalties. This involves establishing what a reasonable person would do in the same circumstances and takes into account such factors as the age, health, and background of the taxpayer in question.

Example 30

Dave works in irrigation and has been an employee for most of his career. He is now at a point where he wants to be a sole trader, and he establishes a company called Dave's Drainage Limited (DDL). Dave doesn't engage an accountant straight away, as his partner thinks the business is simple and they can deal with the compliance themselves. Down at the pub, one of his mates, who also runs their own company, tells him to make sure he buys a double cab ute under the company name, as they are exempt from fringe benefit tax (FBT).

Dave follows his mate's advice, and he never files an FBT return. After three years of growth, Dave thinks it is a good time to get an accountant, as his tax affairs are getting more and more complicated.

The accountant asks Dave for his FBT returns and discovers they have never been filed. The accountant immediately makes a voluntary disclosure for the three years of outstanding FBT returns.

The question here is whether Dave exercised reasonable care to determine the correctness of his tax position. As Dave knows drainage, not tax, he is compared against someone in similar circumstances.

In this situation, Dave relies on the advice of someone he thought was more knowledgeable than him. He makes a reasonable attempt to comply with all his other tax obligations, but he did not think he had to comply with FBT. As soon as he spoke to his new accountant, he wanted to ensure he was fully compliant, and the accountant made the voluntary disclosure on DDL's behalf as soon as they discovered the omission.

It is likely that DDL took reasonable care in taking their tax position and made the disclosure within a reasonable timeframe. Therefore, Dave will be able to make use of amended section RP 17B and use tax pooling funds for any FBT liabilities.

Example 31

J & T's Boat Building is New Zealand's largest boat and marine building company. It operates around the world and has over 500 employees.

As part of their operations, they rely on a large number of contractors. They have sophisticated software that they use when engaging with contractors. However, a bug is discovered where the non-resident contractor checkbox is not reporting when it is checked. This bug has been in the system for five years. This means that hundreds of non-resident contractors over the five years have not had non-resident contractor withholding tax withheld.

As soon as the tax team discovers this, they contact Inland Revenue. However, due to the size of the issue, they inform Inland Revenue it will take six months to collect the information before they can make a voluntary disclosure.

This is longer than the three months that is usually considered a "reasonable time". However, due to the facts of the situation, and because they quickly alerted Inland Revenue, six months is a reasonable time to make the voluntary disclosure.

They would be able to rely on this provision and use tax pooling to satisfy their liability.

See, also, Interpretation Statement IS0053 "Shortfall penalty for not taking reasonable care", which provides a detailed interpretative explanation of the shortfall penalty imposed by the Commissioner under section 141A of the Tax Administration Act 1994 on taxpayers who do not take reasonable care in carrying out their tax obligations.

Overseas donee status

Section YZ 5 and schedule 32 of the Income Tax Act 2007

The following charities have been granted overseas donee status from the 2021-22 and later income years:

- Community Transformation Trust
- Firefly Children's Home Charitable Trust

- Hadassah Medical Relief Association of New Zealand
- Hands Across the Water New Zealand Trust
- Institute for Indian Mother and Child Aotearoa Charitable Trust
- Medic to Medic
- Missio Benevolent Society
- Prabh Aasra Trust
- Reemi Charitable Trust
- Talalelei Life Futures Fund
- YWAM Ships Aotearoa Limited

The following references to two existing charities have been updated:

- "UN Women Aotearoa New Zealand Incorporated" has replaced "UN Women National Committee Aotearoa New Zealand Incorporated", with effect from 4 May 2020.
- "Child Rescue Charitable Aid Trust" has replaced "Child Rescue Charitable Trust", with effect from 11 August 2017.

Overseas donee status for the New Zealand Memorial Trust – Le Quesnoy has been extended to 31 March 2025.

The following organisations have been removed from the donee list with effect from 30 March 2022:

- Books for Cambodia Trust
- Channel 2 Cyclone Aid for Samoa
- Cyclone Ofa Relief Fund
- Cyclone Val Relief Fund
- Kyrgyzstan New Zealand Rural Trust
- L Women of Africa Fund
- The Band Aid Box
- The Serious Road Trip Charitable Trust
- The Sir Walter Nash Vietnam Appeal.

Interest limitation

The interest limitation rules are part of the Government's initiatives to address housing affordability. The aim of the reform is to reduce investor demand for residential property.

Many landlords invest in residential property expecting a large capital gain when they sell the property. The tax system previously allowed landlords to deduct interest expenditure for residential rental property, even if gains made on sale of the property were not taxed. The new interest limitation rules have limited the deductibility of interest expenses incurred by property investors from 1 October 2021. The extent of the limitation depends on whether the property was acquired on or after 27 March 2021.

Summary of key features:

- **Disallowed residential property subject to interest limitation:** Property that is commonly and foreseeably used to provide residential accommodation on a long-term basis and is (or could be) used as an owner-occupied residence is subject to the interest limitation rules. This property is referred to as disallowed residential property (DRP). From 1 October 2021, deductions are denied for interest incurred in deriving income from DRP acquired on or after 27 March 2021 (subject to certain exceptions).
- **Application to certain companies:** The provision allowing for an automatic deduction of interest for most companies is overridden for certain close companies and companies whose assets are primarily DRP. These companies are now required to trace the use of their borrowed funds and are denied deductions for interest incurred on borrowings used to derive income from DRP.
- **Excepted residential land excluded from DRP:** Certain types of property not suitable for long-term residential accommodation, and which cannot be substituted for such, are excluded from DRP and not subject to the interest limitation rules.

- **Exemptions:** Land businesses, developments and new builds are exempt from the interest limitation rules. New builds are exempt for a period of 20 years from their date of completion.
- **Grandparented residential interest subject to progressive limitation:** For DRP acquired before 27 March 2021, deductions for interest are being progressively denied over the transition period between 1 October 2021 and 31 March 2025. DRP owners are required to trace the use of their borrowed funds to ensure the limitation is applied to interest incurred on borrowings used to derive income from the DRP. The current tracing approach applies for loans used to fund DRP – that is, tracing funds borrowed to taxable and non-taxable purposes to determine the deductibility of interest on a loan (unless the borrower is a company). This includes borrowings to fund expenses incurred in deriving income from the DRP, for example, interest on borrowings to pay a rental property's rates (although the deductibility of the underlying rates expenditure is not affected by the interest limitation rules).
- **Rollover relief for transfers of DRP:** Rollover relief is provided for certain transfers or disposals of DRP to ensure grandparented residential interest remains deductible throughout the full transition period between 1 October 2021 and 31 March 2025.
- **Interest deductions on taxable sale of the DRP:** Interest deductions are allowed on the taxable sale of the DRP.
- **Interposed entities:** Interposed entity rules ensure taxpayers cannot claim interest deductions for borrowings used to acquire DRP indirectly through interposed entities.
- **Specific anti-avoidance rules:** Specific anti-avoidance rules support the integrity of the interest limitation rules.

Bright-line changes

As well as introducing new interest limitation rules, several changes have been made to the bright-line rules for sales of residential land.

Key changes:

- **5-year new build bright-line test:** Owners of new builds are subject to a 5-year bright-line period rather than the 10-year period.
- **Amendment to main home exclusion:** The portion of land attributable to the main home will generally not be taxed on disposal under either the 10-year or 5-year bright-line tests.
- **Rollover relief:** Limited extensions to rollover relief from the bright-line test are available for some common ownership change scenarios where economic ownership has not changed or is materially the same as it was before.

Definition of disallowed residential property

Sections DH 5(2), YA 1, and schedule 15 of the Income Tax Act 2007

The new interest limitation rules apply to "disallowed residential property", and new section DH 5(2) introduces a definition of that term. "Disallowed residential property" means land in New Zealand to the extent to which—

- it has a place configured as a residence or abode
- the owner has an arrangement to erect a residence or abode, or
- it is bare land that could be used to erect a place configured as a residence or abode.

The definition excludes land to the extent it is "excepted residential land".

Background

The new interest limitation rules in subpart DH of the Income Tax Act 2007 are intended to apply to properties that are, or could be, commonly and foreseeably used to provide long-term residential accommodation. The focus is on whether a property is physically configured or structured in such a way that could support the use of the property as a self-contained private residence. Effectively, the rule applies to property that could be used for private owner-occupation. In practice, this means most houses and apartments are subject to interest limitation unless a specific exclusion applies.

A focus on actual use as long-term residential accommodation was not considered to be appropriate. This was because property owners would be able to circumvent the rules by changing the use of the property (for example, by listing the property on a digital platform for short-stay accommodation instead) and this could impact the supply of properties available for long-term occupation (either rented or owner-occupied).

Key features

New subpart DH introduces the interest limitation rules. These rules deny an interest deduction for interest incurred for disallowed residential property on or after 1 October 2021.

New section DH 5 defines the key terms used in the interest limitation rules. The terms "disallowed residential property" (DRP) (defined in section DH 5(2)) and "excepted residential land" (defined in section DH 5(3) and new schedule 15) provide the scope of property subject to interest limitation.

The definition of DRP covers any land in New Zealand to the extent to which it has a place configured as a residence or abode, the owner has an arrangement to erect such a place, or it is bare land on which such a place could be erected. Note that the definition applies to structures that could be used as a residence or abode. Whether they are used as such is not considered by the definition.

Excepted residential land is excluded from being DRP. Excepted residential land is described in new schedule 15 of the Income Tax Act 2007.

Where a single parcel of land contains both a place configured as a residence or abode and a structure that is listed in schedule 15 as being excepted residential land, apportionment principles apply to exclude the part that is excepted residential land. This means that the interest limitation rules only apply to the portion of the land that relates to the residence or abode.

Application date

The provisions came into force on 27 March 2021 with application to interest incurred on or after 1 October 2021.

Detailed analysis

Disallowed residential property

New section DH 5(2)(a) defines "disallowed residential property" as land in New Zealand to the extent to which:

- it has a place configured as a residence or abode, regardless of whether it is used as such (subparagraph (i))
- the owner has an arrangement that relates to erecting a place configured as a residence or abode there, regardless of whether that place is, or is to be, used as such (subparagraph (ii)), or
- it is bare land that, under rules in the relevant operative district plan, may be used for erecting a place configured as a residence or abode there, regardless of whether that place is, or is to be, used as such (paragraph (a)(iii)).

In each case, it includes any appurtenances belonging to or enjoyed with the place.[6]

DRP does not cover residential properties that are not in New Zealand. Foreign residential properties are therefore not subject to interest limitation under subpart DH.

Note that while the definition of DRP is similar to the definitions of "residential land" and "dwelling" used for other purposes in the Income Tax Act 2007, each of the terms serve distinct purposes. The interest limitation rules are a standalone regime and therefore differences between the definitions are intended.

DRP does not include land to the extent it is "excepted residential land" (section DH 5(2)(b)). Standard apportionment principles apply to ensure that the part of a residential property that qualifies as "excepted residential land" is not subject to interest limitation.

Excepted residential land

"Excepted residential land" is defined in new section DH 5(3) as land to the extent to which it is described in new schedule 15. The contents of schedule 15 are described in more detail in the "Excepted residential land – schedule 15" section.

Use of the phrase "to the extent" means that where a given parcel of land or property is partly DRP and partly "excepted residential land", a reasonable apportionment must be made according to general tax apportionment principles. This is usually only relevant where the different structures are on the same legal title. Where they are on separate legal titles, the accompanying loans may be structured separately, making it more straightforward to distinguish between interest that relates to excepted residential land and interest that relates to the DRP.

[6] A common example of an appurtenance is a driveway or path.

Example 32: Dual purpose land and interest limitation

Tāmati owns a two-storey building with mixed residential and commercial use, which he acquired before 27 March 2021. The ground floor is a clothing store, and the top floor is rented out as long-term residential accommodation.

The whole building is on a single legal title. Tāmati has one loan that relates to the whole property.

Tāmati's building is DRP to the extent it is configured as a residence or abode and to the extent it is not excepted residential land. The top-floor apartment is DRP, but the clothing store on the ground floor is not.

Following standard principles for apportionment, Tāmati calculates that the clothing store accounts for 55% of the interest paid on his loan and the residential rental property accounts for the remaining 45%. Therefore, Tāmati is subject to interest limitation under subpart DH for 45% of his interest expenses, as this is interest that relates to DRP.

For the period from 1 October 2021 to 31 March 2025, an increasing portion of that 45% of his interest expenses is denied in accordance with the table in section DH 8(2). From 1 April 2025, no deduction is available for any of that 45% of his interest expenses relating to the DRP.

Change in use during income year

The use of a property may change during the income year. Depending on the circumstances, this may lead to a change in status from DRP to excepted residential land, or vice versa. In these cases, some of the owner's interest deductions relating to the property will be denied or limited under subpart DH and some will be unaffected by subpart DH, depending on when the interest is incurred.

This could occur, for example, when an owner-occupier moves out of their residential property partway through the year and they rent the property out instead of selling it. The property no longer qualifies for the main home exception in schedule 15,[7] and any interest incurred from that point is subject to interest limitation under subpart DH.

Similarly, a person could move into their rental property. While it is a rental property, it is DRP and subject to interest limitation under subpart DH. When it becomes the person's main home, it becomes excepted residential land and is no longer subject to subpart DH. This means that some interest may be deductible if they use their main home to earn income (for example, if they have a flatmate or rent out a spare room for short-stay accommodation).

Taxpayers therefore need to determine whether the property was DRP or excepted residential land at the time the interest is incurred to ascertain whether that interest expense is subject to denial under subpart DH.

For further information on how this works during the transition period (1 October 2021 – 31 March 2025), see the "Grandparented residential interest" section.

[7] See discussion of the main home exception in the "Excepted residential land – schedule 15" section.

Example 33: Change of status during income year

Grace owns a two-bedroom house in Tauranga with a mortgage. Grace is a standard balance date taxpayer, so her income year is 1 April to 31 March.

From 1 April 2026 until 29 September 2026, Grace lives in the house and rents out the spare bedroom to help cover the cost of her mortgage. During this period, the property is considered excepted residential land, as it is covered by the main home exception in clause 7 of schedule 15. Grace can claim some of the interest on her mortgage as an expense against the rental income from her flatmate. She calculates that, based on the size of the property and the use of communal areas, 30% of her interest expense is deductible while she has a flatmate.

In September, Grace receives a job offer that requires her to move to Christchurch, and from 29 September 2026, the property is rented out and no longer her main home. This means that, from 29 September 2026, the property is no longer excepted residential land; it is now disallowed residential property. Because it is DRP, her interest expense is subject to interest limitation under subpart DH. Grace can no longer claim any mortgage interest as a deduction against her rental income.

Grace's mortgage interest is incurred monthly. For the month of September, the property is DRP for 2/30 days and excepted residential land for 28/30 days. Grace determines the impact of the interest limitation rules on her Tauranga property for the 2025-26 income year as follows:

Month	Total interest	Classification	Result under subpart DH
April	$600	Excepted residential land	No interest limitation under subpart DH, but only 30% is deductible according to Grace's apportionment of areas used by her flatmate.
May	$590		
June	$580		
July	$570		
August	$560		
September	$550	Excepted residential land for 28 days	$513.33 (being $550 x 28/30) is not subject to interest limitation under subpart DH. Only 30% of $513.33, being $154, is deductible according to Grace's apportionment calculation.
		Disallowed residential property for 2 days	$36.67 (being $550 x 2/30) is subject to interest limitation and denied under subpart DH.
October	$540	Disallowed residential property	All of Grace's interest expense is subject to interest limitation and is denied a deduction under subpart DH.
November	$530		
December	$520		
January	$510		
February	$500		
March	$490		

Social, emergency, transitional, and council housing

Sections DH 4(4), (5) and (6) of the Income Tax Act 2007

Land used to provide social, emergency, transitional and council housing is exempted from the interest limitation rules.

Background

Social housing is accommodation provided at low or no cost to individuals, families and whānau who have an income below a specific threshold and are unable to afford or access housing at current market prices. It also aims to support people who are experiencing homelessness or who are at risk of homelessness. Social housing can take a variety of forms, depending on the level

and type of need. Types of housing offered include public housing owned by Kāinga Ora–Homes and Communities (Kāinga Ora), housing offered at below market rent by registered community housing providers (CHPs), or council housing provided by local authorities. It also includes emergency housing and transitional housing that is provided to people in need while they seek, or are assisted in finding, more permanent accommodation. For most types of social housing, the cost to the individual, family and whānau is calculated according to their household income. Without a specific carve-out, a number of properties used for emergency, transitional, public or council housing could otherwise be subject to interest limitation.

Social housing plays an important role in providing accommodation for low-income people in New Zealand. The carve out for social housing in its various forms ensures that the supply of social housing is not disrupted because these properties are withdrawn from the market.

Key features

New sections DH 4(4)-(6) provide that the interest limitation rules do not apply to:

- interest incurred for a property used exclusively by a registered community housing provider (CHP), Kāinga Ora–Homes and Communities (Kāinga Ora), or another government department to provide social, emergency or transitional housing
- interest incurred in relation to a property used exclusively by a local authority or council-controlled organisation (CCO) to provide council housing, and
- Kāinga Ora and its wholly-owned subsidiaries.

Application date

The new provisions came into force on 27 March 2021 with application to interest incurred on or after 1 October 2021.

Detailed analysis

Social, emergency, and transitional housing

New section DH 4(4) specifies that subpart DH does not apply to interest incurred by a person for land to the extent to which the land is used for the specified forms of housing by:

- a registered community housing provider under the Public and Community Housing Management Act 1992
- Kāinga Ora or a wholly-owned subsidiary of Kāinga Ora, or
- a government department listed in schedule 2, part 1 of the Public Service Act 2020.[8]

To qualify for the exemption, the property must be used by one of the above entities solely for one or more of the following specified forms of housing for people in need:

- "social housing" as defined in section 2 of the Public and Community Housing Management Act 1992 (section DH 4(4)(a))
- temporary accommodation for people in need while they seek, or are assisted in finding, more permanent accommodation (section DH 4(4)(b))
- other accommodation for people in need (section DH 4(4)(c)), or
- services connected with such housing or accommodation (section DH 4(4)(d)).

Section DH 4(4)(c) is intended to cover accommodation provided by a government department that is not otherwise covered by paragraphs (a) or (b). This includes, for example, housing used by Oranga Tamariki to provide accommodation for tamariki and rangatahi.

Section DH 4(4)(d) exempts services connected with housing or accommodation described in paragraphs (a) to (c). This ensures a residential property that also provides wraparound services (such as onsite counselling or therapy) is not inappropriately disqualified from being eligible for the exemption.

The exemption only applies to the extent to which a given property is used

- by one of the entities listed in section DH 4(4) (a qualifying entity)
- for one or more of the purposes listed in sections DH 4(4)(a) to (d).

[8] Available at **legislation.govt.nz/act/public/2020/0040/latest/LMS106159.html**

If a property satisfies one of these conditions but not the other, it is still subject to interest limitation. For example, if a house is rented out by a community housing provider at normal market rent and not as social housing, the property would not meet the requirement of being provided for a purpose listed in sections DH 4(4)(a) to (d), and the exemption from the interest limitation rules would not apply.

The entity that owns or rents the property does not need to be the same entity that provides the social, emergency or transitional housing. For example, one entity may be responsible for managing the property portfolio, but it may contract out the client relationship to another entity. In this case, the exemption would still be available.

A taxpayer who leases their property to a qualifying entity for a purpose listed in paragraphs (a) to (d) can qualify for the exemption for the duration of the lease, even if they are not a qualifying entity themselves and have no interaction with the individual tenant. However, the exemption does not apply to private property owners who lease their properties directly to low-income tenants, such as tenants in receipt of an accommodation supplement.

The social housing exemption applies on a property-by-property basis. If there are multiple buildings on a single piece of land (residential or commercial) and only one of the buildings is used for social, emergency or transitional housing, the exemption is only available for that particular property. The person claiming the interest deductions may need to apportion their interest expense accordingly.

In addition, the whole property must be used for one or more of the purposes described in paragraphs (a) to (d) to qualify for the exemption. If only one room in a property is rented by a qualifying entity and the other rooms are rented to third parties, the exemption would not apply.

The exemption covers periods of vacancy between social housing tenants if the property continues to be under lease to a qualifying entity during that time. In the case of social housing, the definition in the Public and Community Housing Act 1992 includes premises that are "to be let" as community housing by a CHP or as Kāinga Ora housing.

In contrast, if a disallowed residential property is occasionally rented by a qualifying entity to provide emergency or transitional housing, but no exclusive lease exists for the property, periods of vacancy would not be covered by the exemption.

Example 34: Registered community housing providers and periods of vacancy

Olivia owns a house in Christchurch and leases it to the Chan Community Housing Trust (CCH Trust), a registered community housing provider, for use as social housing. The lease is for a fixed period of three years starting from 1 July 2021.

From 1 October 2021 until 7 June 2022, the CCH Trust rents the house as social housing to Jason. Jason moves out of the house on 7 June 2022. The house is temporarily vacant while the CCH Trust prepares it for another social housing tenant to move in. On 1 August 2022, the CCH Trust begins renting the house as social housing to Rosemary.

Olivia's Christchurch property is exempt from the interest limitation rules while it is under lease to the CCH Trust. This includes the period it is vacant from 8 June 2022 to 31 July 2022.

Example 35: Property occasionally rented by community housing provider

Kris owns a house in the Bay of Plenty that is occasionally rented by a community housing provider when the provider requires emergency or transitional housing for its clients. The booking arrangement is on a casual basis and is dependent on the availability of the property, as the property can also be booked by members of the public for short-stay accommodation.

During the 2022–23 tax year, the house is rented by the community housing provider for the provision of emergency or transitional housing from 16 June to 31 August and again from 28 October to 17 November. For the remainder of the year, it is either rented by members of the public or not rented by anyone and vacant.

For the 2022–23 tax year, Kris only qualifies for the social housing exemption for interest incurred from 16 June to 31 August and from 28 October to 17 November.

Council housing

Many local authorities around New Zealand provide council housing, similar to social, emergency or transitional housing, at below market rates. While local authorities are generally exempt from income tax under section CW 39 of the Income Tax Act 2007, the properties may be owned by taxable council-controlled organisations (CCOs).

New section DH 4(5) specifies that subpart DH does not apply to interest incurred for land to the extent the land is used by a CCO or a local authority solely for:

- housing for people assessed by a local authority as being eligible for housing at less than market rent (paragraph (a)),
- services connected with such housing (paragraph (b)).

Section DH 4(5)(b) ensures that, as with the social, emergency, and transitional housing exclusion in section DH 4(4), the provision of wraparound services in connection with council housing does not disqualify a property from being eligible for the exemption. In many situations, such services are not provided in a building that is configured as a residence or abode, but paragraph (b) puts the issue beyond doubt.

Interest incurred on a property would still be subject to interest limitation if the land is used by a local authority or CCO but not used for council housing – for example, if a CCO provides rental housing at market rates.

A private landlord who leases their property to a local authority or CCO for the provision of council housing can qualify for the exemption for the duration of the lease, even though they are not a local authority or CCO themselves and have no interaction with the individual tenant. However, the exemption does not apply to private property owners who lease their properties directly to low-income tenants.

As with the social, emergency, and transitional housing exemption, the whole property must be used for council housing (including services provided in connection with council housing) to qualify for the exemption. If only one room in a property is rented by a local authority or CCO and the other rooms are rented to third-party individuals, the exemption in section DH 4(5) would not apply.

Note that this exemption uses the definition of "council-controlled organisation" provided in section 6 of the Local Government Act 2002,[9] rather than the definition given in section YA 1 of the Income Tax Act 2007.

Application to companies

Sections DH 3, DH 5(4), (8), (9), (10) and (11) of the Income Tax Act 2007

The interest limitation rules apply to all companies whose main business involves disallowed residential property (DRP) (other than DRP subject to the land business or development exemptions) and to most close companies that hold DRP. Companies that are not close companies and whose main business does not involve DRP are generally not subject to the rules.

If the interest limitation rules apply to a company, it must trace its borrowings to identify interest it has incurred for DRP. It is denied a deduction for that interest unless an exemption applies.

Key features

The interest limitation rules apply to a company that is a:

- residential land company
- residential land wholly-owned group member, or
- close company that is not an exempt Māori company.

Residential land companies and residential land wholly-owned group members

The interest limitation rules apply to companies that are residential land companies and not part of a wholly-owned group. If a company is part of a wholly-owned group, the rules apply if the company is a residential land wholly-owned group member.

A "residential land company" is a company where the combined value of its DRP (excluding DRP subject to the land business or development exemptions) and the shares it holds in other residential land companies makes up more than 50 percent of the value of its total assets.

A "residential land wholly-owned group member" is a member of a wholly-owned group where the combined value of the group's DRP (again excluding DRP subject to the land business or development exemptions) and the shares the group holds in non-group companies that are residential land companies makes up more than 50 percent of the value of the group's total assets.

[9] **legislation.govt.nz/act/public/2002/0084/latest/contents.html**

Close companies

The interest limitation rules apply to close companies that incur interest for DRP unless the company is an exempt Māori company. In general terms, a "close company" is a company controlled by five or fewer natural persons or trustees as shareholders.

A close company (other than an exempt Māori company) does not have to consider the amount of DRP held as a percentage of its total assets. If it holds any DRP and incurs interest for that DRP, the interest limitation rules apply to the company. It is required to trace its borrowings and is denied deductions for interest incurred for DRP unless an exemption applies.

Exempt Māori companies

An exempt Māori company is a company that:

- is a Māori authority or is eligible to be a Māori authority, or
- is wholly-owned by a Māori authority or by a company or trust that is eligible to be a Māori authority, and
- is not a "residential land company" (if it is not a member of a wholly-owned group) or a "residential land wholly-owned group member" (if it is a member of a wholly-owned group).

A Māori authority is a trustee or a certain type of company with the obligation to administer assets communally owned by Māori.

The exclusion for an "exempt Māori company" recognises that, while an exempt Māori company may legally be a close company, it is, in substance, a company for the benefit of, and accountable to, a very large number of individuals. In terms of control and governance, an exempt Māori company is very different to a typical close company.

Application date

The new provisions came into force on 27 March 2021 with application to companies incurring interest on or after 1 October 2021.

Detailed analysis

Relationship between sections DB 7 and DB 8 and new section DH 3

Section DB 7 provides that most companies are allowed deductions for interest incurred without having to trace their borrowings and establish a nexus between the interest incurred and assessable or excluded income.

Section DB 8 provides that companies are generally allowed deductions for interest incurred on money borrowed to acquire shares in another company that is part of the same group.

New section DH 3 sets out when the interest limitation rules in subpart DH apply to companies.

Subpart DH overrides sections DB 7 and DB 8. If section DH 3 provides that the subpart applies to a company, that company must apply the interest limitation rules and not sections DB 7 or DB 8.

When subpart DH applies to companies (section DH 3)

Section DH 3 sets out when the interest limitation rules in subpart DH apply to companies.

Section DH 3(a) specifies that the interest limitation rules apply to close companies that are not exempt Māori companies. A "close company" is (in general terms) a company controlled by five or fewer natural persons or trustees as shareholders.

Sections DH 3(b) and (c) specify when the interest limitation rules apply to companies that are not close companies. If a company is not a member of a wholly-owned group, section DH 3(b) provides that the interest limitation rules apply if the company is a residential land company. If a company is a member of a wholly-owned group, section DH 3(c) provides that the interest limitation rules apply if it is a residential land wholly-owned group member.

If a company is required to apply the interest limitation rules, it must trace its borrowings to identify any interest it has incurred for DRP, and it is denied a deduction for that interest unless an exemption applies.

To understand how the rules apply to companies, it is helpful to consider first how the rules apply to residential land companies and residential land wholly-owned companies.

Residential land companies

If a company is not a close company and is not a member of a "wholly-owned group", it will only have to apply the interest limitation rules if it is a "residential land company" (section DH 3(b)).

The term "residential land company" is defined in section DH 5(8). A company is a "residential land company" if at any time during the income year the company has a ratio equal to or greater than 50 percent calculated using the following formula:

(disqualified property + indirect disqualified property) ÷ total assets

To apply the formula, the value of a company's disqualified property, indirect disqualified property, and total assets must be determined.

The items in the formula are defined in section DH 5(9), and their values are determined under the valuation rules in section DH 12.

Disqualified property

"Disqualified property" is defined in section DH 5(9)(a) as the value of the company's DRP, excluding DRP subject to the land business or development exemptions in sections DH 4(2) and (3) respectively. The exclusion of DRP subject to these exemptions is to reduce compliance costs for companies who hold land for the purposes of dealing, development, subdivision, or building.[10]

However, "disqualified property" does include DRP that is subject to the new build exemption in section DH 4(1). This is for two reasons.

- First, a company whose main business is residential rental may hold DRP that is a mixture of new builds and old builds. If "disqualified property" excluded new build DRP, a company could hold slightly more new builds than old builds (say 51 percent new builds by value) so that the company would not have to apply the interest limitation rules and would be allowed a deduction for all its interest costs under section DB 7. This is inappropriate, as the rules are intended to apply to companies whose main business is residential rental.
- Second, the new build exemption is time-restricted to twenty years. A company that started out holding mostly new builds may, over time, end up holding mostly old builds. If new builds were excluded from the definition of "disqualified property", such a company would not have to apply the interest limitation rules initially but would have to apply them at a later point. This may prove difficult, or even impossible, unless the company had traced its borrowings from the start.

Indirect disqualified property

"Indirect disqualified property" is defined in section DH 5(9)(b) as the value of shares that the company holds in other companies that are residential land companies. This ensures that companies cannot circumvent the interest limitation rules by holding DRP indirectly through other companies.

To save compliance costs, "indirect disqualified property" does not require companies to look through chains of companies to work out the precise amount of disqualified property held indirectly. Companies only need to consider the value of any shares they hold in other companies that are residential land companies.

Total assets

"Total assets" is defined in section DH 5(9)(c) as the total value of the company's assets.

[10] For detailed analysis on the exemptions, see the "Exemptions for new housing supply – overview" and following sections.

Example 36: Residential land company

A Ltd's total assets consist of the following:

- DRP with a value of $400,000.
- Other business property with a value of $500,000.
- 50 percent of the shares in B Ltd with a value of $300,000.

To determine if A Ltd is a residential land company, A Ltd has to apply the formula in section DH 5(8):

(disqualified property + indirect disqualified property) ÷ total assets

A Ltd's disqualified property is $400,000, being the value of its DRP. However, to determine if A Ltd has indirect disqualified property, it must determine whether B Ltd is a residential land company.

B Ltd's total assets consist of the following:

- DRP with a value of $400,000.
- Other business property with a value of $200,000.

Applying the above formula to B Ltd, the value of B Ltd's disqualified property as a percentage of its total assets is 66.7% (being $400,000/$600,000). B Ltd is therefore a residential land company.

A Ltd must therefore include the value of its shares in B Ltd ($300,000) as indirect disqualified property in the above formula.

The value of A Ltd's disqualified property and indirect disqualified property as a percentage of its total assets is therefore 58.3% (($400,000 + $300,000)/$1,200,000). A Ltd is therefore also a residential land company.

Residential land wholly-owned group member

If a company with DRP is not a close company and is a member of a wholly-owned group, it must apply the interest limitation rules if it is a "residential wholly-owned group member" (section DH 3(c)).

The term "wholly-owned group" is defined in section YA 1. It has the same meaning as the term "wholly-owned group of companies", which is defined in section IC 4. In general terms, a "wholly-owned group of companies" means two or more companies in relation to which a group of persons holds common voting interests that add up to 100 percent.

"Residential land wholly-owned group member" is defined in section DH 5(10). The definition is similar to the definition of a "residential land company" in section DH 5(8), but the formula is applied on a consolidated basis. A company is a "residential land wholly-owned group member" if it is a member of a wholly-owned group of companies and, at any time during the income year, the group has a ratio equal to or greater than 50 percent calculated using the following formula:

(disqualified property + indirect disqualified property) ÷ total assets

The items in the formula are defined in section DH 5(11), and the values for those items are determined under the valuation rules in section DH 12.

"Disqualified property" is defined in section DH 5(11)(a) as the value, on a consolidated basis, of the wholly-owned group's DRP, excluding DRP subject to the land business or development exemptions in sections DH 4(2) and (3). The reasons for excluding DRP subject to the land business or development exemptions, but not the new build exemption, are the same as those outlined above for residential land companies.

"Indirect disqualified property" is defined in section DH 5(11)(b) as the value of shares that the wholly-owned group holds in non-group companies that are residential land companies.

"Total assets" is defined in section DH 5(11)(c) as the total value, on a consolidated basis, of the wholly-owned group's assets.

The requirement in the definitions of "disqualified property" and "total assets" to value these items on a consolidated basis is to prevent intra-group shares and loans being doubled counted.

Example 37: Residential land wholly-owned group – intra-group assets

Land Group is a wholly-owned group of companies with the following members and assets:

Holding Co (a non-close company)			
Assets	**$**	**Liabilities**	**$**
Shares in A Co	4m	Bonds	3m
Shares in B Co	6m	Equity	
		Shareholder capital	7m
Total	**10m**	**Total**	**10m**

A Co			
Assets	**$**	**Liabilities**	**$**
DRP	2m	None	
Other business property	1.5m	Equity	
Loan to B Co	0.5m	Shareholder capital	4m
Total	**4m**	**Total**	**4m**

B Co			
Assets	**$**	**Liabilities**	**$**
DRP	2.5m	Loan from A Co	0.5m
Other business property	4m	Equity	
		Shareholder capital	6m
Total	**6.5m**	**Total**	**6.5m**

Close companies

Section DH 3(a) provides that the interest limitation rules apply to a close company that is not an exempt Māori company.

Meaning of close company

A close company is a company that is controlled by a small number of individuals.

The term "close company" is defined in section YA 1. In general terms, a company is a close company if at any time there are five or fewer natural persons or trustees the total of whose voting interests in the company is more than 50 percent. For the purposes of this definition, natural persons that are associated with each other are treated as a single person.

Exempt Māori company

The term "exempt Māori company" is defined in section DH 5(4).

An exempt Māori company is a company that is:

- a Māori authority or eligible to be a Māori authority, or
- wholly-owned by a Māori authority or by a company or trust that is eligible to be a Māori authority, and
- not a "residential land company" (if it is not a member of a wholly-owned group) or a "residential land wholly-owned group member" (if it is a member of a wholly-owned group).

A Māori authority is a trustee, or a certain type of company, with the obligation to administer assets communally owned by Māori that has elected, under section HF 11, to become a Māori authority. Section HF 2 specifies the persons eligible to be a Māori authority.

The exclusion for an "exempt Māori company" recognises that, while an exempt Māori company may legally be a close company, it is, in substance, a company for the benefit of, and accountable to, a very large number of individuals. In terms of control and governance, an exempt Māori company is very different to a typical close company.

To be an exempt Māori company, a company cannot be a "residential land wholly-owned group member" if it is a member of a wholly-owned group, or a "residential land company" if it is not a member of a wholly-owned group. These terms are explained above. This ensures that Māori companies whose main business involves DRP (other than DRP subject to the land business or development exemptions) still have to apply the interest limitation rules.

Excepted residential land – schedule 15

Sections DH 5(3) and YA 1 and schedule 15 of the Income Tax Act 2007

Excepted residential land is excluded from the interest limitation rules. Schedule 15 sets out the types of land that are considered "excepted residential land."

Background

The interest limitation rules apply to disallowed residential property (DRP). Commercial properties that are not set up to provide accommodation (for example, office buildings and shops) are not intended to be covered by subpart DH.

However, some commercial properties are used to provide accommodation. Commercial accommodation can take a variety of forms. In some cases, the provision of accommodation is related, but ancillary, to another function of the property (for example, a hospital or hospice). In most cases, it is not intended that these types of property be subject to interest limitation under subpart DH. This is because, while stays in such properties could be long term, they are generally not substitutable for an owner-occupied property. In other cases, the provision of accommodation is the core function of the property or business. Properties used to provide accommodation on a commercial basis can take a variety of forms. Some of these cannot easily be made suitable for owner-occupation (for example, a hotel or motel) and are thus more suitable for an exclusion, while others could more easily be used or converted to this purpose (for example, short-stay accommodation in what could otherwise be a regular residential home) and should be subject to interest limitation to ensure there is no negative impact on housing supply.

Some property types are not necessarily commercial in nature, but they do not impact on the general New Zealand housing market and are therefore excluded from the rules. These include properties located outside New Zealand.

Key features

New section DH 5(3) and schedule 15 provide that the following types of land are "excepted residential land":

- Business premises (this does not cover business premises that are used or available for use in a business of supplying accommodation).
- Farmland.
- A hospital, convalescent home, nursing home, or hospice.
- A hotel, motel, inn, hostel, or camping ground.
- A boarding establishment.
- A rest home or retirement village.
- The person's main home.
- Student accommodation.
- Employee accommodation.
- Māori excepted land.

Application date

The new provisions came into force on 27 March 2021 with application to interest incurred on or after 1 October 2021.

Detailed analysis

Section DH 5(2)(b) provides that land is not included in DRP for the interest limitation rules to the extent to which it is "excepted residential land". Section DH 5(3) defines "excepted residential land" as land to the extent to which it is described in schedule 15.

The schedule lists the different types of land and property that are excepted from the interest limitation rules. Note that they are excepted *to the extent that* they are described in the schedule. Where some areas of a given parcel of land or property meet the criteria and others do not, a reasonable apportionment must be made on normal tax apportionment principles.[11]

Main home (clauses 1 and 7)

Clauses 1 and 7 of the schedule provide that a person's main home is excepted from the interest limitation rules. This relies on the pre-existing definition of "main home" in section YA 1 – the one place that is used as a residence by the person or, if they have more than one residence, the residence with which they have the greatest connection.

Clause 7 permits interest deductions to continue to be taken where a homeowner rents out a room (or rooms) in their main home to flatmates, private boarders, or as short-stay accommodation. It also applies to a non-accommodation income-earning use of the main home – for example, a workshop or a contractor's home office.

Clause 1 mirrors the business premises exclusion in the bright-line test, which provides that the business premises exclusion applies for premises used for an accommodation business only if it is the person's main home. This is intended to capture, for example, a bed and breakfast establishment where the owner lives onsite.

Example 38: Main home

Tane owns two residential properties – one in Wellington and another up the coast at Waikanae beach. He has mortgages over both properties. He spends most of his time in Wellington. Tane has a flatmate at his Wellington property.

Tane spends many weekends at his property in Waikanae, normally driving up Friday night and returning to Wellington on Sunday.

Tane's Wellington property is his main home and is not subject to interest limitation under subpart DH. However, the proportion of interest expense on his mortgage he can deduct in relation to the rent from his flatmate is limited under other parts of the Income Tax Act 2007.

Tane's Waikanae property is a DRP. Interest expense on his mortgage on that property is subject to the interest limitation rules.

An exception from the interest limitation rules in subpart DH does not mean that interest deductions are automatically available for the main home. Other requirements in the Income Tax Act 2007 still need to be satisfied, including meeting the general permission (that is, a nexus to income exists) and not being subject to the general limitations. For example, to the extent an expense relates to private use, deductions are generally not available. In a flatmate situation, this means apportioning expenses between shared areas, areas exclusively used by the flatmate, and areas exclusively used by the homeowner to determine the amount that is deductible.

Example 38 continued: Apportioning interest for the main home exception

Consider Tane's main home in Wellington and the income he derives from having a flatmate. Tane's monthly interest expense on his mortgage is $600.

Tane has exclusive use of one bedroom, an ensuite and a spare room, which he uses as an office. His flatmate has exclusive use of a second bedroom and a different bathroom. They both have shared use of the lounge, dining room, kitchen and laundry. Looking at the shared-use and exclusive-use areas, Tane calculates that 30% of his interest expense relates to the income from his flatmate and is deductible. The remaining 70% is non-deductible due to the private limitation. Tane calculates he can deduct $180 of his monthly interest expense.

To qualify for the main home exception, the person who incurs the interest and the person who owns the main home would generally need to be the same person. In most cases, only natural persons can be considered to have main homes. However, an individual who holds their property through a transparent entity, like a look-through company (LTC), may be able to qualify for the main home exception. This is because shareholders in LTCs are deemed to hold their proportion of LTC assets directly for tax purposes. Opaque structures, such as ordinary (non-LTC) companies, do not have access to the main home exception.

Trusts are generally opaque, but it is not uncommon for people to hold their homes in trust structures. Therefore, clauses 1 and 7 contain an additional rule for trusts. This rule provides that a property can be excepted residential land under the main home

[11] For more on this interaction, see the "Definition of disallowed residential property" section.

exception for the trustee of a trust if it is the main home of one of the trust's beneficiaries and a principal settlor does not have a different main home of their own. A principal settlor is someone whose settlements for the trust are the greatest, or greatest equal, by market value. This ensures that trusts cannot be used to gain an exception from the interest limitation rules if such an exception would not be available if the settlors held the property directly.

Example 39: Main home exception, settlors and beneficiaries

Michael and Stephen have bought a house in Auckland for their son, Jeremy, to live in. They settle the house in a family trust of which they are the trustees and principal settlors. They, along with Jeremy, are the beneficiaries.

Jeremy finds flatmates who pay market rent for the spare bedrooms.

Initially, Michael and Stephen continue to live in their own main home in Hamilton. This means they cannot claim the main home exception for the Auckland house because, as principal settlors, they have a different main home. The trustees would only be able to claim the exception if Michael and Stephen had no main home or lived in the Auckland property.

Years later, Michael and Stephen retire. They decide to move into the Auckland property because Jeremy has moved elsewhere. The spare bedrooms are rented out for short-stay accommodation on a digital platform. From this point on, the trustees qualify for the main home exception in clause 7 of schedule 15 for the Auckland property. This is because Michael and Stephen, as principal settlors of the trust, do not have a different main home.

Where there are multiple residential properties on the same parcel of land (for example, a self-contained flat or cottage, sometimes advertised as "home and income"), only the property used by the owner as the main home qualifies for the main home exception. Thus, the carve-out from DRP only applies to the part that is the main home. Other self-contained units on the same title are DRP and subject to interest limitation under new subpart DH. This is the same result as if the multiple units or properties were on separate legal titles.

Example 40: Multiple residences on a single legal title

Mandi owns a property that was advertised as "home and income". The building is split into two –a self-contained one-bedroom flat on the ground floor and a larger three-bedroom unit above it.

Mandi lives in the upstairs three-bedroom unit. Mandi wants a flatmate in her unit and also wants to find a tenant for the downstairs flat. Mandi's friend Miriama moves in to one of the bedrooms upstairs. Mandi advertises the downstairs flat online and finds a tenant to move into it.

The upstairs three-bedroom unit is Mandi's main home and qualifies for the main home exception. Mandi would be able to deduct some of the interest expense on her mortgage against her rental income from Miriama. The downstairs one-bedroom flat is not part of her main home and would be DRP subject to the interest limitation rules.

Business premises (clause 1)

Clause 1 of schedule 15 contains an exception for business premises.

Section YA 1 provides that "business premises" is defined in section DD 11 for the entertainment expenditure and land sales provisions as follows:

> **business premises**—
>
> (a) means the normal business premises or a temporary workplace of the person (or an associate):
>
> (b) does not include premises or a workplace established mainly for the purpose of enjoying entertainment.

This definition is intended to apply for the purposes of the interest limitation rules.

The business premises exception is intended to buttress the general rule in section DH 5(2)(a), which provides that land is DRP to the extent it has a place configured as a residence or abode. Under that general rule, if the parcel of land does not contain such a structure, it is not DRP.

The interest limitation rules should not apply to property used for commercial purposes unrelated to accommodation (for example, shops, offices, entertainment venues, warehouses, factories) as these kinds of property are not generally configured as residences and are therefore unlikely to meet the basic definition of DRP. However, the business premises exception is intended to put any ambiguity beyond doubt.

In some cases, the property may originally have been configured a residence or abode, but it has since been reconfigured for a different purpose or used for a non-accommodation business. For example, consider a villa that has been converted into a doctor's surgery or a restaurant. If there is any ambiguity in determining whether this villa is DRP under section DH 5(2)(a) and subject to interest limitation, the business premises exception in clause 1 of schedule 15 applies to ensure that the villa is not subject to interest limitation.

Premises used for a business of supplying accommodation do not qualify for the business premises exception in clause 1 unless it is the owner's main home (as discussed under the heading "*Main home (clauses 1 and 7)*" above) or is covered by another specific exception in schedule 15.

This ensures that short-stay accommodation in a standard residential property is subject to the interest limitation rules in the same way long-term rental property is. An exclusion for such accommodation could have a detrimental impact on the supply of available housing in New Zealand for renters and owner-occupiers.

An exception to this rule exists where the premises used for a business of supplying accommodation are the person's main home. This exception is intended to cover bed and breakfast establishments where the owner lives onsite and is discussed under the heading "*Main home (clauses 1 and 7)*" above.

Businesses providing accommodation on a commercial scale, such as hotels and motels, are carved out in specific exceptions elsewhere in schedule 15, discussed below.

Farmland (clause 2)

Farmland is excepted from the interest limitation rules under clause 2 of schedule 15. "Farmland" is defined in section YA 1 as land that is being worked in the farming or agricultural business of the land's owner or that, because of its area and nature, is capable of being worked as a farming or agricultural business. A farming or agricultural business includes forestry, horticultural and pastoral businesses.[12]

To be "capable of being worked as a farming or agricultural business", the parcel of land must be capable of producing revenue sufficient to cover all costs of holding and operating the land over time without significant investment or modification. This includes the cost of capital employed and a reasonable recompense for the proprietor's labour.

However, given that the interest limitation rules apply to land to the extent the land contains a place configured as a residence or abode, the exception for farmland in schedule 15 also specifically includes such structures. Thus, any place configured as a residence or abode, whether used as such or not, and including any appurtenances belonging to or enjoyed with the place, is included in the farmland exception. This ensures that a farmhouse or workers' quarters on the farmland is not subject to interest limitation.

Accommodation in medical and care facilities (clause 3)

Accommodation provided in hospitals, convalescent homes, nursing homes, and hospices is excepted from the interest limitation rules. These forms of accommodation are specifically intended for patients and those in need of care and are generally straightforward to distinguish from standard residential properties.

These terms are not defined in the Income Tax Act 2007. Therefore, whether a given property qualifies for an exception under clause 3 depends on the particular facts and circumstances.

Excepted commercial accommodation (clauses 4 and 5)

Clauses 4 and 5 provide an exception for various forms of commercial accommodation. These forms of accommodation are designed predominantly for short-term use on a large-scale commercial basis. They are generally straightforward to distinguish from standard residential properties that could be a private owner-occupied residence. Exceptions for these listed types of accommodation do not disadvantage prospective owner-occupiers or generally impact the housing market.

Boarding establishments (clause 4)

The commercial accommodation exceptions broadly mirror those in paragraph (b)(ii) of the previous definition of "dwelling" in section YA 1 of the Income Tax Act 2007. However, no exception for a "boardinghouse" is provided. Instead, clause 4 provides an exception for a new defined term, a "boarding establishment".

[12] For further discussion on the meaning of "farmland" and how this differs from a lifestyle block, see QB 18/17 'Income tax – bright-line test – farmland and main home exclusion – sale of lifestyle blocks' available at**taxtechnical.ird.govt.nz/en/questions-we-ve-been-asked/2018/qb1817-qb-1817-income-tax-bright-line-test-farmland-and-main-home-exclusions-sale-of-lifestyle-block**

Note that the definition of "dwelling" in section YA 1 has also been amended to replace the term "boardinghouse" with "boarding establishment" for the 2022–23 and later income years. See the "Amendment to definition of 'dwelling'" section for more information.

Having a new defined term that is not "boardinghouse" is intended to provide clarity to taxpayers and reduce any uncertainty or confusion created because of the similar term "boarding house" in the Residential Tenancies Act 1986 (the RTA).

An exception for an RTA "boarding house" was not considered to be appropriate because, for many properties, it is simply the difference between renting a house out on a single contract versus renting a house out on a room-by-room basis.

Conversely, a "boardinghouse" is undefined for tax purposes, and whether a property constitutes a "boardinghouse" depends on the facts and circumstances of each property so that the answer may not always be clear to landlords applying the interest limitation rules.

Larger boardinghouses may be structurally similar to hostels and may not be suitable for owner-occupation, but smaller boardinghouses may resemble standard residential properties and should prima facie be subject to interest limitation.

To ensure that large-scale commercial boardinghouses are not subject to interest limitation, the defined term, "boarding establishment", has been introduced into section YA 1. This term is intended to encompass commercial boardinghouses unsuitable for owner-occupation.

A "boarding establishment" is defined as premises that:

- are used in a business of supplying accommodation
- are managed by the business
- consist of at least ten boarding rooms that are not self-contained (that is, they do not contain all the necessary features for living, such as a full kitchen or bathroom), and
- include shared living facilities (which provide the necessary features for living not delivered in the residents' boarding rooms) available to all residents.

All these requirements must be satisfied for premises to qualify for the "boarding establishment" exception.

Example 41: Property rented out on a room-by-room basis

Gordon owns a six-bedroom villa in central Auckland that he previously rented out on a single tenancy contract. Gordon decides it is better for him and more convenient for the tenants to rent the house on a room-by-room basis.

Each occupant signs a contract for exclusive use of their individual room and shared use of common areas, like the lounge, kitchen and two bathrooms. Under the Residential Tenancies Act 1986, the bedrooms are boarding rooms, and the house is a boarding house.

Gordon's property is not a boarding establishment and therefore does not qualify for the boarding establishment exception in clause 4 of schedule 15. Because the property has fewer than ten boarding rooms that are not self-contained, there is no need to consider whether it satisfies the other limbs of the definition.

Management by the business is intended to encompass a range of scenarios, including, for example, where a manager lives on-site and has a permanent office, or where someone travels between multiple establishments operated by the business across different locations in a city.

Premises refers to a single site or location, although the relevant facilities may be in multiple buildings on the same site. Buildings located on different pieces of land do not satisfy the requirements, even if the sections are adjacent.

A taxpayer might operate several establishments at different locations. Each location needs to satisfy the "boarding establishment" requirements to be considered excepted residential land. This means that a taxpayer could have multiple boarding establishments for the purposes of subpart DH.

Provided the establishment contains at least ten boarding rooms that are not self-contained, other boarding or cabin-style rooms on the same site would form part of the "boarding establishment" and qualify for the exception.

Example 42: Boarding establishment

Carl and Emily own C&E Boarding Lodge, a commercial establishment in New Plymouth. C&E Boarding Lodge consists of:

12 rooms that are not self-contained, with no additional private facilities

a further six rooms with individual ensuites, and

six pre-fab cabins with basic bathroom and kitchen facilities.

Occupants sign the same contract, regardless of the type of room, and all occupants have access to shared living facilities, including communal lounges, a commercial-sized kitchen, bathrooms and a coin-operated laundry. Electricity and gas are included in the weekly rent.

Occupants are expected be neat and tidy, although C&E Boarding Lodge cleans and maintains the communal areas and ensures that furnishings in the boarding rooms are in reasonable working order.

C&E Boarding Lodge qualifies as a "boarding establishment", because there are more than ten boarding rooms that are not self-contained.

However, the premises must still have at least ten boarding rooms that are not self-contained. If there are fewer than ten rooms that are not self-contained, the balance required cannot be satisfied by other rooms.

Example 43: Fewer than ten boarding rooms that are not self-contained

Ivy owns "City View Lodge" in Auckland, which consists of a large house and some self-contained studio units at the back of the section. There are:

six boarding rooms that are not self-contained, with no additional private facilities, and

four self-contained studio units with basic bathroom and kitchen facilities.

Occupants sign the same contract, regardless of the type of room, and all occupants have access to shared living facilities in the main house, including a communal lounge, a kitchen, bathrooms and a laundry. Electricity and gas are included in the weekly rent.

City View Lodge does not qualify as a "boarding establishment", because even though it has a total of ten rooms for accommodation, only six satisfy the requirement that they are not self-contained.

Other commercial accommodation (clause 5)

Hotels, motels, hostels, inns, and camping grounds are excepted from the interest limitation rules under clause 5. These terms are not defined in the Income Tax Act 2007. Therefore, whether a given property qualifies for an exception under clause 5 depends on the facts and circumstances of each property.

Rest homes and retirement villages (clause 6)

Rest homes and retirement villages are excepted from the interest limitation rules. Retirement villages are defined in the Retirement Villages Act 2003 as, broadly, premises containing two or more residential units that provide, or are intended to provide, residential accommodation together with services or facilities, or both, predominantly for persons in their retirement.[13] The Health and Disability Services (Safety) Act 2001 considers rest home care to be services provided on premises held out as being principally "a residence for people who are frail because of their age".[14] Both retirement villages and rest homes are subject to regulatory frameworks set out in the above Acts.

Student accommodation (clause 8)

Certain student accommodation is excepted from the interest limitation rules. A new definition of "student accommodation" that applies for the purposes of subpart DH has been inserted in section YA 1 of the Income Tax Act 2007. The definition is intended to align with the pre-existing regulatory regime in section 5(1)(h) of the Residential Tenancies Act 1986 (RTA), and it defines "student accommodation" as follows:

[13] See section 6 of the Retirement Villages Act 2003 **legislation.govt.nz/act/public/2003/0112/latest/contents.html**

[14] See section 6 of the Health and Disability Services (Safety) Act 2001 **legislation.govt.nz/act/public/2001/0093/latest/contents.html**

- means commercial boarding premises used to provide accommodation for students enrolled at a registered school or premises described in section 5B of the RTA, and
- includes premises described in section 5B of the RTA even if they are used mainly, but not exclusively, for the accommodation of students.

Broadly, section 5B of the RTA covers exempt student accommodation and describes premises owned or operated by, or in conjunction with, a tertiary education provider and used to provide accommodation for students. A "tertiary education provider" is defined in section 10(1) of the Education and Training Act 2020 and includes universities, wānanga, Te Pūkenga—New Zealand Institute of Skills and Technology, private training establishments and government training establishments.

This exception is available for halls of residence and hostels that are owned by either the tertiary education provider, or another person who has a specific arrangement with the tertiary education provider, and that meet the requirements under the RTA.

This exception is not available to a landlord who leases their residential rental property to students privately.

Example 44: Accommodation rented to students that does not meet criteria

Ralph owns a five-bedroom house in Kelburn, close to Victoria University of Wellington. Because of its proximity to the university, Ralph rents the rooms in the property exclusively to students on an individual basis. Ralph decided that this approach was more convenient and more appropriate for his investment strategy than renting out the house on a single lease.

Although the property is accommodation provided exclusively to students, Ralph has no arrangement with the university as set out in section 5B(5) of the Residential Tenancies Act 1986. Likewise, he does not provide any services for his student tenants over and above the minimum required under Part 2 of the Residential Tenancies Act 1986 (as required by section 5B(2)). The property is not excepted residential land and would therefore be DRP and subject to the interest limitation rules.

Section 5B of the RTA requires that the property must be exclusively used to provide accommodation to students. However, paragraph (b) of the definition of "student accommodation" in section YA 1 provides that exclusive use as student accommodation over the course of the year is not required for the exception to be available. This is intended to allow the exception for student accommodation to continue to apply for the year where, for example, apartments in a hall of residence are rented out over the summer break to non-students.

Example 45: Student accommodation used for other purposes over summer break

StudyLyfe is a privately owned company and is a hall of residence owner. It operates a single building with 100 apartments. It has an agreement with Victoria University of Wellington that satisfies the requirements of section 5B of the Residential Tenancies Act 1986.

During semesters one and two, all 100 apartments are rented exclusively to students. However, over the summer, the reduced demand for tuition means the demand for student accommodation is also reduced. StudyLyfe continues to rent out 20 apartments to summer students but puts the other 80 on the general rental market on short-term leases.

Although the hall is not exclusively used for student accommodation over the summer, paragraph (b) of the definition of "student accommodation" means the building qualifies as excepted residential land for the whole year. No apportionment is required to reflect the change of use in the summer period. Interest incurred for StudyLyfe's building is not subject to the interest limitation rules in subpart DH.

Employee accommodation (clause 9)

Employee accommodation is excepted residential land and excluded from the interest limitation rules. A new definition of "employee accommodation" has been inserted in section YA 1 of the Income Tax Act 2007. The definition provides that "employee accommodation" means property provided by a person, or a company in the same wholly-owned group as the person, to their employees or other workers for accommodation in connection with their employment or service. The inclusion of property provided to a person's employees by a company in the same wholly-owned group as the person takes into account corporate group scenarios where the company employing the workers may not be the same company that holds the property. However, the definition does not include accommodation provided to employees or other workers who are associated with the person, unless it is necessary for the person to provide the accommodation because of the nature or remoteness of their business.

The definition follows the existing exclusion for employee accommodation in the residential rental loss ring-fencing rules contained in subpart EL of the Income Tax Act 2007.

Māori excepted land (clause 10)

Clause 10 of schedule 15 provides that "Māori excepted land" is excepted residential land and therefore not subject to interest limitation. "Māori excepted land" is defined in section YA 1 as follows:

- Māori customary land, Māori freehold land, Crown land reserved for Māori, and land set aside as a Māori reservation (paragraph (a)(i)).
- Land provided as a residence to a shareholder or beneficiary of a Māori authority (including an entity eligible to be a Māori authority) to the extent the land is partly or wholly owned (directly or indirectly) by that Māori authority or entity. This extends to situations where multiple Māori authorities or entities co-own land, such as through a limited partnership, and use it to provide residences for their members. This is intended to cover Māori communal housing, such as papakāinga and kaumātua housing, where such housing is on general title land and not otherwise covered by paragraph (a)(i) above (paragraph (a)(ii)).
- Land owned, directly or indirectly, by a Māori authority (or entity eligible to be one) to the extent the land was acquired under a Treaty settlement or a post-Treaty settlement mechanism (for example, through a right of first refusal) relating to that Māori authority (or eligible entity). This includes land that is subsequently transferred by the post-settlement governance entity to members of the claimant group or within an entity's corporate structure (paragraph (a)(iii)).
- However, where land described in paragraph (a)(iii) is held by a Māori authority (or entity eligible to be one) and leased to a third party that is not owned, directly or indirectly, by that Māori authority or eligible entity, the lessee is not able to claim the exception. In this case, only the lessor qualifies for the exception from interest limitation (paragraph (b)).

The purpose of paragraphs (a)(i) and (a)(ii) is to provide an exception for papakāinga or kaumātua housing that would otherwise be subject to the interest limitation rules because the resident pays rent. The aims of papakāinga housing include providing whānau with quality affordable housing and promoting Māori community development. Papakāinga housing therefore plays an important role in supporting and fostering cultural identity and financial stability. Kaumātua housing can play a similar role, while also recognising the important role that elders have in society. The interest limitation rules should not hamper these aims.

The purpose of paragraphs (a)(iii) and (b) is to ensure the interest limitation rules do not impact on Māori communities' ability to retain and make unencumbered use of land returned to them via Treaty settlement. This is intended to recognise the role of Treaty settlements in acknowledging, and providing redress for, the Crown's breaches of te Tiriti o Waitangi and how this cultural context can impact how land returned under a Treaty settlement is subsequently held.

Paragraph (a)(i)

The terms used in paragraph (a)(i) are defined in Te Ture Whenua Māori Act 1993. The legal framework in Te Ture Whenua Māori Act 1993 governs the use of Māori land and how such land can be bought and sold.

In many cases, land included in paragraph (a)(i) does not satisfy the general definition of DRP to begin with. In this situation, the exception puts beyond doubt that the rules in subpart DH do not apply.

In other cases, where there is residential property on the land (for example, in the form of papakāinga or kaumātua housing), the ability to reside in the property is generally only available through an occupation order or a licence to occupy and may be limited to those having a connection to the hapū or whānau who hold the land. It is uncommon that land such as that described in paragraph (a)(i) can be sold, or rented, to a member of the general public.

Paragraph (a)(ii)

Not all papakāinga and kaumātua housing is on Māori title land and covered by the exception in paragraph (a)(i). Paragraph (a)(ii) is intended to provide an exception where papakāinga and kaumātua housing is located on general title land.

Properties on general title land used to provide long-term rental accommodation should, in most cases, be subject to interest limitation. This should include where a Māori authority holds a residential property on general title land that it rents out on arm's length terms to a member of the general public

The exception in paragraph (a)(ii) only applies where housing on land owned by a Māori authority, an entity eligible to be a Māori authority, or an entity that is wholly owned or controlled (either directly or indirectly) by a Māori authority or eligible entity, is provided to a shareholder or beneficiary of that Māori authority or eligible entity.[15]

[15] Māori authorities can be trusts or companies.

The reference to a shareholder or beneficiary of a Māori authority or eligible entity is intended to ensure the exception is only available to housing provided to members of the iwi, hapū or whānau represented by the Māori authority or eligible entity.

The reference to indirect ownership is intended to cover ownership structures where there is a nested structure and the land is not held by the top-level entity. This covers a chain of wholly-owned subsidiary companies. It is also intended to cover a trust that is controlled by an entity in the chain where beneficiaries of that trust may either be the same individuals who are shareholders or beneficiaries of the top level entity, or another entity in the chain.

The entity that actually manages the housing does not need to be the one that owns the land. This mirrors how the social housing exemption in new section DH 4(4) operates.[16]

In some situations, the Māori authority set up to hold the land is not the entity that develops the property or manages the papakāinga or kaumātua housing. This could be for a variety of reasons including, for example, being due to the original mandate of the land-owning Māori authority. The land-owning entity may contract out to a subsidiary or another party to manage the provision of housing. In such a case, the exception in paragraph (a)(ii) would still be available.

Example 46: Māori housing on general title managed by entity not a Māori authority

An iwi acquires a large block of land on general title close to its marae. It decides to invest in a papakāinga housing development on this land to encourage community development around the marae.

The land is held by a trust, MA Trust, that is eligible to be a Māori authority. The trust benefits the iwi and its members. MATrust has a loan that was drawn down to acquire the land.

MATrust enters into an arrangement with a related entity, PPKCo, for the construction and management of the housing.

PPKCo engages a private developer, DevCo, to construct the papakāinga housing.

PPKCo takes out a loan to fund the construction of the papakāinga housing. It builds the houses and rents them to members of the iwi at affordable rates. Once constructed, PPKCo owns the housing on the land. While PPKCo manages the properties on a day-to-day basis, the land remains owned by MATrust.

As the housing is on land owned by an entity eligible to be a Māori authority (MATrust) and provided as a residence to the beneficiaries of that entity (the iwi members who benefit from MATrust), the housing would be covered by the exception in paragraph (a)(ii). This is the case even though the housing is provided by a different entity, PPKCo.

The exception in paragraph (a)(ii) would apply for both MATrust and PPKCo.

Collective housing projects

In some cases, general title land used for papakāinga and kaumātua housing is not held by a single Māori authority, but rather by multiple Māori authorities using a structure allowing for joint ownership, such as a limited partnership. The partnership develops homes on the land for rent by members of the relevant iwi represented by the partners. Some of the houses may be rented to the general public.

It is intended that a limited partnership housing project representing multiple iwi and hapū qualifies as Māori excepted land to the extent it is provided as a residence to beneficiaries or shareholders of one or more of the Māori authorities involved in the limited partnership.

To be eligible for the exception, the partner/co-owner must be:

- a Māori authority or entity eligible to be one, or
- an entity owned (directly or indirectly) by a Māori authority or eligible entity.

Partners in a collective housing project who are neither a Māori authority (or eligible to become one) nor owned directly or indirectly by such an entity do not qualify for the exception. This could include a private developer or investor involved in the project, for example.

[16] For more on the social housing exemption, see the "Social, emergency, transitional, and council housing" section.

Example 47: Limited partnership in a collective housing project

Three iwi, Iwi A, Iwi B, and Iwi C, form a limited partnership to hold 20 houses on a large block of land on general title as papakāinga housing. Iwi A's share in the partnership is 40%, while Iwi B and Iwi C each have a 30% share. The agreement is to develop 20 houses to be rented to members of the three iwi, based on each iwi's share in the partnership.

Iwi A and Iwi B hold their shares in the partnership via landholding trusts that are eligible to be a Māori authority and can therefore claim their share of interest deductions under paragraph (a)(ii). Iwi C is a Māori authority, but it holds its share in the partnership through a company wholly owned by Iwi C, LandCo, which is not itself eligible to be a Māori authority. However, as LandCo is 100% owned by a Māori authority, it is able to claim its share of interest deductions under paragraph (a)(ii).

The limited partnership's interest expense for the year for the 20 houses is $200,000. The partners allocate the interest among themselves according to their share in the partnership. Since all of the 20 houses in the development are rented exclusively to members of Iwi A, Iwi B, and Iwi C, all of the interest is incurred for Māori excepted land and is therefore not subject to denial of deductions under subpart DH. Iwi A can claim 40% of the interest (or $80,000), while Iwi B and Iwi C can claim 30% (or $60,000) each.

In some situations, some houses on the land might be rented to the general public, rather than being reserved for members of the Māori authorities involved in the partnership. Land is not considered to be Māori excepted land where it is provided as a residence to people other than beneficiaries or shareholders of the relevant Māori authorities.

In this case, standard tax apportionment principles need to be applied to determine the proportion of housing provided to the partners' members versus non-members at the partnership level. This percentage is then applied by each eligible partner to determine what proportion of their allocated interest expense can be deducted.

Example 47 continued: Houses in a collective housing project rented to general public

To help raise funds for the purchase, the three iwi agree to bring a fourth investor into the limited partnership. The fourth investor, D Co, is a private investor and is not a Māori authority, an entity eligible to be one, or directly or indirectly owned by one.

Each iwi trades a 5% share of the partnership to D Co and, as part of the amended partnership agreement, three of the 20 houses are rented to the general public. The three houses do not qualify as Māori excepted land under paragraph (a)(ii) and are disallowed residential property. The overall position of each partner is shown in the table below:

	Iwi A	Iwi B	Iwi C	D Co	Total
Share of partnership	35%	25%	25%	15%	100%
Number of houses	7	5	5	3	20

The limited partnership's interest expense for the year for the housing project is $200,000. To work out how much interest expense each partner can deduct and how much is ineligible, the partnership must first determine the proportion of the property that qualifies as Māori excepted land at the partnership level — 17 of the 20 houses, or 85%. Each eligible partner will then apply this percentage to their allocated interest expense.

The interest is then allocated to each partner according to their share of the partnership, as shown in the table below:

	Iwi A	Iwi B	Iwi C	D Co
Share of partnership	35%	25%	25%	15%
Allocated share of partnership interest	$70,000	$50,000	$50,000	$30,000
Eligible interest in relation to Māori excepted land	$59,500	$42,500	$42,500	$0
Interest denied	$10,500	$7,500	$7,500	$30,000

Iwi A claims an interest deduction of $59,500 (85% x $70,000), while Iwi B and Iwi C claim a deduction of $42,500 each (85% x $50,000). The ineligible interest allocated to each iwi in relation to disallowed residential property (being 15%) is denied under subpart DH.

While D Co, prima facie, may have eligible interest of $25,500 (being 85% of $30,000), D Co is not a Māori authority or entity eligible to be one, and is not owned by such an entity. D Co is denied any deduction in relation to its share of the partnership interest, even for its share of property that would otherwise be Māori excepted land.

The interest is then allocated to each partner according to their share of the partnership, as shown in the table below:

	Iwi A	Iwi B	Iwi C	D Co
Share of partnership	35%	25%	25%	15%
Allocated share of partnership interest	$70,000	$50,000	$50,000	$30,000
Eligible interest in relation to Māori excepted land	$59,500	$42,500	$42,500	$0
Interest denied	$10,500	$7,500	$7,500	$30,000

Iwi A claims an interest deduction of $59,500 (85% x $70,000), while Iwi B and Iwi C claim a deduction of $42,500 each (85% x $50,000). The ineligible interest allocated to each iwi in relation to disallowed residential property (being 15%) is denied under subpart DH.

While D Co, prima facie, may have eligible interest of $25,500 (being 85% of $30,000), D Co is not a Māori authority or entity eligible to be one, and is not owned by such an entity. D Co is denied any deduction in relation to its share of the partnership interest, even for its share of property that would otherwise be Māori excepted land.

Paragraphs (a)(iii) and (b)

An exception is also considered to be appropriate in the context of land acquired under a Treaty settlement, given the role of Treaty settlements in acknowledging and addressing breaches by the Crown under Te Tiriti o Waitangi – The Treaty of Waitangi. It would not be appropriate for interest limitation to impact the value of Treaty settlements or the economic viability of Treaty settlement land. It could also create fairness issues between iwi groups that have already settled and those that have not.

Therefore, paragraph (a)(iii) provides that land held directly or indirectly by a Māori authority, or an entity eligible to be one, where the land was acquired as part of a Treaty settlement (including post-Treaty settlement mechanisms such as a right of first refusal), is Māori excepted land and is not subject to the interest limitation rules. The reference to indirect ownership ensures that the exception continues to apply if the land is transferred within a wholly-owned group of companies and corporate group structures involving a trust. If the land is on-sold (for example, to a property investor beyond the claimant group), the exception would not apply to that subsequent owner.

Note that, for tax purposes, land includes an "interest in land", which can include a ground lease from the perspective of the lessee. Many apartment buildings, particularly in Auckland city, are on ground lease land – this means that an investor in such an apartment would have a leasehold interest, rather than a freehold interest. That is, they would own the physical apartment but not the underlying land.

It is not uncommon for Treaty settlement land to be the subject of a long-term ground lease (for example, on a 99-year term). This allows the land to be developed and used efficiently by a third party while ensuring continuing ownership of the land itself.

Paragraph (b) ensures that the exception in paragraph (a)(iii) for Treaty settlement land does not apply to these leasehold interests by limiting the application of paragraph (a)(iii) to only the underlying owner of the land. This is to ensure that, for an investor purchasing a leasehold apartment, it should not matter to them who the ground lessor is or whether the land was returned under a Treaty settlement.

Therefore, paragraph (b) is necessary to ensure that property investors with leasehold interests in Treaty settlement land are not excluded from the interest limitation rules.

In some situations, the Māori authority (or eligible entity) that holds the land may not be able to use that particular entity to undertake development activity or manage the use of the land. Instead, they may set up another entity to carry out these activities and, to permit full use of the land, a ground lease may be entered into with that other entity as the lessee. In this case, the restriction in paragraph (b) does not apply.

Example 48: Ground leases and Treaty settlement land exception

LeaseCo is a private company engaged in property investment. LeaseCo has a 150-year ground lease for a parcel of land from a Māori authority for the purpose of building rental properties. LeaseCo owns the rental properties and derives rental income from the tenants. The Māori authority retains underlying ownership of the land. The Māori authority acquired the parcel of land via a post-Treaty settlement mechanism that gave it a right of first refusal over the purchase of the land; however, the Māori authority took out a loan to purchase the land.

The Māori authority is not subject to the interest limitation rules for its loan for the land, as the land meets the requirements of the definition of "Māori excepted land" (paragraph (a)(iii)) and is therefore excluded from being disallowed residential property (DRP). However, as LeaseCo is not owned by the Māori authority, the land is excluded from the definition of "Māori excepted land" for LeaseCo by paragraph (b). The land is therefore DRP and LeaseCo is subject to the interest limitation rules in subpart DH for the interest it incurs on the rental properties.

Exemptions for new housing supply – an overview

Sections DH 4(1)(2) and (3), DH 5(7), and YA 1 of the Income Tax Act 2007

The land business, development, and new build exemptions from the interest limitation rules all share the objective of ensuring the rules do not disincentivise investment in new housing supply. This section provides an overview of key concepts relevant to the exemptions and explains how the exemptions interrelate.

The land business, development, and new build exemptions

The **land business exemption** applies to interest incurred in relation to land held by taxpayers with professional property development, dealing, building or subdivision businesses under section CB 7. An exemption is provided for interest incurred in relation to land held in these businesses because they play an important role in the supply of new housing.

The **development exemption** applies to interest incurred in relation to land held by taxpayers who are undertaking activities on the land that contribute to new housing supply, but who are not professional property developers/builders so do not have a land business under section CB 7. Essentially, if a person does not qualify for the land business exemption but is developing land with an aim to creating new housing, then the development exemption should apply to the person.

The **new build exemption** generally applies once a new build has been added to the land, and in most cases applies for 20 years from the date the new build is completed. In most cases, the date a Code Compliance Certificate (CCC) was issued for a new build is used as a proxy for the date the new build was completed. The new build exemption will normally apply to interest incurred by a person who buys land with a new build on it (for example, from a property developer), or who has added a new build to land that they already own. All owners of new build land during the 20-year period qualify for the exemption – this includes the initial owner and any subsequent purchasers within that period.

Table 1 compares how the three exemptions work at a high level.[17]

Table 1: Comparing the land business, development, and new build exemptions

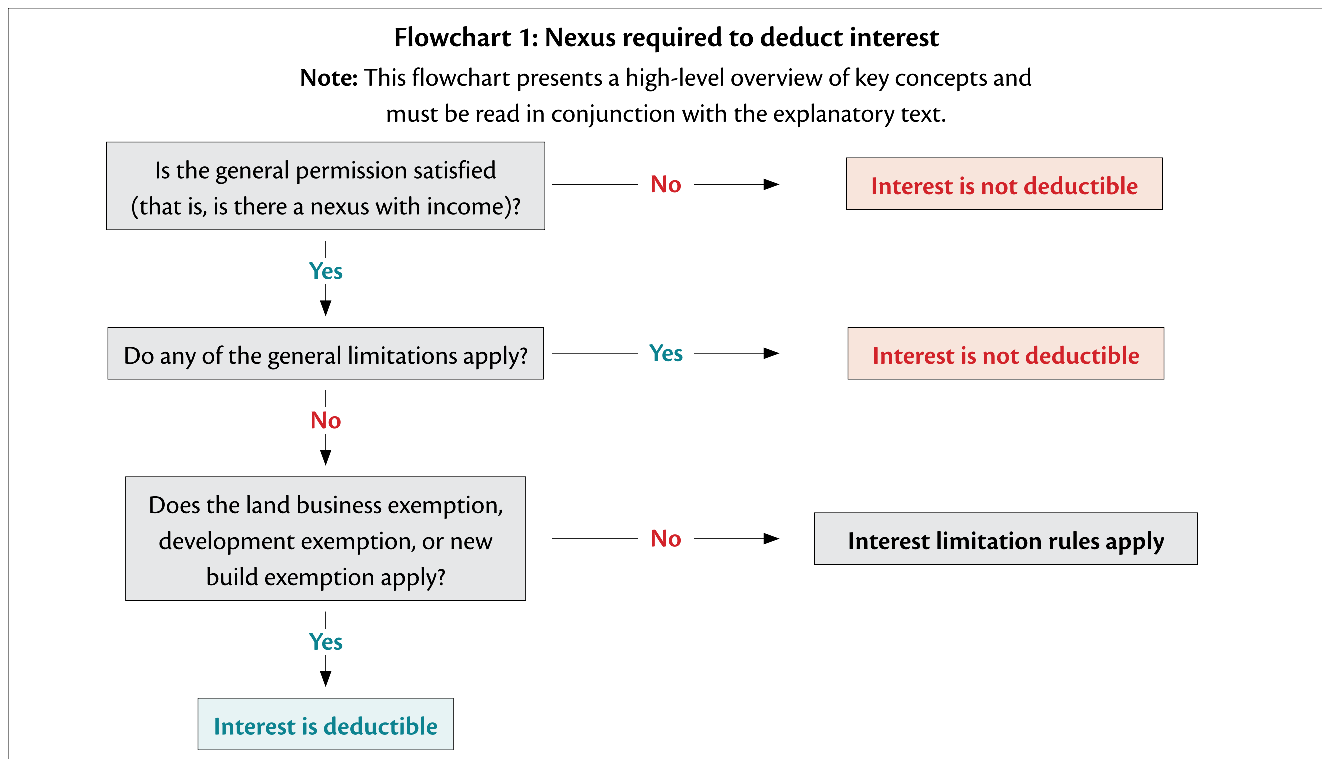
Exemption	What does it apply to?	Example	Start of the exemption	End of the exemption	Application to subsequent purchasers
Land business exemption	Interest incurred in relation to land held by a taxpayer in a section CB 7 land business (that is, a land building, development, subdivision, or dealing business).	*Interest incurred in relation to land held by a professional property developer.*	When land is acquired.	Ends when the taxpayer's section CB 7 land business ceases.	Does not transfer to subsequent purchasers. Subsequent purchasers can qualify if they themselves meet the criteria for the land business exemption.
Development exemption	Interest incurred in relation to land that the land business exemption does not apply to, but which is held by a taxpayer who has an undertaking or scheme to develop, build or subdivide land for the purpose of creating new build land.	*Interest incurred in relation to land being developed by a person who has a rental property business, but who is not a professional property developer themselves.*	When the person's undertaking or scheme begins.	Ends the earlier of when the land is disposed of or when it becomes new build land (in which case the new build exemption applies). Exceptions apply in rare cases.	Does not transfer to subsequent purchasers. Subsequent purchasers can qualify if they themselves meet the criteria for the development exemption.
New build exemption	Interest incurred in relation to new build land if it is incurred within 20 years of the new build being added to the land (usually the date the CCC for a new build on the land was issued).	*Interest incurred by a person who has bought land with a new build on it from a property developer and rents that new build out.*	When the land becomes new build land (normally when a new build's CCC is issued, unless the new build is purchased off the plans, when the exemption will apply from time of purchase).	Generally, for a taxpayer, ends the earlier of when the taxpayer disposes of the land, or when 20 years have passed from the date the new build's CCC was issued.	Transfers to subsequent purchasers within the 20-year period the exemption applies for.

Key concepts

Nexus required for interest to be deductible

The application of an exemption does not automatically guarantee that interest will be deductible. The exemptions stop the interest limitation rules from applying to the interest, either completely or for a period. However, normal tax rules regarding interest deductions still have to be satisfied for the interest to be deductible.

[17] See the "Land business exemption", "Development exemption", and "New build exemption" sections for more information on each of the exemptions.



This means that a taxpayer will need to consider whether they have satisfied the general permission in section DA 1 first, before they consider whether an exemption applies to them. The general permission allows a person a deduction for an amount of expenditure or loss to the extent to which it is incurred by them in deriving income or carrying on a business. That is, if a person's interest has a nexus (or a sufficient connection) with their income-earning activity, then the general permission enables them to deduct that interest unless a deduction is denied by another provision.

Once a person has determined they have satisfied the general permission, they will need to consider whether any of the general limitations in section DA 2 apply to prevent them deducting the interest. There are several general limitations, including the private limitation, which denies deductions for private or domestic expenditure or loss. There are also other specific provisions in the Income Tax Act 2007 that deny deductions that taxpayers will need to consider.

Example 49 illustrates how a nexus with income is required in the context of the new build exemption.

Example 49: No nexus because 'new build' is owner's main home

In 2022, Joshua buys a brand-new townhouse in New Plymouth that he decides to live in as his main home. He does not have any flatmates and does not use any part of the land as business premises. While the new build exemption would technically apply to any interest Joshua incurs in relation to the townhouse, he cannot deduct the interest because the interest has no nexus with income.

Fact variation: New build is used as rental property

Assume the same facts, but instead of living in the townhouse as his main home, Joshua rents it out. The new build exemption applies, and Joshua can deduct the interest he incurs in relation to the townhouse. There is a nexus between Joshua's income from the rental property and the interest he incurs on the townhouse, and there are no other provisions in the Income Tax Act 2007 that would prevent him from deducting the interest.

Example 50: Nexus and the development exemption

Amal owns and manages multiple rental properties. Assume the activity amounts to a business. Amal has engaged a building firm to build a house on an empty piece of land. He intends to use this new build as another rental property in the future. In these circumstances, the development exemption would apply, and the interest incurred by Amal for the development activity would be deductible as there is a nexus with his larger property rental business.

Annie engages a builder to build a property on an empty piece of land. Annie intends to live in the property with her wife as their main home and has obtained a loan to fund the development. Although Annie is building a new house, she has not met the requirements to obtain an interest deduction – there is no nexus to an income-earning activity.

What interest can qualify for the exemptions?

Any interest incurred in relation to land that qualifies for an exemption is deductible as long as the nexus with an income-earning activity is met.[18] This may include interest incurred on borrowings that relate to:

- acquiring land
- developing or subdividing the land
- constructing or installing a new build on the land
- land holding costs (such as rates and insurance)
- renovating, maintaining, or repairing a new build.

Example 51: Interest deductible under land business exemption

Kamal is a sole trader who carries on a successful business of building small houses and selling them to first home buyers. Kamal usually obtains a loan to buy the land and pay the related expenses of the building activity. This includes expenses such as the cost of buying the land, making any payments to local or building consent authorities in relation to the land, legal and other professional fees (such as for architects and surveyors) incurred in relation to the land, and the costs of building materials. Interest on the loan will be exempt from the interest limitation rules under the land business exemption and deductible because it meets the deductibility rules under existing tax law, being incurred in the course of carrying on a business to derive income.

Example 52: Exemption applies to all interest for new build land

Iona owns land that qualifies for the new build exemption. The new build on the land is always rented out. During the period the exemption applies, Iona decides to add a new deck to the new build. Iona will be able to deduct the interest she incurs on the loan she takes out to add the deck.

Ten years after the new build receives its CCC, Iona decides to repaint it. She takes out another loan to pay for repainting the new build. The interest she incurs on that loan would also be deductible.

If Iona is still incurring interest in relation to the new build land after the exemption expires (20 years after the CCC was issued), she will not be able to deduct that interest because the interest limitation rule will apply.

What is "new build land"?

The development and new build exemptions both refer to "new build land". "New build land" is defined in section DH 5(7). Generally, new build land is defined to mean land that has a self-contained residence or abode on it, provided the residence/abode received a CCC on or after 27 March 2020 confirming it has been added to the land. Once such a residence or abode (a new build) has been added to residential land, that land becomes "new build land".

Land for which there is an agreement to add a new build may qualify as new build land. In addition, buildings that are converted into self-contained residences (such as office blocks converted into apartments, or large houses converted into multiple units), and existing buildings that are remediated for weathertightness or seismic issues, may also qualify as new build land if certain criteria are met.

For more information, see the "Definition of 'new build land'" section.

[18] And none of the general limitations or other provisions, apart from the interest limitation rules, would prevent the interest from being deducted.

Apportionment may be required

The provisions that contain the exemptions (sections DH 4(1) to (3)) all include the words "to the extent", as shown in the table below.

New build exemption	Land business exemption	Development exemption
(1) This subpart[19] does not apply to interest incurred by a person **to the extent** to which it is– (a) incurred in relation to new build land; and (b) incurred before the date that is 20 years after the earliest of the following dates for the new build land …	(1) This subpart does not apply to interest incurred by a person **to the extent** to which it is in incurred in relation to a business described in section CB 7 (Disposal: land acquired for purposes of business relating to land).	(1) This subpart does not apply to interest incurred by a person (person A) **to the extent** to which it is incurred in relation to land (the land) that is or was subject to person A's undertaking or scheme involving development, division, or building for the purpose of creating new build land. However, the exemption in this subsection ceases for person A **to the extent** to which the land is new build land owned by person A.

The inclusion of the words "to the extent" means that sometimes interest will need to be apportioned because only a portion of the interest a taxpayer incurs qualifies for an exemption.

Apportionment will only be required where the interest incurred partially qualifies for an exemption. For example, where a loan is for a parcel of land that has both a new build on it and an older house that was built some time ago, only the interest that relates to the new build portion of the land would qualify for the new build exemption. Alternatively, there could be one loan that relates to two different parcels of land, one of which is new build land, while the other is subject to interest limitation. In this case, only interest incurred in relation to the parcel of land that is new build land would qualify for the new build exemption.

Where apportionment is required, existing apportionment principles must be applied. Any reasonable apportionment method can be used – this can include a valuation-based apportionment method or a land area apportionment method.

[19] The subpart referred to in these provisions is subpart DH, which contains the interest limitation rules.

Example 53: Interest relates to land with a new build and a non-new build

This example illustrates how interest could be reasonably apportioned where it only partially relates to new build land. There may be other apportionment methods that, if applied in accordance with existing tax principles, could also be considered acceptable.

Bridgette acquires 1500m^2 of land in Kaitaia. The land has a 1970s standalone house (non-new build), as well as two new build townhouses. Bridgette takes out a loan of $1m to acquire the land. All three buildings on the land are used as long-term rentals.

The total land area of 1500m^2 is used as follows:

- 400m^2 is used exclusively by the non-new build
- 800m^2 is used exclusively by the two new builds, and
- 300m^2 is a shared outdoor area.

Because the shared outdoor area is used by three residences, two of which are new builds, it is reasonable for Bridgette to apportion the shared outdoor area as ⅔ relating to the new builds. After apportioning the shared outdoor area:

- **500m2 is not considered new build land**. This is the 400m^2 used exclusively by the non-new build, plus one third of the shared outdoor areas (⅓ x 300m^2 = 100m^2).
- **1000m2 is considered new build land**. This is the 800m^2 used exclusively by the new builds, and two thirds of the shared outdoor areas (⅔ x 300m^2 = 200m^2).

It would therefore be reasonable for Bridgette to deduct two-thirds of the interest she incurs in relation to the land, because two-thirds of the total land area (1000m^2 of the total 1500m^2) is attributable to the new builds. One-third of the interest she incurs would not be deductible, because it would be attributable to the non-new build portion of the land.

Fact variation: Valuation-based apportionment

Assume similar facts to above, except that Bridgette apportions based on valuation. A valuation for the property has attributed the following values to the land and the residences on it:

- The land (unimproved) is valued at $700,000.
- The non-new build is valued at $250,000.
- The new builds are valued at $450,000.

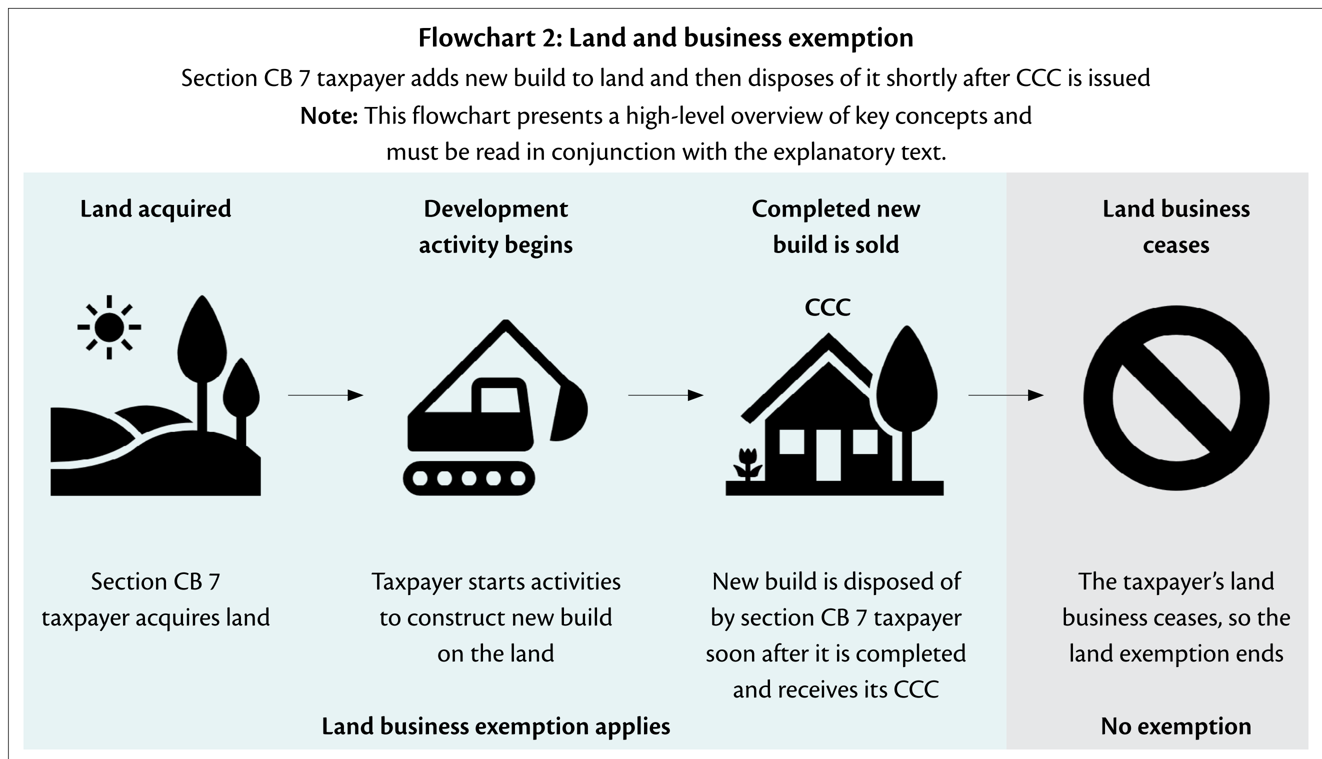
Applying a valuation-based apportionment method, the following proportion of interest that Bridgette incurs in relation to the land would be deductible:

Valuation for	Value	% of total value of the property	% total interest incurred in relation to the property (to which new build exemption applies)
Land	$700,000	50%	33.33% (since two thirds of the total land area is used by the new builds, only that proportion of the land valuation is attributable to the new builds – ⅔ x 50% is 33.33%)
Non-new build	$250,000	17.86%	0%
New builds	$450,000	32.14%	32.14%
% of total interest incurred in relation to the property that is deductible			**65.47%**

Relationship between the exemptions

Land business exemption

If the land business exemption applies, the development and new build exemptions will not be relevant for that taxpayer. However, those other exemptions could be relevant to a subsequent purchaser after the taxpayer disposes of the land.



What exemption applies for a subsequent purchaser?

If the land business exemption applies to land and the land is later disposed of to another taxpayer, interest incurred by that subsequent taxpayer in relation to the land does not automatically qualify for the land business exemption. If the taxpayer acquiring the land:

- **has a section CB 7 land business and holds the land as part of that business**, then the land business exemption will apply to interest incurred by the taxpayer in relation to the land.
- **does not have a section CB 7 land business but develops, subdivides, or builds on the land for the purpose of creating new build land**, then the development exemption criteria will be met, and interest incurred by the taxpayer in relation to the land may be deductible (subject to normal deductibility criteria – see discussion on nexus above).
- **does not have a section CB 7 land business and does not qualify for the development exemption, but the land is considered 'new build land'**, the new build exemption will apply to interest incurred by the taxpayer in relation to the land (as long as the interest is incurred during the 20-year period the new build exemption applies for).

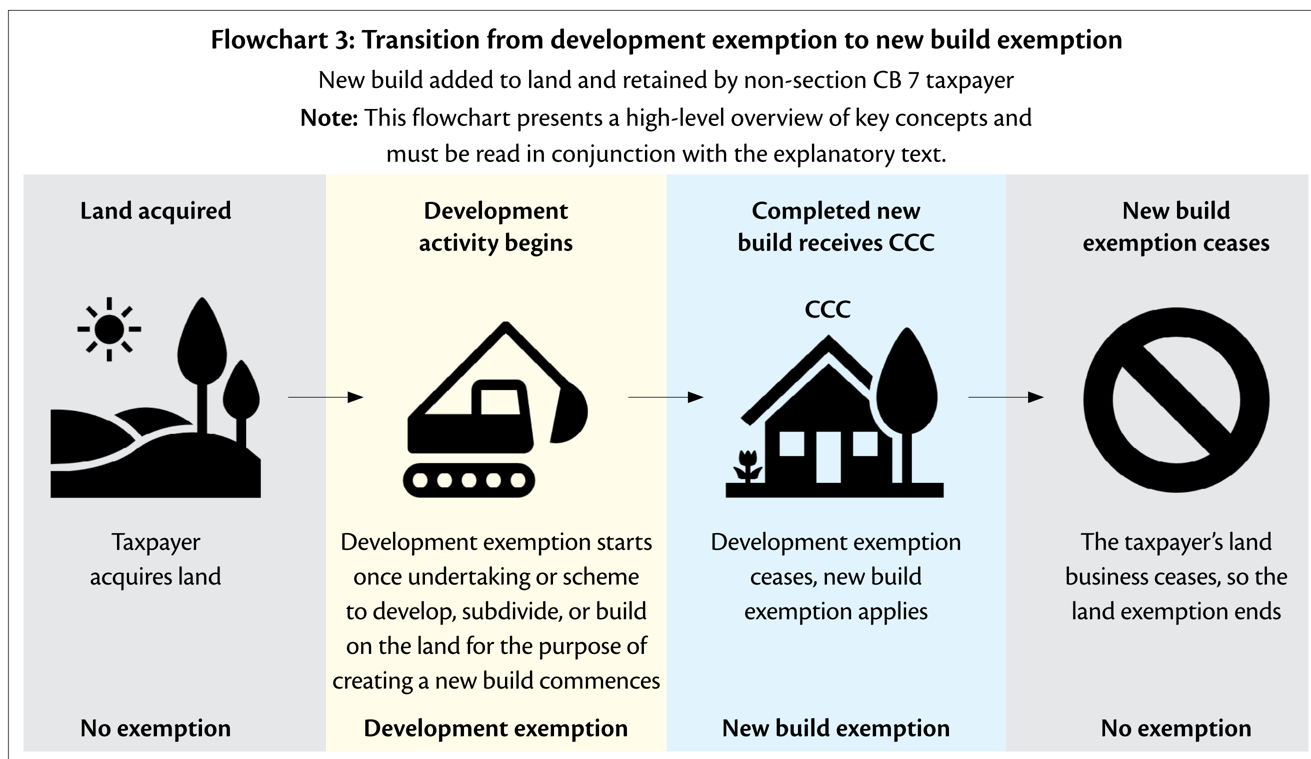
Development exemption transitions to new build exemption

The development exemption applies to interest incurred in relation to land that is, or was, subject to a person's undertaking or scheme involving development, division, or building for the purpose of creating new build land. Once the land becomes new build land, if the person retains the land, the development exemption would no longer apply and the new build exemption would instead apply to the land.

Flowchart 3: Transition from development exemption to new build exemption

New build added to land and retained by non-section CB 7 taxpayer

Note: This flowchart presents a high-level overview of key concepts and must be read in conjunction with the explanatory text.



If the land is sold, the new build exemption would continue to apply for any subsequent purchaser during the 20-year period that the new build exemption applies for.

Example 54: Land transitions from development exemption to new build exemption

Amber and Sandy buy a large section in Orewa. They purchase the land with the intention of adding new builds to the land, renting these out for a short period, and then selling them off for a profit. Once they start an undertaking or scheme to develop and build on the land to add new builds, they qualify for the development exemption.

After construction is complete, the new builds receive their CCCs. At this point, the development exemption ceases to apply to the land, and instead, the new build exemption starts to apply. The new build exemption will continue to apply to the land until 20 years have passed from the date the new builds received their CCCs.

Three years after the residences receive their CCCs, Amber and Sandy sell the land to James. The new build exemption continues to apply to the land, but it will only apply for another 17 years – the 20-year exemption period does not reset when the land is sold.

Exemptions may apply concurrently for two taxpayers

Sometimes, the new build exemption can apply for the purchaser of a new build at the same time the land business or development exemption applies for another taxpayer that is developing the land. This will usually occur where a new build is purchased off the plans (that is, before it is constructed).

When a new build is purchased off the plans:

- The developer or builder may qualify for the land business or development exemption while they are adding the new build to the land.
- The purchaser may also qualify for the new build exemption while the new build is being added to the land if they have already acquired an interest in the land. (Although note that a nexus would be required for the interest to be deductible, even if the new build exemption applies.)

Example 55: Exemptions apply concurrently for land business taxpayer and purchaser

Neo and Archie own a large property development business, Neo-Archie Homes Ltd, that specialises in building property sold off the plans during construction. They acquire some former farmland in South Wairarapa that they intend to subdivide and construct new builds on. On 1 October 2021, Bagheera enters into an agreement to buy a new build from Neo-Archie Homes Ltd. The new builds are still being constructed and do not receive their CCCs until 24 October 2022. On 31 October 2022, title for Bagheera's new build is registered to him.

Neo-Archie Homes Ltd

The land business exemption applies to Neo-Archie Homes Ltd while it holds the land. This is because it holds the land as part of a land-related business.

Bagheera

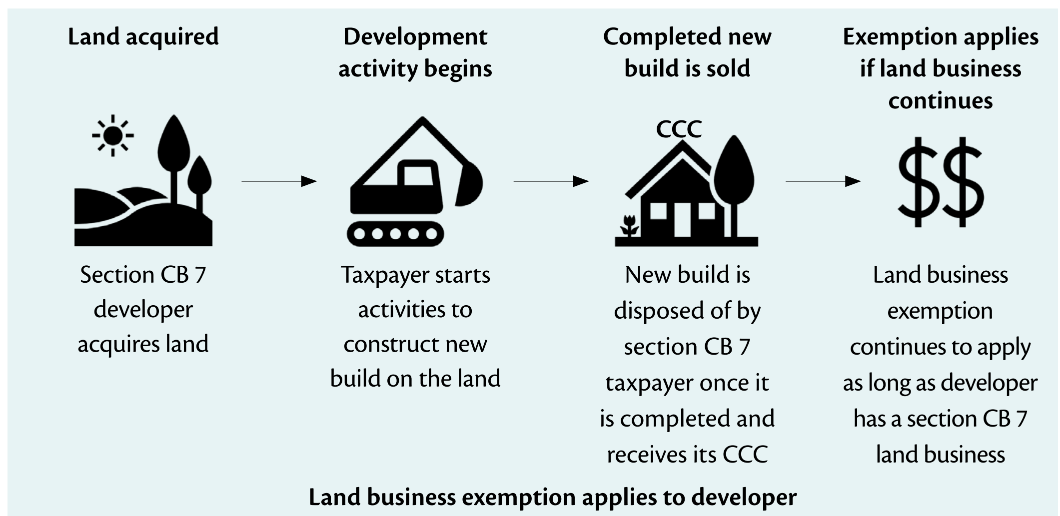
Bagheera will meet the criteria for the new build exemption from 1 October 2021 because he has acquired a new build off the plans. He would therefore potentially be able to deduct interest from that date, but only if he satisfies the normal deductibility requirements under existing tax rules. The new build exemption will apply to the land until 23 October 2042, 20 years after the new build received its CCC.

Flowchart 4: Exemptions may apply concurrently

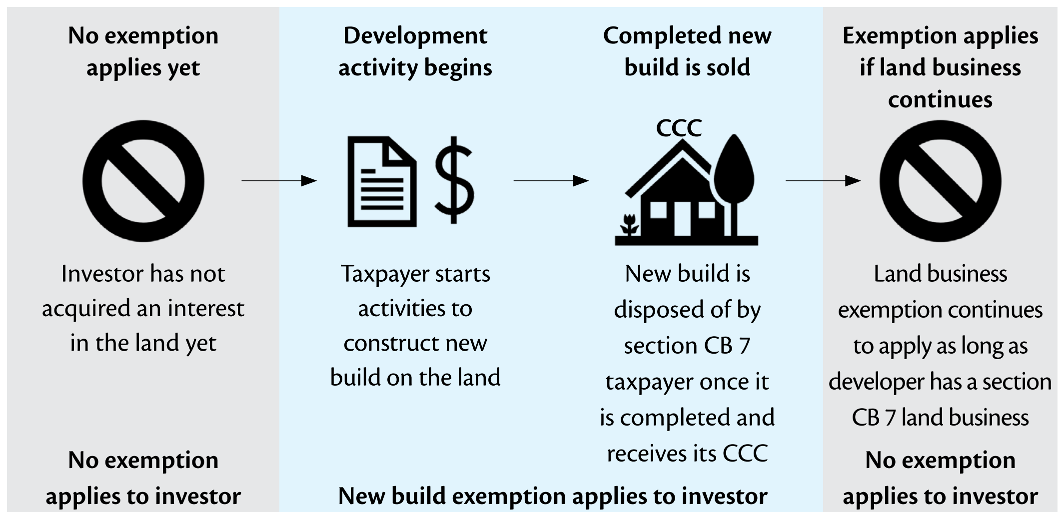
New build is purchased by an investor off the plans from a section CB 7 property developer

Note: This flowchart presents a high-level overview of key concepts and must be read in conjunction with the explanatory text.

Section CB 7 Developer



Investor who purchases new build off the plans



NEW LEGISLATION

Land business exemption

Section DH 4(2) of the Income Tax Act 2007

The land business exemption is aimed at ensuring the interest limitation rules do not negatively impact upon new housing supply. The exemption applies to interest for all land to which section CB 7 applies, even if there is no active development, division, or building work occurring on the land at the time. This is because of the significant role section CB 7 land businesses play in providing new housing stock, and because it is likely that section CB 7 taxpayers have multiple plots of land with different debt funding relating to a number of them.

Key features

The key features of the land business exemption are discussed above in the "Exemptions for new housing supply – overview" section.

Application date

The land business exemption came into force on 27 March 2021 and applies to interest incurred on or after 1 October 2021. However, the exemption may apply for a given taxpayer from a later date, depending on when the section CB 7 land is acquired – refer to the discussion under the "*Land business exemption start and end date*" heading below.

Detailed analysis

Exemption applies to land businesses

An exemption from the interest limitation rules applies to the extent interest is incurred by a taxpayer in relation to land held by that taxpayer as part of a business described in section CB 7. This exemption is set out in section DH 4(2) and is referred to as the "land business exemption."

The following businesses are described in section CB 7:

- dealing in land
- developing land
- dividing land into lots, and
- erecting buildings.

Practically, this means people who are professional land dealers, land developers or engaged in land subdivision will qualify for the land business exemption for interest incurred for the land they acquire and hold as part of their land business. Additionally, professional builders who acquire land for their business and make improvements to the land will also qualify for the land business exemption, provided they meet the requirements of section CB 7.

Example 56: Land developed by taxpayer with land-related business

XD Developers is a company that regularly buys land, develops the land into residential subdivisions and sells the divided lots to buyers. XD Developers is a land-related business, and the sale of its land is taxable under section CB 7.

XD Developers decides to acquire a new piece of land for property development. It obtains a loan from Big Bank to buy the land, and Big Bank obtains security over the land.

Once XD Developers commences the development activity, it obtains further funding from Big Bank to help with its development expenses. Since XD Developers is a land-related business and has acquired the property for the business, the land business exemption applies. All interest on the loans obtained from Big Bank for the land will be deductible.

Land not originally acquired for section CB 7 land business

If a person does not acquire land for a land-related business but later forms an intention to develop the land, the land business exemption will not apply. Instead, the person will need to meet the requirements of the development exemption to avoid the application of the interest limitation rules (see the "Development exemption" section for more information).

Taxpayer with both section CB 7 and non-section CB 7 land

If a taxpayer holds a mixture of section CB 7 and non-section CB 7 land, the land business exemption will not apply to all the taxpayer's land. The exemption only applies to the section CB 7 land held by the taxpayer. The interest limitation rules will apply to the taxpayer's non-section CB 7 land unless another exemption (such as the development or new build exemption) applies.

Example 57: Rental property retained by taxpayer with land-related business

Jones Co is a business that subdivides rural land and sells it to property developers, who in turn develop and build on the land. Therefore, Jones Co's income from disposing of the land held in the business is subject to tax under section CB 7.

Since section CB 7 applies, the land business exemption will apply as soon as Jones Co purchases the land for its business and will continue to apply for long as Jones Co continues its land-related business. The exemption will apply to interest incurred on all borrowings for land acquired for Jones Co's business.

On one occasion, Jones Co decides to acquire land to try its hand at building a house to keep and rent out long term. In so doing, the relevant land is not held on revenue account under section CB 7. The land business exemption will therefore not apply.

The criteria for the development exemption may be met until the time the new build added to the land receives a code compliance certificate (CCC). However, even if the criteria are met, interest will only be deductible if the normal deductibility rules are satisfied - that is, there must be a nexus with income derived. Once a CCC has been issued, the new build exemption will apply.

Remediating or renovating older houses

Where a taxpayer's section CB 7 land business involves remediating or renovating older houses for sale, the exemption will also apply to interest incurred on borrowings used in relation to that business. This is a unique feature of the land business exemption. The development and new build exemptions do not apply to interest incurred on remediating or renovating non-new builds, except to the extent the repairs or renovation work relate to remediating an earthquake prone or leaky building (see the "New build exemption" section for more information).

Example 58: Renovating properties

Rainbow Builders Ltd (RB) has a business of buying old properties, adding new features, and selling the properties for a profit. RB acquires a large number of old villas in an older neighbourhood to renovate and on sell. RB modernises the properties by updating their electrical systems and refitting their kitchens and bathrooms with new fixtures. RB also repaints the interiors and adds new decks to each of the properties.

RB acquired the portfolio of villas to renovate and sell them as part of a land-dealing business under section CB 7, so the interest RB incurs for the properties will qualify for the land business exemption. All interest incurred for loans to acquire the villas, hold them, and renovate them will be deductible and not subject to the new interest limitation rules.

Land business exemption start and end date

The exemption starts from the date section CB 7 land is acquired by a taxpayer and ends when the taxpayer ceases to have a section CB 7 land business. So, if a taxpayer has land to which section CB 7 applies and then disposes of that land, the land business exemption will continue to apply for interest incurred in relation to that land. For example, if the land is sold at a loss and the sale proceeds do not fund complete repayment of the loan, some debt relating to the land may remain after its sale. The exemption will continue as long as the taxpayer still has a section CB 7 land business. When the taxpayer's section CB 7 land business ceases, the exemption will cease to apply as well.

Development exemption

Sections DH 4(3), DH 5(7), and YA 1 of the Income Tax Act 2007

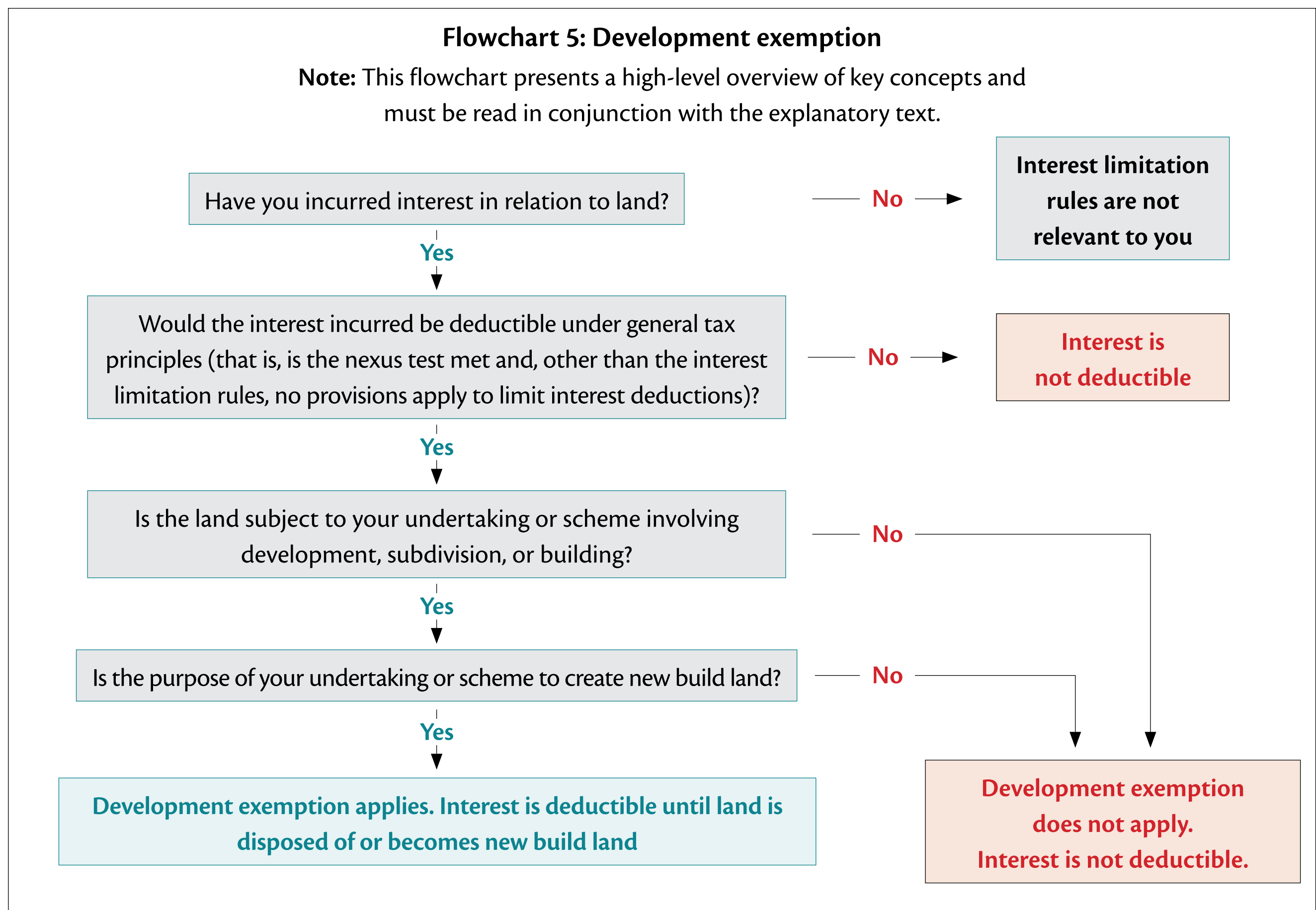
The development exemption is aimed at ensuring the interest limitation rules do not negatively impact upon activity that creates new housing supply. The exemption applies to interest a person incurs for development, subdivision or building activity undertaken to create new build land.

Key features

The key features of the development exemption are discussed above in the "Exemptions for new housing supply – overview" section.

Application date

The development exemption came into force on 27 March 2021 and applies to interest incurred on or after 1 October 2021. However, the exemption may apply for a given taxpayer from a later date, depending on when the taxpayer's undertaking or scheme to develop the land begins – refer to the discussion under the "*Development exemption start and end date*" heading below.



Detailed analysis

An exemption from the interest limitation rules applies for interest a person incurs in relation to an undertaking or scheme involving developing, subdividing or building for the purpose of creating new build land. This exemption is set out in section DH 4(3) and is referred to as the "development exemption". The activities to which the development exemption applies (developing, dividing, and building) are referred to as "development" below.

Unlike the land business exemption,[20] the development exemption applies to interest incurred by a person developing land where section CB 7 does not apply.

Undertaking or scheme

The exemption applies to the extent the interest incurred is in relation to land subject to an undertaking or scheme involving development, subdivision, or building to create new build land. The existing meaning of "undertaking or scheme", as used in section CB 12, applies. An undertaking or scheme is a plan, design or program of action devised to attain some end result. For the development exemption, it is sufficient to demonstrate a coherent plan or purpose that involves a series of steps to create new build land.

Example 59: Undertaking or scheme

Brooke owns and manages ten residential rental properties. She also owns a large section of land that she decides to subdivide and build five additional townhouses on. She plans to sell the townhouses.

The development exemption begins when Brooke's undertaking or scheme to subdivide the land begins. For example, it may start once Brooke engages a company to survey the land and prepare the subdivision plan. When an undertaking or scheme begins will depend on the facts of each case.

Fact variation: Subdivision with no intention to create new build land

Assume the same facts, except that Brooke decides to subdivide the large section of land but has no intention of creating new build land herself. After she subdivides the section, Brooke sells it to a property developer. The development exemption does not apply to the land because Brooke subdivided the land without an intention to create new build land.

[20] See the "Land business exemption" section for more information.

Development exemption start and end date

The exemption applies from the date an undertaking or scheme to develop, subdivide or a build on the land for the purpose of creating new build land begins.

It will end for the person undertaking the development once the land becomes new build land if the person retains the land. Land would generally become 'new build land' when a code compliance certificate (CCC) is issued for a self-contained residence or abode that has been added to the land, provided the CCC is issued on or after 27 March 2020 (for more information, see the "Definition of 'new build land'" section).

Example 60: Transition from development exemption to new build exemption

Abigail is engaged in the development of a new self-contained residence. While Abigail is in the process of developing these "new builds", the development exemption will apply. However, Abigail will only be able to deduct interest under this exemption if the general deduction criteria set out in existing tax rules are met. Once the new self-contained residence has received its CCC, the development exemption will cease to apply, and the new build exemption will apply to the land instead.

The development exemption may still apply to interest on debt if the development has been sold at a loss and the proceeds were insufficient to repay all the debt, such that interest is still being incurred after the land is disposed of. However, in most cases interest will not be deductible after the land is disposed of it because the nexus test will not be met.

Definition of "new build land"

Sections DH 5(7) and YA 1 of the Income Tax Act 2007

A definition of "new build land" has been introduced for the purposes of the new build exemption from interest limitation[21] and the 5-year new build bright-line test.[22] The definition is also relevant to the development exemption from interest limitation.[23]

New build land is generally defined to mean land to which a self-contained residence or abode has been added, provided a Code Compliance Certificate (CCC) is issued on or after 27 March 2020 showing that the residence/abode has been added to the land (although some exceptions apply, as discussed below).

Key features

"New build land" is defined in new section DH 5(7) to mean land to the extent to which it has a place configured as a self-contained residence or abode (self-contained residence), provided one or more of the following paragraphs in section DH 5(7) are satisfied:

Description	Examples	Section
A CCC has been issued on or after 27 March 2020 evidencing that the **place was added to the land.**	*A self-contained residence is constructed on (or relocated onto) the land.*	DH 5(7)(a)
A CCC has been issued on or after 27 March 2020 evidencing a **place already on the land has been converted** into the self-contained residence.	*A commercial building is converted into one or more self-contained residences.* *An existing home is converted into two or more self-contained residences.*	DH 5(7)(a)

Continued...

[21] See the "New build exemption" section.

[22] See the "5-year new build bright-line test" section.

[23] See the "Development exemption" section.

Description	Examples	Section
Local or building consent authority[24] records show that the **conversion of the place from a hotel or motel** into one or more self-contained residences was completed on or after 27 March 2020.	*A hotel is converted into individual self-contained units or apartments.*	DH 5(7)(d)
The place was **removed from the earthquake-prone buildings (EPB) register** on or after 27 March 2020, and either: received a CCC on or after 27 March 2020 evidencing that building work to remediate the place is complete, or local or building consent authority records show that the building work to remediate the place was completed on or after 27 March 2020 and was verified by a suitably qualified engineer.	*An existing apartment block that is on the EPB register is remediated and then removed from the register.*	DH 5(7)(e)
The place was **not previously weathertight**, but a CCC has been issued on or after 27 March 2020 evidencing that **at least 75% of the place's cladding has been replaced**.	*An existing self-contained residence that has weathertightness issues is re-clad to fix those issues.*	DH 5(7)(f)

Includes exclusive areas and some shared areas (section DH 5(7)(b))

New build land includes any areas of land that are exclusively used by residents of the self-contained residence. It also includes a reasonable proportion of shared areas of land that are appurtenant to the residence.

Agreement to add residence to land (section DH 5(7)(c))

For the purposes of the new build exemption from interest limitation, new build land includes land for which there is an agreement to add a self-contained residence, provided a CCC will be issued on or after 27 March 2020 evidencing the place was added to the land. This inclusion does not apply for the purposes of the new build bright-line test (see section CB 6A(1)(b)(iii)).

Application date

The definition of new build land applies:

- To residential land acquired on or after 27 March 2021 for the purposes of the new build bright-line test.[25]
- From 1 October 2021 for the purposes of the new build exemption from interest limitation, regardless of when the land is acquired.

Detailed analysis

"To the extent" means apportionment may be required

The definition of new build land in section DH 5(7) mentions the words "to the extent". For example, paragraph (a) of the definition says:

> [New build land] means land **to the extent** to which it has a place that is configured as a self-contained residence or abode, if a code compliance certificate has been issued on or after 27 March 2020 evidencing that the place was added to the land or converted into a residence or abode;

The inclusion of the words "to the extent" means that sometimes only part of a piece of land may be new build land. How land that is only partially new build land should be apportioned for the new build exemption from interest limitation is covered in the "Exemptions for new housing supply – overview" section. See the "5-year new build bright-line test" section for more information on how to apportion for the purposes of that test.

Self-contained residence

Land can only satisfy the definition of new build land if there is a place that is configured as a self-contained residence on the land.

'Self-contained' is not explicitly defined in the legislation, but it is intended to mean a place that is able to be lived in by a single household, without that household having to share essential facilities, such as a kitchen or bathroom, with another household.

[24] "Building consent authority" has the meaning given to it in the Building Act 2004.

[25] But not to residential land acquired on or after 27 March 2021 as a result of an offer made by the purchaser on or before 23 March 2021, provided the offer could not be revoked before 27 March 2021.

Example 61: Place with shared kitchen facilities

Kate owns land with an existing self-contained residence on it. The land is not new build land, as the residence was completed and received its CCC before 27 March 2020.

Kate adds a sleepout, which she intends to rent out, behind the existing residence. The sleepout can function as an extra bedroom and has its own bathroom, but it does not have its own kitchen. Anyone living in the sleepout would have to use the kitchen located in the existing dwelling.

Having no kitchen means the sleepout is not self-contained. Therefore, the land is not considered new build land after the sleepout is added to it.

Land that has a place on it that was not previously self-contained, such as a sleepout, may qualify as new build land if the place later becomes self-contained.

Example 62: Sleepout converted to self-contained residence

Assume same facts as in example 61 above. Six months after she builds the sleepout, Kate adds a kitchen to it. The building work to turn the sleepout into a self-contained residence receives a CCC on 20 December 2021.

The following areas of land would be considered new build land:

- the area the new self-contained residence (the sleepout) is on
- land used exclusively by the residents of the sleepout, such as an exclusive outdoor garden or patio area, and
- a reasonable proportion of any shared areas, such as a driveway that is shared with the other residence on the land.

The remainder of the land would be attributable to the existing residence (not the new self-contained residence that was formerly a sleepout), so would not be considered new build land.

Even if some areas of a property are shared with other household units, a residence may still be considered self-contained as long as it has its own essential facilities.

For example, a residence could be considered self-contained even if it shares the following facilities/areas with other residences/places:

- **A landing or entranceway**. For example, where the front doors in a block of apartments or units come off the same landing or entranceway.
- **Laundry facilities**. For example, where a block of four units all have access to a shared room that has a communal washing machine and dryer, or all share an outdoor washing line.
- **Recreational facilities**. For example, a swimming pool or a shared exercise room/gymnasium.
- **Outdoor areas**. For example, a shared outdoor entertainment area, driveway, or garden area.

Example 63: Apartment block with communal facilities

Amber owns an apartment in a five-storey apartment block. The apartment has its own kitchen and bathroom facilities, and its front door is located on a landing that is shared with three other apartments (with the landing accessible by stairs or lift).

All the apartments in the block share a ground floor lobby area, stairs, and a lift. Occupants of all the apartments can use a shared gymnasium and pool, as well as a small room that contains washing machines and driers.

Amber's apartment is considered "self-contained", even though she shares some areas and facilities with other residents of the apartment block.

A residence that shares a utilities connection with another residence may also be considered self-contained.

Example 64: Internal access door and shared utilities connections

Blair owns a large two-storey house. It has two kitchens, three bathrooms and five bedrooms. Upstairs there is one kitchen, two bathrooms and four bedrooms. The remaining kitchen, bathroom and bedroom are downstairs. The downstairs area (the flat) can be locked off from the rest of the house via a lockable internal door.

A firewall separates the flat from the main house. It has its own front door, which opens out to a shared front garden area. The flat and main house share power and water connections.

The flat is a self-contained residence. It is capable of being rented out and occupied by a single household unit, without the household in the flat having to share any essential facilities with residents of the main house. It does not matter that there is an internal door through which the flat can be accessed by the main home, because that internal door can be locked when the flat is being rented out. It also does not matter that the power and water connections are shared by the flat and main house.

Materials used and type of new build

It does not matter what size a self-contained residence added to the land is for the purposes of determining whether the land is new build land. For example, adding a tiny home to land would enable the land to qualify as new build land (as long as the home is self-contained and receives a CCC on or after 27 March 2020 showing that it has been added to the land).

The materials used to construct a residence on new build land are also irrelevant. Brand new materials or recycled/reclaimed materials could be used in the construction of the residence, provided the property is still able to obtain its CCC (or satisfy the local/building consent authority record requirements in sections DH 5(7)(d) and (e)(ii) if these provisions apply). An older house that is relocated onto the land may also enable the land to qualify as new build land.

Example 65: New build constructed off-site using reclaimed materials

Sandy has a tiny home constructed off-site from reclaimed materials. The tiny home contains its own kitchen and bathroom facilities. When construction is complete, Sandy adds the tiny home to her residential land, and it receives its CCC on 22 February 2021 evidencing that it has been added to the land. As the tiny home is self-contained and received its CCC after 27 March 2020, Sandy's land qualifies as new build land.

27 March 2020 date

The definition of "new build land" requires there to be proof that a self-contained residence was either added to the land or converted from an existing place on the land. The proof required is generally a CCC issued on or after 27 March 2020. However, for hotel/motel conversions and EPBs that are remediated, other records held by a local authority or building consent authority can be used instead of a CCC.

Date of acquisition not relevant

The acquisition date of the land is not relevant to determine whether land can qualify as new build land. Instead, the date a residence on the land receives its CCC will generally be what is important.

Example 66: Date of acquisition irrelevant

Mark acquires residential land on 1 November 2019. He adds a self-contained dwelling to the land that is completed and receives its CCC on 31 March 2020. The land that the self-contained dwelling has been added to qualifies as new build land because the dwelling's CCC was issued after 27 March 2020. It does not matter that Mark acquired the land before 27 March 2020, as the date of acquisition is not relevant to whether the land satisfies the definition of new build land.

Added to the land (section DH 5(7)(a))

"Added to the land" includes where:

- a new residence is constructed on the land
- a modular home is added to the land, and
- an older home is relocated onto the land.

It does not matter whether there is an existing residence on the same title, or whether the residence that is added to the land is standalone or attached[26] to another residence on the land.

[26] For example, a new residence added to the land could be added below, above, or to the side of an existing residence on the land.

Example 67: New self-contained residence added to land

Linda owns a rental property in Opaki that received its CCC in the 1980s. She adds a second self-contained residence that is attached to the existing rental property. The new self-contained residence receives its CCC on 11 February 2022. The portion of the land attributable to the new self-contained residence is considered new build land.

Existing house moved to enable new development

Land may qualify as new build land because a self-contained residence that is already on it is shifted from one position to another but remains on the land (provided a CCC is issued on or after 27 March 2020 evidencing the residence was added to the new location on the land).

This may occur, for example, where an existing house is shifted to make room for one or more new self-contained residences a taxpayer is adding to the land.

Example 68: Existing home relocated to make room for new residences

James owns a sizeable section in Lower Hutt that has a 1930s bungalow in the middle of it. In October 2022, he relocates the bungalow to the north-west corner of the section. A CCC is issued once the work necessary to finish relocating the bungalow is completed. James then adds three new self-contained residences to the section. They all receive their CCCs in due course.

The entire section is considered new build land. It does not matter that the bungalow is not made of brand-new materials, or that it was relocated on the same section.

Fact variation: Relocation to enable subdivision

After shifting the bungalow, James decides he does not want to continue with the development himself. He subdivides the section into four, and then sells off each parcel of land separately. The parcel of land that the bungalow is on is considered new build land because it has a self-contained place on it that received its CCC on or after 27 March 2020. However, the three other parcels of land do not qualify as new build land as they are bare land and do not have self-contained residences.

If a place was relocated on the same piece of land just to gain the benefit of the new build exemption or to qualify for the 5-year new build bright-line test instead of the 10-year test, this would be considered tax avoidance.

Conversion into a self-contained residence (section DH 5(7)(a))

Section DH 5(7)(a) includes conversions where:

- An existing home is converted so that where there was one residence there are now two or more self-contained residences.

Example 69: Existing home converted into two self-contained residences

Felicity owns a large two-storey character home on a moderately sized residential section in Thorndon. After permanently moving to the Wairarapa, she decides to rent out the Thorndon property. Before she rents it out, Felicity decides to convert the home into two self-contained residences, so that she can rent the property out to two different households.

She separates the two storeys, adding in a firewall between them. She adds a kitchen to the second storey (the first storey has the original kitchen), as well as two new bathrooms. She then adds an external staircase and a front door to the second level, so that it has its own entrance. The bottom level is able to use the original front door for the house. After the renovations, each floor is a self-contained residence capable of being lived in long term by a household unit. A CCC is issued on 31 October 2021 evidencing that the conversion of the home has been completed.

No apportionment is required between those parts of the residences that are newly added and those parts that were from the original home. The entire section is considered new build land.

- An existing residential building is converted, so that there is now a self-contained residence where there was not one previously (see examples 30 and 31 above regarding the converted sleepout).
- An existing commercial building is converted into one or more self-contained residences.

Example 70: Commercial to residential conversions

Shirley & Susan Homes Ltd (SSH) purchases a central city office block in Auckland CBD that it converts into 25 small self-contained apartments. A CCC is issued on 14 February 2022 that confirms the building work to convert the office block into apartments is complete. The land that the apartment block is on is considered new build land from 14 February 2022, the date the self-contained residences received their CCCs.

After a conversion has occurred, the land is considered new build land to the extent it has a self-contained residence on it that received a CCC on or after 27 March 2020 confirming this.

Exclusive areas and reasonable proportion of shared areas (section DH 5(7)(b))

New build land includes any areas of land exclusively used by the residents of the self-contained residence added to or converted on the land. It also includes a reasonable proportion of any shared areas of land appurtenant to the place. The legislation does not require that a particular approach to apportionment be taken, but consistent with existing apportionment principles, the apportionment must be done on a fair and reasonable basis.

Example 71: Reasonable proportion of shared areas

Cicillia owns a home and income property. It is on a 950m2 section in Auckland. She lives in the larger home on the property and rents out a smaller self-contained unit, which received its CCC in June 2021. Both dwellings are one storey. The land is made up of the following areas:

Description	Land area	Used by	New build land?
Floor area of the main home	200m^2	Main home	No
Outdoor areas exclusively used by residents of the main home	300m^2	Main home	No
Front garden area shared by residents of both the main home and the unit	200m^2	Main home and unit	Yes – 100m^2
Driveway and parking area shared by residents of both the main home and the unit	100m^2	Main home and unit	Yes – 50m^2
Floor area of the unit	100m^2	Unit	Yes – 100m^2
Outdoor areas exclusively used by residents of the unit	50m^2	Unit	Yes – 50m^2
Total new build land area			**300m^2**

Exclusive areas attributable to the unit are considered new build land. This includes the floor area of the unit itself (100m^2) plus the unit's exclusive outdoor areas (50m^2). The unit shares the front garden area and driveway/parking area with just one other home, so it is reasonable to attribute 50% of those shared areas to the unit. Applying this approach, 300m^2 of Cicillia's land is considered new build land. The remaining 650m^2 is not considered new build land.

Off the plans purchases (section DH 5(7)(c))

Under section DH 5(7)(c), new build land includes land for which there is an agreement to add a self-contained residence, provided a CCC will be issued on or after 27 March 2020 evidencing the place was added to the land.

Example 72: Agreement to add self-contained residence to land

Josephine decides to invest in a new rental property. She enters into an agreement to purchase a new self-contained residence off the plans from a property developer. Under that agreement, title will be transferred to Josephine once the construction of the self-contained residence on the land is complete and a CCC has been issued. For the purposes of the new build exemption from interest limitation, the land is new build land from the date Josephine enters into the agreement.

However, it is important to note that while the section DH 5(7)(c) definition of "new build land" includes off-the-plans purchases, that part of the definition is explicitly excluded for the purposes of the 5-year new build bright-line test (see section CB 6A(1)(b)(iii)). In other words, land that only qualifies as new build land because of section DH 5(7)(c) will not qualify as new build land for the new build bright-line test.

Hotel or motel conversions (section DH 5(7)(d))

Section DH 5(7)(d) provides that land that previously had a hotel or motel on it qualifies as new build land if:

- the hotel or motel is converted into self-contained residences, and
- the conversion is recorded in the records of a local authority or building consent authority as having been completed on or after 27 March 2020.

While section DH 5(7)(a) already allows for commercial to residential conversions to qualify, section DH 5(7)(d) removes the CCC requirement for hotels or motels that are converted on or after 27 March 2020.

Hotels and motels are already used for short-stay accommodation, and they often already have cooking facilities and bathrooms. Compared with other conversions, less work may be required to convert a hotel or motel into self-contained residences. This may mean no CCC is issued once the conversion is completed. For this reason, an exception to the CCC requirement applies for hotels and motels that are converted into self-contained residences.

Example 73: Motel converted into apartments

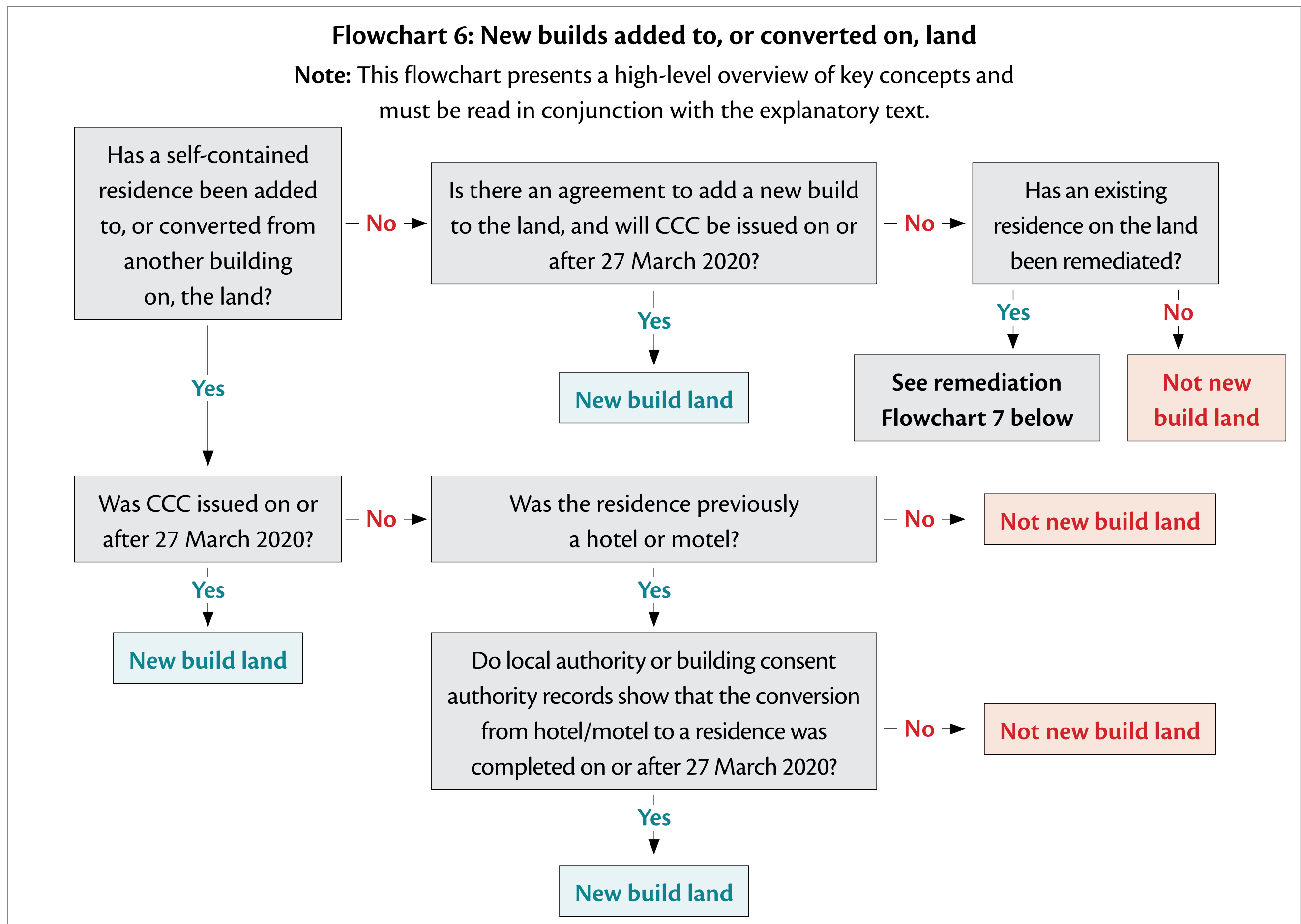
In December 2020, Chris decides to convert his motel into self-contained apartments. The motel units already have bathrooms and cooking facilities, so only a small amount of work is required to make the units suitable for long-term rental accommodation. After the renovations are complete, Chris notifies his local council (which is a local/building consent authority) that his motel units will be used as residential apartments going forward. The conversion of the motel units is noted in the council's records. The land the former motel units are on is considered new build land from the date the records show the conversion was completed.

Remediation of existing residences (sections DH 5(7)(e) and (f))

Land with existing self-contained residences that are remediated may qualify as new build land in two circumstances:

- where they were on the earthquake prone buildings (EPB) register but have been remediated and removed from the register, or
- where they had weathertightness issues but have been at least 75% reclad.

These two categories of land qualify as new build land because the amount of building work required to remediate the existing residences on the land will generally be significant.



Furthermore, it is objectively verifiable that these residences required remediation, and that they have subsequently been remediated. This ensures that Inland Revenue and taxpayers can clearly identify whether land is new build land. This is important because the new build exemption from interest limitation applies for 20 years and applies to subsequent purchasers of the land during this period.

EPBs (section DH 5(7)(e))

To the extent land has a self-contained residence that is removed from the EPB register[27] on or after 27 March 2020, the land is new build land if:

- a CCC is issued on or after 27 March 2020 evidencing the building work to remediate the residence is complete, or
- local or building consent authority records show that the building work to remediate the residence was completed on or after 27 March 2020 and that this has been verified by a suitably qualified engineer.

Section DH 5(7)(e)(ii) (bullet point 2 above) provides an exception to the CCC requirement because, in some circumstances, remediation of an EPB may not result in a CCC being issued. However, to qualify as new build land, local or building consent authority records must show that:

- the remediation was completed on or after 27 March 2020, and
- the building work to remediate the building was verified by a suitably qualified engineer.

Example 74: Remediation of apartment building on EPB register

Robin has an apartment in an apartment building in Wellington that is on the EPB register. Robin and the owners of the other apartments in the building agree to proceed with building work to remediate the apartment building. Over a period of 12 months, building work to remediate the apartments takes place. On 30 June 2021, a CCC is issued confirming that the building work has been completed. The apartment building is removed from the EPB register. The apartments are considered new build land from this date.

Residence with weathertightness issues (section DH 5(7)(f))

To the extent land has an existing self-contained residence that is remediated for weathertightness issues, the land will qualify as new build land provided:

- at least 75% of the residence is reclad, and
- a CCC is issued on or after 27 March 2020 evidencing that the cladding has been replaced.

It does not matter whether the residence is standalone or if (for example) it is part of an apartment block.

Requiring at least 75% of a residence to be reclad ensures that only land with a residence that has had significant weathertightness issues – and has been substantially reclad – will qualify as new build land.

[27] "EPB register" has the meaning given to it in the Building Act 2004.

Example 75: Leaky home remediated

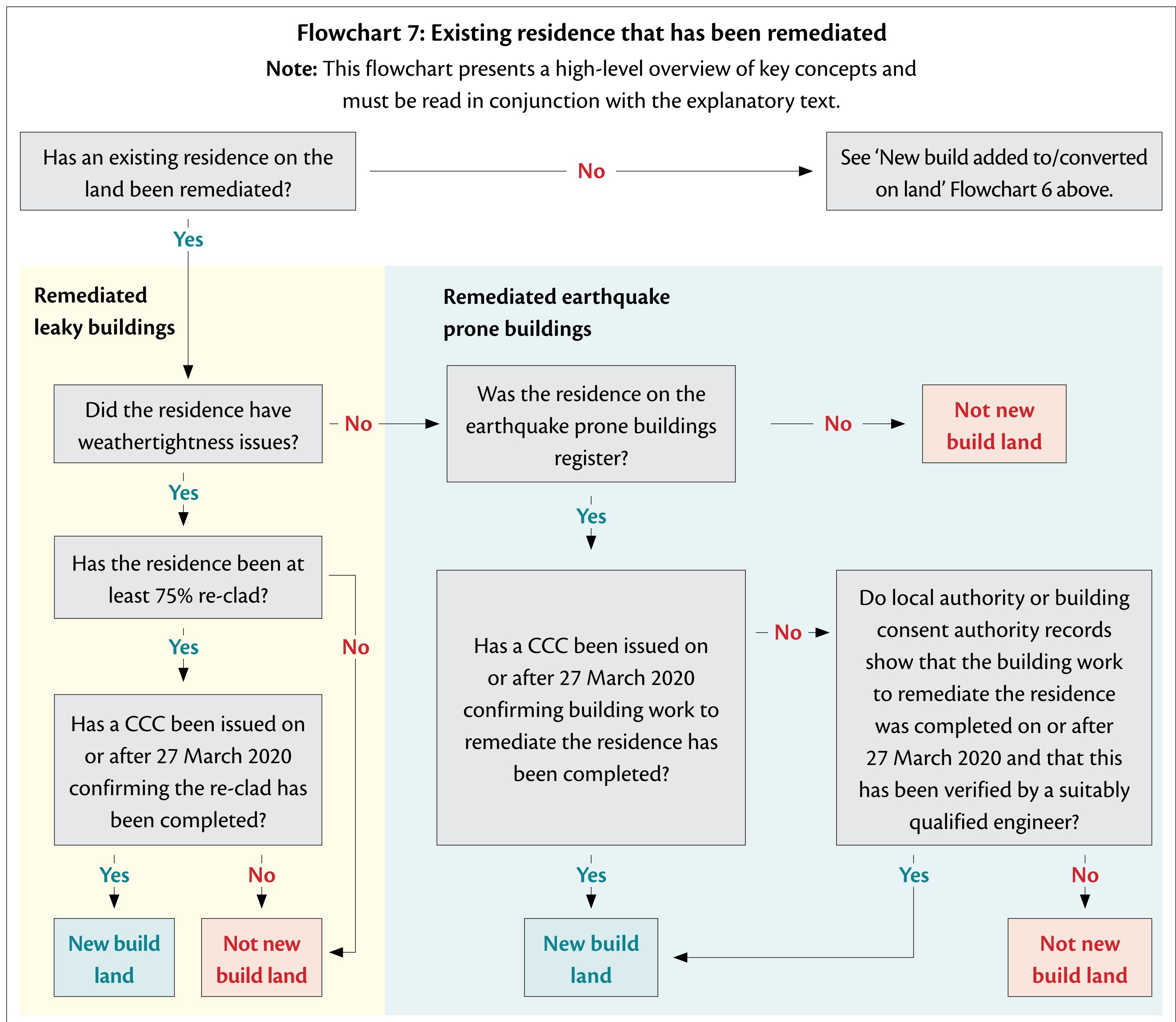
Miranda owns a self-contained residence in Auckland that has significant weathertightness issues. It needs to be completely reclad, and large amounts of its interior need to be completely replaced because of mould and rot. Miranda arranges for the work to be done. A CCC is issued on 20 December 2020 evidencing that the residence has been at least 75% reclad, and that various other building work has been undertaken to remediate the property. The land that the residence is on is considered new build land from this date.

Fact variation: Only portion of home reclad

Steve owns a self-contained residence in Wellington that was built from native timber in the 1920s. In the 1990s, before Steve bought it, an extra couple of rooms were added to the residence. Unfortunately, in recent years Steve has discovered that the extra rooms were poorly constructed and have weathertightness issues.

Steve pays a builder to re-clad the extra rooms that were added to the residence. While Steve has re-clad the entire portion of the residence that was leaky, he has only reclad a quarter of the residence overall because most of the residence was not leaky.

The land that the residence is on does not qualify as new build land after the re-clad. This is because at least 75% of the residence would have to have been re-clad to qualify.



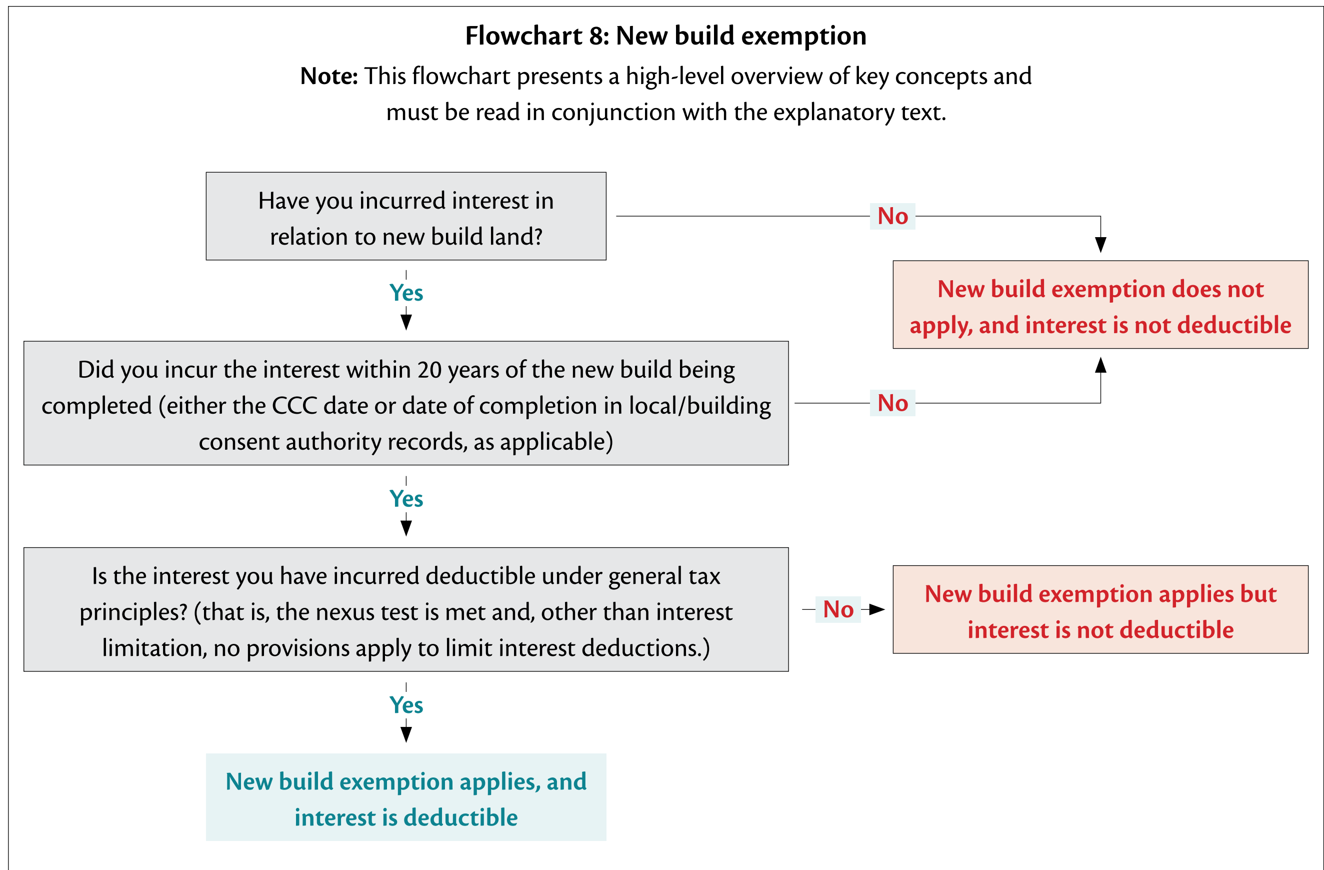
New build exemption

Sections DH 4(1), DH 5(7), and YA 1 of the Income Tax Act 2007

The new build exemption applies to new build land and provides a 20-year exemption from the interest limitation rules for interest incurred in relation to the land. The exemption is aimed at ensuring interest limitation does not negatively impact on new housing supply.

Key features

The key features of the new build exemption are discussed above in the "Exemptions for new housing supply – overview" section. You may also find it useful to read the section on the "Definition of 'new build land'" before reading this section.



Application date

The new build exemption applies to interest incurred in relation to new build land from 1 October 2021. However, the exemption may apply from a different date for interest incurred by a given taxpayer, depending on when the taxpayer acquires the land and when the land becomes new build land. Generally, the exemption starts to apply to interest incurred in relation to land once a CCC for a new build on the land is issued, although some exceptions apply.

Detailed analysis

Section DH 4(1) provides that the new interest limitation rules in subpart DH do not apply to interest incurred by a person to the extent it is incurred in relation to new build land.

The exemption from the interest limitation rules runs for a 20-year period. The 20-year period generally starts from the date a CCC is issued for a self-contained residence (new build) added to the land, although some new builds have an alternative start date.

All owners of new build land during the 20-year period qualify for the exemption – this includes the initial owner and any subsequent purchasers within that period.

Alternative start date for some new builds

For some new builds, the exemption will not start from the date a CCC is issued for a new build on the land. Instead, the exemption will start from the date that construction of the new build was completed. The date of completion used is the date recorded in local authority or building consent authority records.

New build	Explanation	Section
New build was converted from a hotel or motel and no CCC is issued	Hotels/motels are already configured for short-term stays, so the work required to convert a hotel or motel into a place suitable for long-term residential rental accommodation may not always result in a CCC. This rule therefore ties the commencement of the exemption with the date local authority or building consent authority records show the conversion was completed.	DH 4(1)(b)(ii)
New build is a remediated earthquake prone building and no CCC is issued	Sometimes no CCC is issued after an earthquake prone building is remediated, but documentation is lodged with a local authority or building consent authority that shows the remediation has been completed and was verified by a suitably qualified engineer. This rule allows the new build exemption to apply in these cases. This is because records held by the authority ensure it is objectively verifiable that the building was previously on the earthquake prone buildings register but has since been removed.	DH 4(1)(b)(ii)
New build receives its CCC subject to a modification to clause B2.3.1 of the Building Code	There may be circumstances where the issuance of a CCC for a new build is significantly delayed, so it is issued subject to clause B2.3.1 of the Building Code. This rule helps ensure there is no tax benefit for a taxpayer who deliberately pushes out the date their new build receives its CCC. So, where a CCC is issued subject to B2.3.1 modification, the new build exemption applies from the earlier date that the new build was actually completed (as recorded by the relevant local authority or building consent authority), rather than the date the CCC was issued.	DH 4(1)(b)(iii)

Applies for 20 years

The new build exemption generally applies for 20 years (although there is an exception for new builds acquired off the plans, as discussed below). It starts from the date the land becomes new build land, and it ends once 20 years have passed since either:

- the date a CCC was issued for a new build on the land (section DH 4(1)(b)(i)), or
- the date the completion of the new build is recorded by a local authority or building consent authority (sections DH 4(1)(b)(ii) and (iii)).

Example 76: New build receives CCC

Penny acquires an already constructed townhouse in Petone that received its CCC on 24 October 2021 (which is before she acquired it). The new build exemption from the interest limitation rules will apply to interest incurred for the townhouse for 20 years from the date of the CCC. Penny will be able to deduct interest incurred for the townhouse from the date title for the land is registered to her, assuming the normal deductibility criteria are met.

Immediately after acquiring the townhouse, Penny rents the property out to Graham and Claire as a long-term residential rental property. Penny holds on to the property for the next thirty years and continues to use it as a long-term residential rental property during this period.

Since Penny is using the townhouse for an income-earning activity, she will be able to deduct interest for the townhouse while the exemption applies, which is until 23 October 2041. From 24 October 2041 onwards, Penny will not be able to deduct interest for the property. This is because the new build exemption will cease to apply, and she will be denied a deduction for the interest under the interest limitation rules.

Example 77: B2.3.1 modification rule

Rip owns a large section that has a residential rental property on one half of it. The rental was built on the land in the 1980s, so interest deductions are progressively denied from 1 October 2021 under the interest limitation rules. However, Rip decides to develop the other half of the section to add a new build to it. He claims interest deductions for the portion of the land he is developing under the development exemption.

The building work for the new build is substantially completed by 24 October 2021. Rip changes his mind about using the new build as a rental property, and he instead decides he wants to live in the new build as his main home, as it is modern and low maintenance. Rip thinks he is likely to sell the property at some point in the next ten years so deliberately holds off getting a CCC for the new build to maximise its potential value to a subsequent debt-financed purchaser. Eight years later, Rip decides he wants to sell the land. Rip gets in touch with his local council to request a CCC for the new build. The council issues a CCC for the new build on 24 October 2029 but issues it subject to a B2.3.1 modification. On the CCC, the substantial completion date for the new build is recorded as being 24 October 2021, which is the date the durability of the building is counted from (instead of the date the CCC was issued).

Since Rip's new build's CCC was issued subject to a B2.3.1 modification, the 20-year period for the new build exemption is counted from the date of substantial completion (24 October 2021), rather than the date the CCC for the new build was issued (24 October 2029). This means that Rip gains no tax advantage by delaying the CCC for his new build. The new build exemption ends on 23 October 2041, even though the CCC was not issued until 24 October 2029.

Example 78: Hotel units converted to new builds

Haydn owns a large hotel complex in Rotorua comprising 100 separate units. Ever since the borders closed because of the COVID-19 pandemic, the reduced number of tourists has meant that many of his units have sat empty or have only been booked a fraction of the time they were previously. He has heard there is a shortage of long-term rental accommodation in the region, so he decides to convert his units into places that can be let as long-term rentals instead.

Since the units were already configured for short-term stays by tourists, they have kitchens and bathrooms. Haydn engages tradespeople to do some work to ensure the units are more appropriately configured for use as long-term residential rental accommodation. The work Haydn has done to the property is not significant enough to require building consents, which means CCCs are not issued for the work.

Haydn gets in touch with his local authority (which is also a building consent authority) and notifies them that he has converted all his hotel units into residential accommodation. This conversion is noted down in the authority's records as having been completed on 24 October 2021. The new build exemption will apply to Haydn's units for 20 years from this date, so until 23 October 2041.

The 20-year fixed period is effectively attached to the land and does not reset when new build land is sold. This means that all owners of the new build land during the 20-year period would qualify for the exemption. This includes the initial owner and any subsequent purchasers within that period.

Example 79: Office block conversion with new builds sold within 20 years

Sandra owns an office block that she has decided to convert into ten apartments. She arranges for extensive building work to be done to convert the office space into individual apartments, including adding in bathrooms and kitchens for each unit. CCCs are issued on 24 October 2021 confirming that the building work to convert the office space into apartments is complete. The new build exemption from the interest limitation rules would apply to the apartments from 24 October 2021 until 23 October 2041.

Ten years later, on 24 October 2031, Sandra sells the apartment block because she is moving overseas. Sean acquires the apartment block and keeps it for five years. On 24 October 2036, Sean sells the apartment block to Josh. Josh holds the apartment block for fifteen years.

The apartments are always rented out for the period covered by this example.

Sandra and Sean can deduct interest for the apartment block for the entire period they own the apartments (from 24 October 2021 to 23 October 2031 for Sandra, and from 24 October 2031 to 23 October 2036 for Sean). This is because the new build exemption applies.

Josh can deduct interest from 24 October 2036 to 23 October 2041. The new build exemption ends on 23 October 2041, 20 years after the apartments received their CCCs. Josh will be denied interest deductions from 24 October 2041 onwards under the interest limitation rules.

Relevance of the residential rental loss ring-fencing rules

No changes have been made to the residential rental loss ring-fencing rules. This means these rules continue to apply as they currently do to interest deductions incurred in relation to rental properties.

Grandparented residential interest

Sections DH 5(5), DH 7, DH 8(1), (2) and DH 9 of the Income Tax Act 2007

Grandparented residential interest is interest incurred on the principal of a grandparented transitional loan. Deductions for grandparented residential interest are progressively denied from 1 October 2021 to 31 March 2025. From 1 April 2025, no deductions are allowed. A grandparented transitional loan is, in general terms, a loan for disallowed residential property (DRP) first drawn down before 27 March 2021, although exceptions exist for DRP acquired near the March 2021 announcement date and for refinanced loans.

Inland Revenue has a phasing calculator on its website that can be used by taxpayers to calculate the progressive denial of grandparented residential interest deductions. The calculator is at: **ird.govt.nz/property/renting-out-residential-property**

Key features

Grandparented residential interest is interest incurred on the principal of a grandparented transitional loan to the extent to which it is incurred for DRP. Grandparented transitional loans are New Zealand dollar denominated loans for DRP first drawn down before 27 March 2021, although some exceptions exist for DRP acquired near the March 2021 announcement date and for refinanced loans. Deductions for grandparented residential interest are progressively denied at specified percentages for specified periods from 1 October 2021 to 31 March 2025. From 1 April 2025, no deductions for grandparented residential interest are allowed.

The progressive denial of grandparented residential interest deductions from 1 October 2021 to 31 March 2025 is to mitigate the cashflow impacts of the interest limitation rules on taxpayers who debt funded the purchase of DRP before the announcement of the rules and to allow these taxpayers time to adjust to the rules. The portion of the interest that is not denied a deduction under the interest limitation rules remains deductible, provided the other requirements in the Income Tax Act for deductibility are satisfied (for example, a nexus with income).

Application date

The new provisions came into force on 27 March 2021 with application to interest incurred on or after 1 October 2021.

Detailed analysis

Progressive denial of grandparented residential interest

Section DH 8(1)(b) provides taxpayers are denied a deduction for interest if and to the extent to which it is grandparented residential interest.

Section DH 8(2) provides that, for specified periods from 1 October 2021 to 31 March 2025, the amount of the deduction for grandparented residential interest that is denied (under section DH 8(1)) is limited to specified percentages. The percentage of deduction denied in each of the specified periods is set out in the table below. From 1 April 2025, no deductions for grandparented residential interest are allowed (that is, grandparented residential interest will be treated the same as other interest incurred for DRP).

Period that grandparented residential interest is incurred	Percentage denied
1 October 2021 to 31 March 2022	25%
1 April 2022 to 31 March 2023	25%
1 April 2023 to 31 March 2024	50%
1 April 2024 to 31 March 2025	75%
On and after 1 April 2025	100%

The periods in the table above apply regardless of a taxpayer's balance date. Taxpayers who do not have a 31 March balance date may have to apply different percentages to the grandparented residential interest incurred within their income year, depending on whether the interest was incurred before or after 31 March. For example, a taxpayer working out how much grandparented residential interest is denied a deduction in their income year ended 30 September 2023 would add the following two amounts:

- twenty-five percent of the grandparented residential interest incurred between 1 October 2022 and 31 March 2023, and
- fifty percent of the grandparented residential interest incurred between 1 April 2023 and 30 September 2023.

Up to 31 March 2025, the portion of interest that is not denied under section DH 8 remains deductible, provided the other requirements for deductibility are satisfied. This will generally include satisfying the general permission in section DA 1 and ensuring none of the general limitations in section DA 2 apply.

Grandparented residential interest

"Grandparented residential interest" is defined in section DH 7 as interest on the principal of a "grandparented transitional loan" to the extent to which the interest is incurred for DRP.

Example 80: Grandparented residential interest

Joe took out an interest-only loan to acquire a DRP in 2017. As at 26 March 2021, the balance of Joe's loan is $500,000 and the interest rate is 4.0% pa. Joe does not make any principal repayments on the loan.

The loan would be a grandparented transitional loan and the grandparenting rules would apply to Joe as follows:

- From 1 April 2021 to 30 September 2021, Joe incurs interest expenditure of $10,000, which is fully deductible.
- From 1 October 2021 to 31 March 2022, Joe incurs interest expenditure of $10,000, but 25% of this amount ($2,500) is denied. $7,500 of the interest incurred may be deductible, subject to satisfying the deductibility tests.
- From 1 April 2022 to 31 March 2023, Joe incurs interest expenditure of $20,000, but 25% of this amount ($5,000) is denied. $15,000 of the interest incurred may be deductible, subject to satisfying the deductibility tests.
- From 1 April 2023 to 31 March 2024, Joe incurs interest expenditure of $20,000, but 50% of this amount ($10,000) is denied. $10,000 of the interest incurred may be deductible, subject to satisfying the deductibility tests.
- From 1 April 2024 to 31 March 2025, Joe incurs interest expenditure of $20,000, but 75% of this amount ($15,000) is denied. $5,000 of the interest incurred may be deductible, subject to satisfying the deductibility tests.

From 1 April 2025 onwards, Joe would not be allowed any deductions for interest under his loan.

In some cases, a grandparented transitional loan may have been used for both DRP and for allowed property (for example, a commercial rental property), and it may be very difficult, or even impossible, to determine (trace) the portion of the loan used for DRP. The rules that apply in such a situation to identify the amount of grandparented residential interest are discussed in the "Grandparented transitional loans that cannot reasonably be traced" section.

Grandparented transitional loans

The term "grandparented transitional loan" is defined in section DH 5(5) as loan amounts denominated in New Zealand dollars to the extent to which they are described in one of paragraphs (a) to (f). Loan amounts do not include re-drawings or additional borrowings under the same facility on or after 27 March 2021.[28]

Thus, loan amounts are a grandparented transitional loan to the extent to which the loan amounts satisfy one of the following paragraphs of section DH 5(5).

General rule (paragraph (a))

Section DH 5(5)(a) provides for loan amounts first drawn down before 27 March 2021 for DRP.

Property acquired before 27 March 2021 (paragraph (b))

Section DH 5(5)(b) provides for loan amounts first drawn down on or after 27 March 2021 to acquire DRP if an estate or interest in the DRP was acquired before 27 March 2021.

Section DH 5(5)(b) will apply where a taxpayer entered into a binding agreement for sale and purchase before 27 March 2021, but settlement and the drawing down of the loan to fund the settlement did not occur until on or after 27 March 2021. Interest incurred on such a loan is grandparented residential interest.

Example 81: Grandparented transitional loan – settlement on or after 27 March 2021

Petra entered into a binding sale and purchase agreement to acquire a property in February 2021. Settlement did not take place until April 2021, when she drew down a $400,000 loan to complete the purchase. The $400,000 loan would be a grandparented transitional loan under section DH 5(5)(b).

Petra's interest on her loan is $1,000 per month, and it would qualify as grandparented residential interest.

- Between 1 October 2021 and 31 March 2023, $250 of her monthly interest expense would be denied. The remaining $750 may be deductible, subject to satisfying the deductibility tests.
- Between 1 April 2023 and 31 March 2024, $500 of her monthly interest expense would be denied. $500 per month may be deductible, subject to satisfying the deductibility tests.
- Between 1 April 2024 and 31 March 2025, $750 of her monthly interest expense would be denied. $250 per month may be deductible, subject to satisfying the deductibility tests.

From 1 April 2025, Petra would not be able to claim any interest deduction.

Example 82: Additional borrowings

Assume the same facts as in example 81 above but, in May 2021, Petra drew down an additional $100,000 to add an extra floor onto the same property. Interest on this $100,000 is $250 per month.

The additional $100,000 was not part of the loan required to complete the sale and purchase agreement signed before 27 March 2021 to acquire the DRP. Therefore, it does not qualify as a grandparented transitional loan (or part of such a loan). From 1 October 2021, Petra cannot claim any deduction for the $250 per month interest expense incurred on the additional $100,000.

For tax purposes, a property is generally acquired on the date a binding sale and purchase agreement is entered (even if some conditions still need to be met). Further information on when a property is acquired can be found in QB 17/02.[29]

[28] An exception to this is the high water mark rules: see the "High water mark" section.

[29] QB 17/02: Income tax – date of acquisition of land, and start date for 2-year bright-line test. **taxtechnical.ird.govt.nz/en/questions-we-ve-been-asked/2017/qb-1702-income-tax-date-of-acquisition-of-land-and-start-date-for-2-year-bright-line-test**

Irrevocable offers made on or before 23 March 2021 (paragraph (c))

Section DH 5(5)(c) provides for loan amounts first drawn on or after 27 March 2021 for acquiring DRP if the acquisition is the result of an offer:

- made on or before 23 March 2021, and
- that could not be revoked by the purchaser taxpayer before 27 March 2021.

Irrevocable offers are common when sale is by tender. Prospective purchasers are required to make irrevocable offers for a property by a certain date, with the vendor accepting an offer after that date. Section DH 5(5)(c) only applies to offers made on or before 23 March 2021, which is the date the interest limitation rules were announced. Taxpayers who made an offer to purchase DRP on or before 23 March 2021 that was irrevocable before 27 March 2021 were legally committed to purchase the DRP if their offer was accepted, even if they did not acquire the DRP before 27 March 2021. These taxpayers are in a similar position to taxpayers who purchased DRP before 27 March 2021 and for that reason they can apply the grandparenting rules.

Example 83: Grandparented transitional loan – irrevocable offer

Ted made an offer to purchase a property through a tender process that closed on 22 March 2021, but the offer was not accepted until 27 March 2021. The terms of the tender stated that he could not withdraw the offer until 28 March 2021.

Ted would meet the requirements of section DH 5(5)(c) and his loan to acquire the property would be a grandparented transitional loan. This is the case even though he did not acquire the property before 27 March 2021, as would be required under section DH 5(5)(b).

Rollover relief (paragraph (d))

Section DH 5(5)(d) provides for loan amounts for DRP acquired on or after 27 March 2021 by a taxpayer if three requirements relating to rollover relief for the bright-line test are satisfied. The first requirement is that a previous owner of the DRP (the original owner) had loan amounts described in one of paragraphs (a) to (c). The second requirement is that every transfer of the DRP from the original owner to (any and every intermediate owner and then to) the taxpayer has been a transfer to which a specified bright-line rollover provision has applied. The third requirement is that the loan amounts of the taxpayer are equal to or less than the amount of the original owner's loan at the time the original owner transferred the DRP.

Section DH 5(5)(d) is discussed in detail in the "Rollover relief – transfer of disallowed residential property" section.

Refinancing (paragraphs (e) and (f))

Section DH 5(5)(e) provides for loan amounts drawn down on or after 27 March 2021 that refinance a grandparented transitional loan described in any of paragraphs (a) to (d). If a foreign currency loan that would have been a grandparented transitional loan if it had been denominated in New Zealand dollars is refinanced by a loan in New Zealand dollars drawn down after 27 March 2021, that New Zealand dollar loan will be a grandparented transitional loan under section DH 5(5)(f).

Foreign currency loans

Section DH 5(5) provides that grandparented transitional loans must be denominated in New Zealand dollars. Section DH 9 also excludes a foreign currency loan from the progressive denial of grandparented residential interest under section DH 8(2). "Interest" for income tax purposes includes amounts calculated under the financial arrangements rules.[30]

For a foreign currency loan, income and expenditure under the financial arrangements rules includes foreign exchange gains and losses, which can fluctuate from year to year. These fluctuations would make the calculation of grandparented residential interest for a foreign currency loan extremely complex, and for this reason, a deduction for interest for a foreign currency loan is fully denied from 1 October 2021.

Section DH 5(5)(f), however, provides that where a foreign currency loan that would have been a grandparented transitional loan if it had been denominated in New Zealand dollars is refinanced in New Zealand dollars, the refinanced loan is a grandparented transitional loan from the time the refinanced loan is first drawn down.

[30] See paragraph (c) of the definition of "interest" in section YA 1 of the Income Tax Act 2007.

Change in use from main home to DRP

As mentioned above, a grandparented transitional loan is, in general terms, a loan for DRP first drawn down before 27 March 2021. Grandparented residential interest is interest incurred on a grandparented transitional loan and deductions for such interest are progressively denied from 1 October 2021 to 31 March 2025.

As discussed under the "*Change in use during income year*" heading in the "Definition of disallowed residential property" section, if a person takes out a loan for a main home and the person subsequently moves out and rents that property to tenants, the loan will change from being for excepted residential land (in this case, a main home) to being for DRP. If the loan was drawn down before 27 March 2021 (or it falls within one of the exceptions for property acquired near announcement date and for refinanced loans), the loan will be a grandparented transitional loan for the period the property is DRP. Interest incurred on the loan while it is a grandparented transitional loan will therefore be grandparented residential interest and subject to progressive denial from 1 October 2021 to 31 March 2025.

Example 84: Change in use from main home to DRP

Katie acquired her main home in 2017 using mortgage finance. She lives in it until she permanently moves to a different city for a new job at the end of September 2022. She earns rental income from renting out her property from 1 October 2022.

Katie incurs $1,250 interest each month on her mortgage, or $7,500 every 6 months. Katie has a standard balance date, ending 31 March.

The interest limitation rules do not apply to Katie for the 2021–22 income year as the property was her main home for the full year. The rules also do not apply for the first six months of the 2022–23 income year (1 April 2022 to 30 September 2022) for the same reason. However, she cannot claim an interest deduction because she did not earn any income from her main home.

However, from 1 October 2022, Katie's loan is no longer for excepted residential land (her main home) and is now for DRP. As the loan was drawn down before 27 March 2021, the loan is now a grandparented transitional loan. Assuming the other tests for deductibility are met:

- For the 2022–23 income year, Katie can claim a deduction for $5,625 interest (being 75% of the $7,500 interest incurred for the 6-month period from 1 October 2022 to 31 March 2023).
- For the 2023–24 income year, she can claim a deduction for $7,500 interest (50% of $15,000).
- For the 2024–25 income year, she can claim a deduction for $3,750 (25% of $15,000).

From the 2025–26 income year onwards, Katie is no longer able to claim any deduction for interest.

Grandparented transitional loans that cannot reasonably be traced

Sections DH 5(5), DH 7, DH 8(1), (2) and DH 12 of the Income Tax Act 2007

Generally, interest is denied under the interest limitation rules in subpart DH if it is incurred for disallowed residential property (DRP). Taxpayers must apply existing general tracing principles used in other parts of the Income Tax Act to determine if interest is incurred for DRP.

A "grandparented transitional loan" is generally[31] a loan drawn down before 27 March 2021 that has been used for DRP. Interest incurred on a grandparented transitional loan is "grandparented residential interest", and deductions for grandparented residential interest are progressively denied from 1 October 2021 to 31 March 2025.[32]

In some cases, a grandparented transitional loan may have been used for both DRP and allowed property (for example, a commercial rental property). It may be difficult, or even impossible, to trace such a loan and determine how much of the loan proceeds were used for DRP. In that case, the transitional rule in section DH 7 treats a portion of the grandparented transitional loan as having been used to acquire DRP. Only interest incurred on that portion is grandparented residential interest and progressively denied a deduction. The remaining portion of the grandparented transitional loan is not subject to limitation under subpart DH.

Section DH 7 also contains a rule that specifies how repayments of the grandparented transitional loan are treated.

[31] There are some exceptions, such as loans for property acquired around the March 2021 announcement date and refinanced loans.

[32] See the "Grandparented residential interest" section.

Key features

When a grandparented transitional loan was used for both DRP and allowed property, and the portion of the loan incurred for DRP cannot reasonably be determined, the transitional rule in section DH 7 applies. Whether the portion incurred for DRP cannot reasonably be determined will be a question of fact and degree in each case.

In effect, section DH 7 treats a grandparented transitional loan that cannot reasonably be traced (an untraceable loan) as being used to acquire allowed property before being used to acquire DRP. This is done based on the value of allowed property held by the relevant taxpayer on 26 March 2021. Allowed property is:

- property that gives rise to assessable income and is not DRP, and
- DRP subject to an exemption in section DH 4.

If the balance of an untraceable loan is less than the value of allowed property held on 26 March 2021, none of the interest on the loan is subject to limitation under subpart DH.

If the balance of the untraceable loan exceeds the value of allowed property held on 26 March 2021, the excess is "notional loan principal" and is treated as having been used to acquire DRP. Interest on the notional loan principal is treated as grandparented residential interest and is denied a deduction under section DH 8 on a progressive basis between 1 October 2021 and 31 March 2025.

Section DH 7 also contains rules that specify how repayments of an untraceable loan are to be treated. Generally, repayments are applied to the notional loan principal first, unless the repayment is funded from the disposal of allowed property held on 26 March 2021.

Application date

The new provisions came into force on 27 March 2021 with application to interest incurred on or after 1 October 2021.

Detailed analysis

Grandparented transitional loans and grandparented residential interest

The term "grandparented transitional loan" is defined in section DH 5(5). It is generally a loan drawn down before 27 March 2021 to the extent to which it has been used for DRP.

New section DH 8(1)(a) denies a deduction for interest incurred for DRP, excluding interest for a grandparented transitional loan.

New section DH 8(1)(b) denies a deduction for grandparented residential interest, being interest on a grandparented transitional loan to the extent it is for DRP.

Interest incurred for a grandparented transitional loan is excluded from section DH 8(1)(a) and dealt with in section DH 8(1)(b) because a grandparented transitional loan may have been used for both DRP and other allowed property. For such a mixed-use loan, it is necessary to identify the portion of the loan that is for DRP, as the interest limitation rules will apply only to the interest on that portion (grandparented residential interest). Interest on the remaining portion is not subject to limitation under subpart DH. Whether a deduction is allowed for the interest incurred on the remaining portion is determined under the other rules in Part D.

"Grandparented residential interest" is defined in new section DH 7. In the context of an untraceable loan, it means the portion of interest calculated by reference to a notional loan principal that the person is treated as having used to acquire, on 26 March 2021, the DRP to which the loan relates.

Untraceable loans

An untraceable loan is a grandparented transitional loan used for both DRP and allowed property where the portion of the loan used for DRP cannot reasonably be determined. An untraceable loan is referred to in the legislation as "the underlying loan".

Subpart DH does not specify the circumstances in which the portion of a grandparented transitional loan used for DRP cannot reasonably be determined. It will be a question of fact and degree in each case.

Factors relevant to whether the portion of a grandparented transitional loan used for DRP cannot reasonably be determined may include:

- Whether the necessary information is in the possession of the taxpayer.
- If the necessary information is not in the possession of the taxpayer, whether the taxpayer can reasonably obtain the information (including from a third party, if necessary).

If a taxpayer needs to obtain information from a third party to determine the portion of a grandparented transitional loan incurred for DRP and the third party charges the taxpayer for the information, the fact the third party charges for the information would not in itself mean that the portion of the loan used for DRP cannot reasonably be determined.

Notional loan principal

A taxpayer with an untraceable loan must apply the formula in section DH 7(2) to determine their "notional loan principal". The notional loan principal is the portion of the underlying loan that the person is treated as having used to acquire DRP on 26 March 2021.

The formula is:

$$\text{outstanding borrowings} - \text{allowed property}$$

The items in the formula are defined in section DH 7(3):

- **Outstanding borrowings** is the principal of the grandparented transitional loan (the underlying loan) on 26 March 2021, to the extent it is used for both DRP and allowed property.
- **Allowed property** is the total of the taxpayer's property on 26 March 2021, ignoring property that is not used in deriving assessable income and only including DRP if it is subject to an exemption in section DH 4. The value of "allowed property" as at 26 March 2021 is determined using the valuation rules in section DH 12.

To the extent the principal of the underlying loan is not for DRP or allowed property it is excluded from "outstanding borrowings". For example, if a loan drawn down before 27 March 2021 was used for DRP, allowed property and private purposes, the portion used for private purposes will not form part of the "outstanding borrowings" under section DH 7(3)(a). This ensures the formula only applies to borrowings for which interest expenses were deductible for tax purposes before 1 October 2021.

Section DH 7(2) provides that if the formula results in a negative amount, the amount is treated as zero. When the amount is zero, there is no notional loan principal and no amount of grandparented residential interest. As a result, section DH 8(1)(b), which denies a deduction for grandparented residential interest, cannot apply. Consequently, subpart DH will not apply to any interest incurred on the grandparented transitional loan.

Example 85: No notional loan principal

On 26 March 2021, Tiffany owns two properties that she uses to earn taxable rental income. Both properties were acquired at around the same time in the 1990s. They are:

- a DRP, purchased for $300,000, with a current capital value of $900,000, and
- a commercial rental property, purchased for $400,000, with a current capital value of $850,000.

She acquired the two properties using a combination of loans and savings. Over the years, Tiffany has refinanced and restructured her loans several times and has made many repayments. On 26 March 2021, she has a single grandparented transitional loan of $200,000 and no other debt.

Although Tiffany never used her loan for personal purposes, she did not trace exactly how the borrowed funds were applied to each property in the past and does not have the records to do so now.

Applying the formula in section DH 7(2), outstanding borrowings less allowed property is:

$$\$200{,}000 - \$850{,}000 = -\$650{,}000$$

As the amount is a negative number, it is treated as zero. Therefore, Tiffany would not have a notional loan principal under section DH 7(2) and none of the interest incurred under her grandparented transitional loan would be grandparented residential interest. The interest under her grandparented transitional loan would therefore not be subject to limitation under subpart DH, and Tiffany can continue to deduct all her interest expenditure under the loan indefinitely.

Repayments

When a taxpayer with an untraceable loan has a notional loan principal, the taxpayer is, in effect, treated as having two loans – the notional loan principal, which is treated as having been used for DRP, and the remaining loan portion, which is treated as having been used for allowed property.

When a repayment is made reducing the balance of an untraceable loan, it is necessary to allocate the repayment to the reduction of either the loan for allowed property or the notional loan principal.

Section DH 7(4) specifies how repayments of an untraceable loan are to be allocated.

General repayments rule

The general rule is that repayments are applied against the notional loan principal until it is reduced to zero. When the notional loan principal is reduced to zero, there will be no grandparented residential interest (and the interest limitation rules will no longer apply to the untraceable loan).

Example 86: General rule for repayments

Sanjay earns income from rental properties. On 26 March 2021, Sanjay owns the following assets that he uses to earn taxable rental income:

- a DRP in Christchurch, with a current capital value of $500,000
- a commercial rental property in Ashburton, with a current capital value of $400,000, and
- a commercial rental property in Timaru, with a current capital value of $200,000.

Sanjay's assets were acquired many years ago using a combination of loans and savings. On 26 March 2021, he has one outstanding interest-only loan of $800,000 and no other debt.

Sanjay has always been careful never to use his borrowings for personal purposes, but he did not trace how the borrowed funds were applied in the past and does not have the records to do so now.

For the income year ended 31 March 2022

From 1 April 2021 to 30 September 2021, Sanjay's interest expenditure under his loan totals $18,000.

From 1 October 2021 to 31 March 2022, Sanjay's interest expenditure under his loan totals $20,000.

Sanjay's $18,000 interest expenditure incurred before 1 October 2021 is not affected by the new interest limitation rules and remains fully deductible. For the remaining $20,000 interest expenditure incurred after 1 October 2021, Sanjay has to apply the rules in section DH 7.

Applying the formula in section DH 7(2), Sanjay's outstanding borrowings less allowed property is:

$800,000 – ($400,000 + $200,000) = $200,000

Sanjay's notional loan principal is therefore $200,000. Interest on $200,000 of Sanjay's loan is grandparented residential interest. Interest on the remaining loan portion of $600,000 is not subject to limitation under subpart DH.

To work out his grandparented residential interest, Sanjay has to divide his notional loan principal by his total outstanding borrowings and multiply the result by his interest under the loan:

200,000/800,000 x $20,000 = $5,000 of grandparented residential interest

The amount of interest denied a deduction under section DH 8(2) is therefore $1,250 ($5,000 x 25%).

For the income year ended 31 March 2023

Sanjay receives an inheritance, and he uses it to make a lump sum repayment of $100,000 on his loan on 1 April 2022. His total interest expenditure incurred under the loan for the income year is $30,000.

Sanjay's loan balance on 31 March 2023 is $700,000.

Applying the general repayments rule, the reduction in the loan balance is applied against his notional loan principal. Therefore, Sanjay's notional loan principal is reduced from $200,000 to $100,000. The amount that is grandparented residential interest for the income year is calculated as follows:

100,000/700,000 x $30,000 = $4,286

The amount of interest denied a deduction under section DH 8(2) is therefore $1,071 ($4,286 x 25%).

General repayments rule overridden

The general repayments rule is overridden if the source of the repayment is the disposal of allowed property that was held on 26 March 2021. If the source of the repayment is the disposal of allowed property, only the amount of the repayment that exceeds the 26 March 2021 value of the allowed property is applied against the notional loan principal to reduce it. If the amount of the repayment is less than or equal to the 26 March 2021 value of the allowed property, the repayment does not reduce the notional loan principal.

Example 87: Repayments from sale of allowed property

Assume the same facts as in example 86, but instead of receiving an inheritance, Sanjay sells his Timaru property for $200,000 and uses the proceeds to make the $100,000 lump sum repayment. He uses the remaining $100,000 from the sale proceeds to pay for repairs and improvements to his Ashburton property.

For the income year ended 31 March 2023

Sanjay's loan balance on 31 March 2023 is $700,000 and his total interest expenditure under the loan for the income year is $30,000.

As the source of the repayment was the disposal of allowed property held on 26 March 2021, and the amount of the repayment is less than the value of the Timaru property on 26 March 2021, Sanjay's notional loan principal is unchanged from $200,000.

The amount that is grandparented residential interest is calculated as follows:

200,000/700,000 x $30,000 = $8,571

The amount of interest denied a deduction under section DH 8(2) is therefore $2,143 ($8,571 x 25%).

Existing law on tracing applies to changes of use on or after 27 March 2021

Under existing law on the tracing of funds, where funds have been borrowed and the use of the borrowed funds changes, the deductibility of interest on those funds may also change as the funds are "traced" to a new use. For example, if a taxpayer borrows to acquire a van for their business, interest on their borrowings will be deductible. If they sell the van and use the sale proceeds to go on holiday, interest on the borrowings will become non-deductible.

As explained above, section DH 7 may treat a single loan as being either partly for DRP and partly for allowed property, or entirely for allowed property. Existing law on tracing applies if the DRP or allowed property held on 26 March 2021 is disposed of and the proceeds are applied to new uses.

Example 88: Disposal of allowed property held on 26 March 2021

LandCo is a close company that earns income from residential and commercial rental properties. On 26 March 2021, LandCo holds the following:

- a DRP, with a current capital value of $500,000
- a commercial rental property, with a current capital value of $500,000, and
- an untraceable interest-only loan of $600,000 at 4% pa.

For the income year ended 31 March 2022

From 1 April 2021 to 30 September 2021, LandCo's interest expenditure totals $12,000.

From 1 October 2021 to 31 March 2022, LandCo's interest expenditure totals $12,000.

LandCo's $12,000 interest expenditure incurred before 1 October 2021 is not affected by the interest limitation rules and remains fully deductible. For the remaining $12,000 interest expenditure incurred after 1 October 2021, LandCo has to apply the rules in section DH 7.

Applying the formula in section DH 7(2), LandCo's outstanding borrowings less allowed property is:

$600,000 – $500,000 = $100,000

LandCo's notional loan principal is therefore $100,000. Interest on $100,000 of LandCo's loan is grandparented residential interest. Interest on the remaining loan portion of $500,000 is not subject to limitation under subpart DH.

To work out its grandparented residential interest, LandCo has to divide its notional loan principal by its total outstanding borrowings and multiply the result by its interest under the loan:

100,000/600,000 x $12,000 = $2,000 of grandparented residential interest

The amount of interest denied a deduction under section DH 8(2) is therefore $500 ($2,000 x 25%).

For the income year ended 31 March 2023

On 1 April 2022, LandCo sells the commercial rental property for $500,000 and uses all of the proceeds to acquire an old-build DRP. Under existing tracing principles, interest on the $500,000 loan portion is fully denied under section DH 8(1). Interest on the $100,000 notional loan principal remains grandparented residential interest.

High water mark

Section DH 5(5), DH 7, DH 8(2) and DH 10 of the Income Tax Act 2007

The high water mark simplifies the calculation of grandparented residential interest for taxpayers with variable balance loans.

Key features

The high water mark is a transitional rule to simplify the calculation of grandparented residential interest[33] for taxpayers with variable balance loans (such as a revolving credit facility or an overdraft). Under this transitional rule, taxpayers with such loans are not required to trace each individual withdrawal and deposit to that loan account between 27 March 2021 and 31 March 2025.

A taxpayer who has used a variable balance loan for disallowed residential property (DRP) can treat this loan as a grandparented transitional loan while the balance of the loan (the affected loan balance) remains less than or equal to the initial loan balance on 26 March 2021. The interest on this grandparented transitional loan is grandparented residential interest and continues to be partially deductible during the transitional period under section DH 8(2). If the affected loan balance is higher than the initial loan balance on 26 March 2021, only interest on the initial loan balance is grandparented residential interest.

Application date

The new provisions came into force on 27 March 2021 with application to interest incurred on or after 1 October 2021.

[33] For more on this, see the "Grandparented residential interest" section.

Background

Before the introduction of the interest limitation rules, a variable balance loan could result in declining interest deductions over time if the loan was used to finance a mixture of taxable and private activities. However, if a variable balance loan was used to finance only taxable activity, such as owning a residential rental property, this provided the taxpayer with flexibility in their funding while ensuring all interest was deductible.

Without section DH 10, a variable balance loan that finances DRP under the interest limitation rules could result in the amount treated as a grandparented transitional loan declining faster than the underlying loan balance. This is because each loan payment (such as a deposit of rent received) would reduce the amount of the grandparented transitional loan, while each drawdown (such as a regular interest charge) would be treated as new borrowing that did not qualify as a grandparented transitional loan. This would mean that the amount of grandparented residential interest could also reduce even if the balance of the loan, and the interest charged on that loan, remained constant.

Detailed analysis

Application

Although the high water mark in section DH 10 is designed to apply to variable balance loans (such as a revolving credit facility or an overdraft), the application provision in section DH 10(1) does not include this restriction. This is to prevent the need to define the boundary of what is a variable balance loan. For loans that do not have a variable balance, such as table loans or interest-only loans, section DH 10 will not have any practical effect as the balance would not increase above that owed on 26 March 2021. The provision specifically provides that it only applies to those who choose to rely on it.

What interest can be grandparented residential interest

Section DH 10(3) provides that a person's grandparented residential interest (that is, the amount of interest incurred on the loan that is denied under section DH 8(2) on a progressive basis between 1 October 2021 and 31 March 2025) is calculated based on the lower of:

- the initial loan balance on the date grandparented residential interest is first calculated (usually 26 March 2021, but see below), and
- the amount of their loan that is for DRP (the affected loan balance).

A person with a variable balance loan that has been applied solely to DRP is able to treat all interest as grandparented residential interest provided their affected loan balance remains at or below their initial loan balance. For a person who has also applied the loan for other purposes (for example, on a deductible purpose, such as a new build or commercial property, or on private expenditure) or who has increased the affected loan balance above the initial loan balance, the calculation of grandparented residential interest is still simpler and results in a higher amount of such interest than if section DH 10 was not available.

Initial loan balance

For most taxpayers, the initial loan balance is the balance of their grandparented transitional loan at the end of 26 March 2021: section DH 10(4)(a).

For taxpayers who borrowed on or after 27 March 2021 to acquire a DRP where the loan amount meets paragraph (b) or (c) of the definition of a "grandparented transitional loan" in section DH 5(5), the initial loan balance is set on the date the loan is drawn down: section DH 10(4)(b).

For taxpayers who transfer DRP under section FC 9B(a) to (f), which relate to certain family trusts, Treaty of Waitangi settlements, look-through companies and partnerships, the initial loan balance is set on the date of the transfer: section DH 10(4)(c).

Example 89: Initial loan balance

On 26 March 2021, Davy owes $500,000 on a revolving credit facility that is mostly used to fund his residential rental property. However, on 10 March 2021, Davy withdrew $20,000 to buy a car he uses privately. The revolving credit facility has a limit of $600,000.

Davy's initial loan balance is the portion of the facility allocated to DRP, which is $500,000 - $20,000 = $480,000.

Affected loan balance

The affected loan balance is the actual loan balance of the taxpayer's grandparented transitional loan at any particular time. Under section DH 10(5), this amount is calculated by making adjustments for further amounts borrowed and repaid under the loan after the date of the initial loan balance. These adjustments ensure the amount that has been spent on a grandparented transitional loan can be determined and compared against the initial loan balance.

The formula for calculating the affected loan balance is:

initial loan balance + (advances − repayments) − (unrelated advances − unrelated repayments)

where:

- **initial loan balance** is the amount calculated under section DH 10(4), as explained above
- **advances and repayments** are all debit and credit entries relating to that loan between 27 March 2021 and the date the affected loan balance is calculated. For a person who had applied their loan only to DRP as at 26 March 2021, the total of "initial loan balance + (advances − repayments)" will be equal to the balance of that loan account
- **unrelated advances** are any withdrawals from the loan that are applied to something other than a grandparented transitional loan – this could include, for example, another DRP purchased on or after 27 March, a taxable activity including property that qualified as a new build, or private expenditure. Unrelated advances also include any interest charged on the loan that was apportioned to something other than the property funded by the grandparented transitional loan.
- **unrelated repayments** can only arise for taxpayers who have grandparented transitional loans that cannot be traced under section DH 7(1)(b), meaning there is an initial notional loan principal under section DH 7(2).[34] Unrelated repayments are the portion of a repayment that is not allocated to the notional loan principal under section DH 7(4). This circumstance arises only where a portion of the loan is repaid and that repayment fully repays the portion allocated to the notional loan principal, that is, the amount outstanding is now less than the value of the property funded by the grandparented transitional loan.

Example 90: Affected loan balance remains below initial loan balance

On 26 March 2021, Darryl owes $500,000 on a revolving credit facility used to fund his residential rental property. The revolving credit facility has a limit of $600,000. Darryl does not use this account to fund any private expense or for any other deductible uses. His initial loan balance is therefore $500,000.

When Darryl completes his tax return for the year ended 31 March 2022, he must calculate the affected loan balance for each day between 1 October 2021 and 31 March 2022. As he has only used the revolving credit facility for a rental property acquired before 27 March 2021, the advances and repayments items of the formula are the same as the withdrawals and repayments shown on his internet banking. He has not made any unrelated advances or unrelated repayments so both these items are zero.

In his bank statement, Darryl sees that the balance of the revolving credit facility on 1 October 2021 was $480,000, which is the affected loan balance on that date. He also sees that between 1 October 2021 and 31 March 2022 the balance of the revolving credit facility was always below $500,000.

As the affected loan balance was always below the initial loan balance, 75% of the interest charged on the revolving credit facility during 1 October 2021 to 31 March 2022 can be deducted as grandparented residential interest after applying section DH 8(2).

Sections DH 10(3) and (5) refer to the loan balance at an instant. Typically, lenders will calculate interest based on the outstanding balance at the end of each day even though that charge will be applied over a longer period (for example, fortnightly or monthly). Where there is more than one transaction on an account within this interest calculation period, these will often be able to be aggregated (for example, if money is deposited into an account and withdrawn the same day, the net effect will be zero).

If the affected loan balance was above the initial loan balance for only part of a year, it is intended that separate grandparented residential interest calculations would be completed for each of these periods to arrive at a single grandparented residential

[34] For more on this, see the "Grandparented transitional loans that cannot reasonably be traced" section.

interest calculation for the year. As a lender is unlikely to provide a breakdown of interest charged on a daily basis, a taxpayer in this situation would be required to breakdown their interest calculations beyond that provided by their lender. While this adds complexity, it is an unavoidable consequence of the overall approach. A taxpayer who keeps their affected loan balance below their initial loan balance will not face this complication.

Example 91: Affected loan balance briefly goes above initial loan balance

On 26 March 2021, Nicola owes $500,000 on a revolving credit facility used to fund her residential rental property. The revolving credit facility has a limit of $600,000. Nicola does not use this account to fund any private expense or for any other deductible uses. Her initial loan balance is therefore $500,000.

When Nicola completes her tax return for the year ended 31 March 2022, she must calculate the affected loan balance for each day between 1 October 2021 and 31 March 2022. As she has only used the revolving credit facility for a rental property acquired before 27 March 2021, the advances and repayments items of the formula are the same as the withdrawals and repayments shown on her internet banking. She has not made any unrelated advances or unrelated repayments so both these items are zero.

In her bank statement, Nicola sees that the balance of the revolving credit facility on 1 October 2021 was $490,000, which is the affected loan balance on that date. She also sees a withdrawal on 15 December 2021 took the balance above the initial loan balance to $506,000, and the balance did not return below the initial loan balance until a deposit of $10,000 was made on 24 December 2021. For the remainder of the period, until 31 March 2022, the balance remained below $500,000.

On 31 December Nicola's bank charged her $1,700 in interest for the December month. Nicola calculates the non-deductible interest as the portion of the affected loan balance that was above the initial loan balance ($6,000 x 9 days x interest rate). Of the remainder of the $1,700 interest charge for the month, 75% can be deducted as grandparented residential interest after applying section DH 8(2).

A detailed example of the intended calculation of the affected loan balance is included in example 94 below. This example shows the effect (excluding adjustments for interest) when a single loan has been applied for a mixture of DRP, fully deductible activities and private purposes. If a variable balance loan is only applied for DRP, no adjustments to the balance of the loan are required to calculate the affected loan balance, which simplifies the required calculations.

Example 92: Private expenditure

On 26 March 2021, Ariana owes $500,000 on a revolving credit facility used to fund her residential rental property. Her initial loan balance is $500,000. Although the balance of the revolving credit facility, and therefore the affected loan balance, fluctuates as she receives rent and pays expenses, by 30 September 2021 the affected loan balance is $460,000. The affected loan balance remains below $500,000 until Ariana withdraws $70,000 on 1 April 2023 to buy a car for personal use. This increases the balance of the revolving credit facility from $460,000 to $530,000. However, the affected loan balance remains at $460,000 as the revolving credit facility balance is adjusted down by the private expenditure of $70,000.

The interest affected by limited denial of deductibility under section DH 10(3) from 1 April 2023 is calculated based on the lower of:

- the initial loan balance = $500,000, and
- the affected loan balance = $530,000 – $70,000 = $460,000

Ariana's interest that is affected by limited deductibility would therefore be calculated by multiplying the affected loan balance of $460,000 by the interest rate. Multiplying that amount by the relevant percentage in section DH 8(2) would then provide the non-deductible portion. The portion of the revolving credit facility used to buy the car ($70,000), and any interest charged on that amount, is fully non-deductible.

Example 93: Significant repayment

On 26 March 2021, Kristina owes $500,000 on a revolving credit facility used to fund her residential rental property. Her initial loan balance is $500,000. The balance of the revolving credit facility, and therefore the affected loan balance, fluctuates as she receives rent and pays expenses, and by 30 September 2021 the affected loan balance is $520,000. For the period the affected loan balance is above the initial loan balance, Kristina is only entitled to deductions for the interest calculated on the initial loan balance of $500,000. For the period the affected loan balance is below the initial loan balance, Kristina would calculate her interest deductions based on the affected loan balance, rather than the initial loan balance.

On 17 April 2023, she receives an inheritance of $200,000 and uses it to reduce the balance of the revolving credit facility, and thus the affected loan balance, from $550,000 to $350,000. As this is below the initial loan balance, Kristina can deduct 50% of the interest after applying the 50% denied deduction percentage under section DH 8(2) for the 2023–24 year.

On 3 August 2024, Kristina withdraws $100,000 from the revolving credit facility to renovate her rental property. The balance of the revolving credit facility, and thus the affected loan balance, increases from $370,000 to $470,000. This work does not qualify for the new build exemption. As this is not private expenditure, nor fully deductible, no adjustments are needed to Kristina's affected loan balance.

As the balance of the revolving credit facility, and thus the affected loan balance, is below the initial loan balance, Kristina is entitled to deduct 25% of the interest after applying the 75% denied deduction percentage under section DH 8(2) for the 2024–25 year.

Example 94: Detailed calculation

Mikkel has a revolving credit facility that he used to fund his DRP. On 26 March 2021, the facility has a balance of $500,000. The following transactions occur:

- Interest is charged at 4% x 1/12 on the closing monthly balance.
- Rent of $2,400 is deposited on the 1st day of each month.
- $5,000 is withdrawn on 15 May 2021 and spent on private expenditure.
- $20,000 is withdrawn on 10 August 2021 and spent on Mikkel's separate taxable business.
- On 20 November 2021, $6,500 is withdrawn and spent on repairs to the DRP.

Mikkel's initial loan balance is $500,000 and he calculates the loan balance that has interest deductions limited under section DH 8(2) as follows:

Date	Transaction	Amount	Loan Balance	Affected Loan Balance	Loan Balance under s DH 10(3)	Comment
26-Mar-21	End of day balance		-500,000	-500,000		
31-Mar-21	Interest	-1,667	-501,667	-501,667		
1-Apr-21	Rent	2,400	-499,267	-499,267		
30-Apr-21	Interest	-1,664	-500,931	-500,931		
1-May-21	Rent	2,400	-498,531	-498,531		
15-May-21	Private expenditure	-5,000	-503,531	-498,531		Private expenditure not deductible and affected loan balance does not increase
31-May-21	Interest[35]	-1,678	-505,209	-500,209		
1-Jun-21	Rent	2,400	-502,809	-497,809		

Continued...

[35] $5,000 x 0.04 ÷ 12 x 16/31 = $6.45 of interest relates to private expenditure so would also be added back to the affected loan balance. For simplicity, this example assumes no adjustments to the affected loan balance for private and business interest charges.

Date	Transaction	Amount	Loan Balance	Affected Loan Balance	Loan Balance under s DH 10(3)	Comment
30-Jun-21	Interest	-1,676	-504,485	-499,485		
1-Jul-21	Rent	2,400	-502,085	-497,085		
31-Jul-21	Interest	-1,674	-503,759	-498,759		
1-Aug-21	Rent	2,400	-501,359	-496,359		
10-Aug-21	Business expenditure	-20,000	-521,359	-496,359		Business expenditure fully deductible and affected loan balance does not increase
31-Aug-21	Interest	-1,738	-523,097	-498,097		
1-Sep-21	Rent	2,400	-520,697	-495,697		
30-Sep-21	Interest	-1,736	-522,432	-497,432		
1-Oct-21	Rent	2,400	-520,032	-495,032	-495,032	
31-Oct-21	Interest	-1,733	-521,766	-496,766	-496,766	
1-Nov-21	Rent	2,400	-519,366	-494,366	-494,366	
20-Nov-21	House repairs	-6,500	-525,866	-500,866	-500,000	Expenditure on DRP. Affected loan balance goes above initial loan balance
30-Nov-21	Interest	-1,758	-527,619	-502,619	-500,000	
1-Dec-21	Rent	2,400	-525,219	-500,219	-500,000	
31-Dec-21	Interest	-1,756	-526,970	-501,970	-500,000	
1-Jan-22	Rent	2,400	-524,570	-499,570	-499,570	Affected loan balance goes below initial loan balance
31-Jan-22	Interest	-1,754	-526,318	-501,318	-500,000	Affected loan balance goes above initial loan balance
1-Feb-22	Rent	2,400	-523,918	-498,918	-498,918	Affected loan balance goes below initial loan balance

The private expenditure and business expenditure are adjusted from the affected loan balance. This is an identical calculation to that required under the legislation to determine the amount of deductible interest allocated to the rental property.

Until 30 September 2021, the interest limitation proposals do not apply, so the balance that generates interest deductible against the rental property is the affected loan balance.

Between 1 October 2021 and 19 November 2021, the affected loan balance is lower than the initial loan balance so interest on the affected loan balance is deductible subject to the 25% denial in section DH 8(2).

On 20 November 2021, the house repairs take the affected loan balance above the initial loan balance. Therefore, between 20 November 2021 and 31 December 2021, interest on the $500,000 initial loan balance is deductible subject to the 25% denial. Interest on the difference between the affected loan balance and the initial loan balance, which varies between $219 and $2,619 during this period, is non-deductible under section DH 8(1).

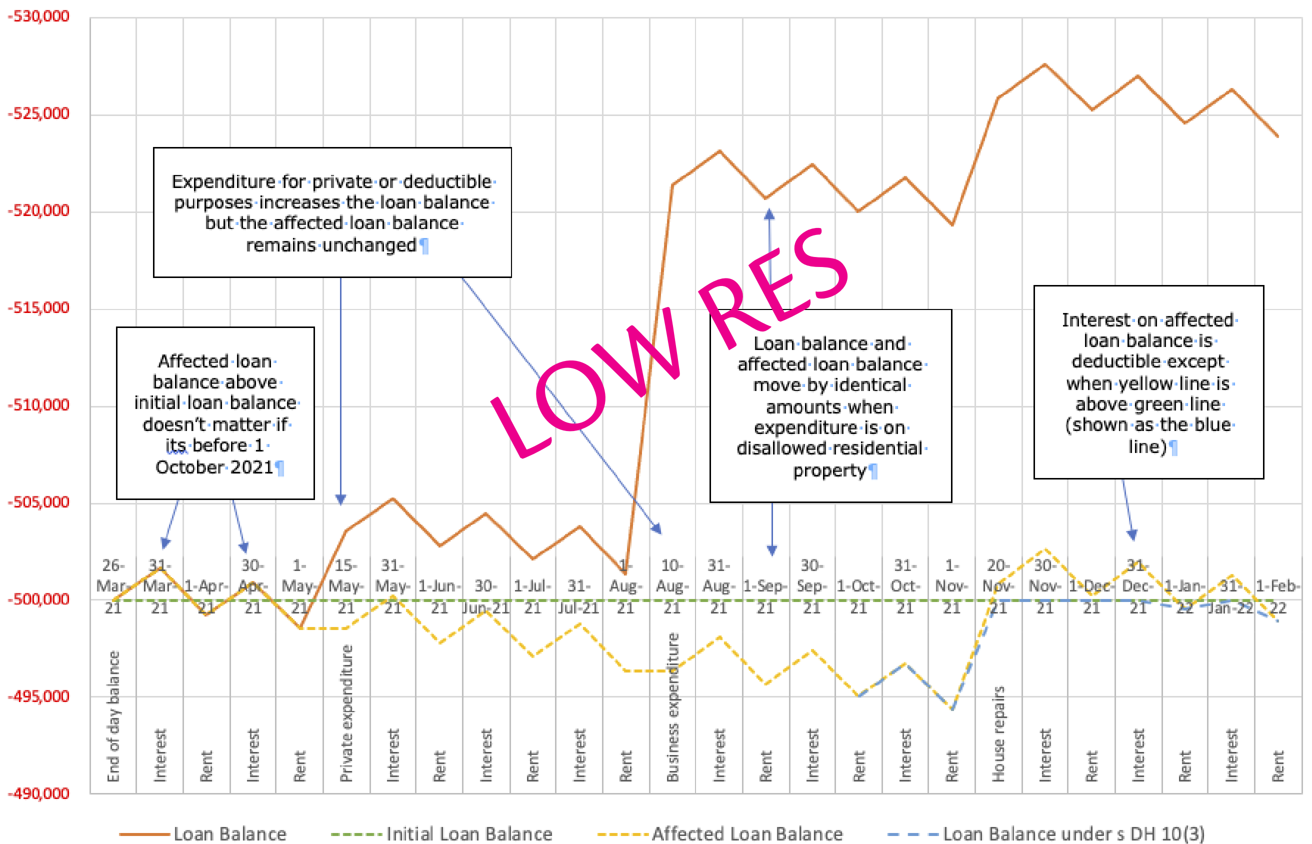
On 1 January 2022, the rent payment reduces the affected loan balance below the initial loan balance. Between 1 January 2022 and 30 January 2022, interest on the affected loan balance is deductible subject to the 25% denial.

NEW LEGISLATION

On 31 January 2022, the interest charged increases the affected loan balance above the initial loan balance. For that day, interest on the initial loan balance is deductible subject to the 25% denial. Interest on the difference between the initial loan balance and the affected loan balance of $1,318 is non-deductible.

On 1 February 2022, the rent payment reduces the affected loan balance below the initial loan balance. Interest on the affected loan balance is deductible subject to the 25% denial. This will remain the case until 31 March 2023, provided the affected loan balance remains below $500,000.

This example can also be shown in a graph as shown below.



Refinancing

Section DH 5(5)(e) and (f)

A taxpayer with a loan that is a grandparented transitional loan (or would have been such a loan if it had been in New Zealand dollars) can take out a second loan to repay the first loan. The second loan, provided it is in New Zealand dollars, follows the treatment of the first loan. It is therefore treated as being for the disallowed residential property (DRP) and the interest should be grandparented residential interest.

Application date

The new provisions apply to refinancing on or after 27 March 2021.

Detailed analysis

Interest deductions for a grandparented transitional loan are progressively denied by section DH 8(2). A taxpayer can refinance that grandparented transitional loan by taking out a second New Zealand dollar loan and using the proceeds to repay the first loan. In these circumstances, the purpose of the first loan and the deductibility of interest on that loan are maintained for the second loan.

A taxpayer that has a foreign currency loan for DRP would not have a grandparented transitional loan as the loan would not meet the definition of that term in section DH 5(5). Consequently, interest on such a loan is non-deductible after 1 October 2021. If the taxpayer refinances such a loan with a New Zealand dollar loan, and the other criteria are met, the new loan will meet the definition of "grandparented transitional loan". Deductions for interest incurred on the New Zealand dollar loan will then be progressively denied under section DH 8(2) until 31 March 2025, when interest on that New Zealand dollar loan also becomes fully non-deductible.

Rollover relief – transfer of disallowed residential property

Sections CB 6AB, CB 6AC, DH 5(5)(d), and FC 9B(a) to (e) of the Income Tax Act 2007

Rollover relief is provided for certain transfers or disposals of disallowed residential property (DRP) to ensure that grandparented residential interest on a grandparented transitional loan remains deductible throughout the full transition period of 1 October 2021 to 31 March 2025.

Relief is available for some transfers to or from family trusts and to or from look-through companies and partnerships. Specific relief applies to transfers to trusts constituted under Te Ture Whenua Māori Act 1993.

Relief is also available for relationship property settlements, certain company amalgamations, and transfers on death.

Background

The new interest limitation rules deny deductions for interest incurred on loans on or after 1 October 2021 where those loans are drawn down on or after 27 March 2021 for DRP.

Loans drawn down before 27 March 2021 are grandparented transitional loans, meaning that interest deductions are progressively denied over the period from 1 October 2021 to 31 March 2025 as grandparented residential interest. In limited circumstances, loans drawn down on or after 27 March 2021 also qualify as grandparented transitional loans.[36]

In general, simple refinancing does not result in a loan losing its grandparented transitional loan status. However, this may not be the case for a person with a grandparented transitional loan who restructures the legal ownership of the property and the accompanying loan on or after 27 March 2021. In the absence of rollover relief, the person may no longer be considered to have a grandparented transitional loan and will not be entitled to deduct any interest expense incurred for the property from 1 October 2021 or for the remainder of the transition period to 31 March 2025. This is the case even if the economic ownership of the property remains the same.

Providing rollover relief is therefore justified on equity grounds in some ownership-change scenarios where economic ownership has not materially changed.

[36] For more on grandparented transitional loans and grandparented residential interest, see the "Grandparented residential interest" section.

Key features

Rollover relief is available for the purposes of subpart DH and determining whether a loan is a grandparented transitional loan when DRP:

- is transferred under a settlement of relationship property
- passes from an amalgamating company to the amalgamated company on a resident's restricted amalgamation, or
- is transferred, following the death of the owner of the property, to an executor or administrator of the estate or to a beneficiary of the estate.

This is consistent with existing rollover relief available under the bright-line test.

Family trusts

Rollover relief is also provided for some transfers of DRP to or from family trusts. This is provided that:

- each transferor (in the case of transfers to a trust) or each recipient (in the case of transfers from a trust back to a settlor) of the DRP is also a beneficiary of the trust
- at least one of those transferors or recipients of the DRP is also a principal settlor of the trust
- each principal settlor is a beneficiary of the trust and a close family associate, and
- each beneficiary is either a close family beneficiary or trustee of another trust with at least one beneficiary that is a close family associate of a beneficiary of the first trust.

For rollover relief to apply when the trustees of a family trust of the type described above transfer the property back to its original settlors, each recipient's proportionate interest in the property has to be the same as in the original settlement of the property on the trust.

Relief is available when DRP is transferred back to the original owner and then settled on a new trust, so rollover relief should also be available for a pure resettlement transaction where the trustees of the trust transfer the DRP to a new trust. While this is not currently provided for in the new legislation, it is intended that rollover relief for such resettlement transactions should be introduced in the next available tax bill.

Specific rule for Māori family trusts

Specific relief is also provided for land subject to Te Ture Whenua Māori Act 1993. Rollover relief applies for transfers to a Māori authority (or a person eligible to be a Māori authority) as the trustee of a trust if:

- the DRP is subject to Te Ture Whenua Māori Act 1993
- the transferors are all beneficiaries, and
- the beneficiaries of the trust are all either:
  - members of the same iwi or hapū, or
  - descendants of the same tipuna (living or dead).

Similar to the rule for general family trusts, relief is also available when the trustees of a Māori trust of the type described above transfer the DRP back to the settlors of the property, provided those settlors are beneficiaries of the trust. It is intended that for rollover relief to apply when the trustees of a trust of the type described above transfer the property back to its original settlors, each recipient's proportionate interest in the property has to be the same as in the original settlement.

As above, relief for resettlement transactions is not provided for in the new legislation, but it is intended that rollover relief should be available and should be introduced in the next available tax bill.

Transfers to or from look-through companies (LTCs) and partnerships

Rollover relief also applies to transfers of DRP to or from LTCs and partnerships. This is intended to apply where each person transferring the DRP to the LTC or partnership (or acquiring it from the LTC or partnership) has the same ownership interest in the property before and after the transfer.

Application date

The provisions came into force on 27 March 2021 with application to interest incurred on or after 1 October 2021.

Detailed analysis

New section DH 5(5)(d) provides for rollover relief for the purposes of subpart DH and determining whether a loan is a grandparented transitional loan when DRP is transferred:

- under a settlement of relationship property
- from an amalgamating company to the amalgamated company on a resident's restricted amalgamation
- following the death of the owner of the property, to an executor or administrator of the estate or to a beneficiary of the estate
- to or from a family trust in certain circumstances
- to or from trustees in certain situations where the DRP is subject to Te Ture Whenua Māori Act 1993, and
- to or from LTCs and partnerships in certain circumstances.

If the requirements for rollover relief are satisfied, the recipient effectively steps into the shoes of the transferor (the original owner with the grandparented transitional loan). This ensures that the recipient can deduct a reducing portion of their interest expense incurred during the period 1 October 2021 to 31 March 2025 for the DRP in accordance with section DH 8(2). The recipient still needs to satisfy the other requirements in the Income Tax Act 2007 to be able to deduct the interest expense (for example, satisfying the general permission and not being subject to a general limitation).

In each case, the recipient's maximum grandparented transitional loan cannot exceed the transferor's loan balance at the time of the disposal – that is, if they borrow more than the transferor owes at the time of transfer, the excess part of the loan is not grandparented, and interest on that excess is not grandparented residential interest and is not deductible.

Relationship property settlements

New section DH 5(5)(d) provides that rollover relief applies to a transfer of DRP made under existing section FB 3A on a settlement of relationship property on or after 27 March 2021 if the previous owner of the DRP (the original owner) had a grandparented transitional loan. "Settlement of relationship property" is defined by existing section FB 1B(a) as a transaction under a relationship agreement[37] that creates a disposal and acquisition of property between two persons who are both either a party to the agreement or associated with a party to the agreement.

This means that certain loans drawn down by, or transferred to, the recipient of DRP under a relationship agreement on or after 27 March 2021 up to 31 March 2025 meet the requirements of new section DH 5(5) and are grandparented transitional loans. This will be the case if the loan held by the transferor before the relationship property settlement was also a grandparented transitional loan. However, the recipient's loan is only a grandparented transitional loan (and interest on it will only be grandparented residential interest) to the extent that the loan balance does not exceed the transferor's loan balance at the time of the transfer.

The recipient of the property is entitled to deduct a reducing portion of their grandparented residential interest expense during the remaining transition period to 31 March 2025 in accordance with the percentages set out in section DH 8(2). This is provided the general requirements for deducting expenses are met (for example, a nexus with income exists).

Example 95: Relationship property settlement

Dale and Dawn, a married couple, decide to separate in April 2022. As part of the relationship property settlement, they agree that Dale will keep the family home and Dawn will keep the investment property they acquired back in 2003, shortly after they got married. Dawn decides to retain the property as an investment rather than move into it herself. There is an existing mortgage over the property that has an outstanding loan balance of $20,000. Dawn has agreed to take this over.

Since the loan was drawn down before 27 March 2021, the loan is a grandparented transitional loan and the interest on the loan is grandparented residential interest. Dale and Dawn are entitled to deduct 75% of the amount of mortgage interest they each incurred for the property over the period from 1 October 2021 to 31 March 2022.

Rollover relief applies to the transfer of Dale's share of the property to Dawn in April 2022, so the $20,000 loan continues to be a grandparented transitional loan, and Dawn is entitled to deduct a reducing amount of interest over the remaining period to 31 March 2025.

[37] A relationship agreement is defined in section YA 1 as an agreement for the purpose of Part 6 of the Property (Relationships) Act 1976 or an order under section 25 of that Act that is made by the person or the court on or after 28 July 1983.

Company amalgamations

Section DH 5(5)(d) also provides that rollover relief applies to a transfer of property as part of a company amalgamation under existing section FO 17. Relief applies when DRP passes from an amalgamating company to the amalgamated company on a resident's restricted amalgamation on or after 27 March 2021, provided the amalgamating company had a grandparented transitional loan. A resident's restricted amalgamation is defined in section FO 3. Effectively, rollover relief is only available if the amalgamating company and amalgamated company are New Zealand resident and are not treated as non-resident under a tax treaty. This is to ensure that, consistent with the rules for bright-line rollover relief, rollover relief for interest limitation is provided on the condition the property remains within the New Zealand tax base. Once again, the amalgamated company's grandparented transitional loan balance cannot exceed the amalgamating company's loan balance at the time of transfer.

Example 96: Company amalgamation

In March 2015, A Co, a close company, purchases several residential apartments. On 1 October 2021, the properties are transferred from A Co to another close company, B Co, as part of an amalgamation. The amalgamation qualifies as a resident's restricted amalgamation under section FO 3 of the Income Tax Act 2007. Immediately before the transfer, A Co has a grandparented transitional loan balance of $2.5 million.

Rollover relief applies to the transfer to B Co in October 2021, meaning that any loans held by B Co for the DRP up to a total value of $2.5 million are deemed to be grandparented transitional loans. B Co is therefore entitled to deduct a reducing amount of interest for any such loans over the transition period (1 October 2021 to 31 March 2025) as grandparented residential interest.

Inherited property

When a person dies, all their property (their estate) is transferred to the executor appointed under the deceased's will or, if there is no will, the administrator of the estate appointed by the court. The executor or administrator is then responsible for dealing with any taxes and debts due out of the estate and distributing any remaining property to the beneficiaries of the estate.

Generally, all the deceased's debt will be repaid by their estate when they die, provided there are sufficient assets to cover the debt. Even if the debt is not repaid in full, any remaining debts are not required to be repaid by the beneficiaries of the estate. However, there may be some situations where a property with a registered mortgage is transferred to a beneficiary of the estate because the beneficiary is willing to voluntarily make the mortgage repayments so that they may keep the property.

Section DH 5(5)(d) provides that rollover relief applies in certain instances to a transfer of inherited DRP in accordance with existing section FC 9 following the death of the original owner if the original owner had a grandparented transitional loan. This includes when the property is transferred to an executor or administrator, or to a beneficiary of the deceased's estate, on or after 27 March 2021. The result is that interest on a loan transferred to, or serviced by, the recipient of the property continues to be grandparented residential interest on a grandparented transitional loan if the deceased had a loan for the same property that qualified as a grandparented transitional loan under new section DH 5(5). This entitles the recipient of the property to deduct interest in accordance with the grandparented residential interest rules in subpart DH for the remainder of the transition period to 31 March 2025. This is only to the extent that the loan balance does not exceed the grandparented transitional loan balance at the time of the transfer of the property.

This ensures the following:

- If the property was held by the deceased as a rental property, the executor or administrator (when filing the estate's income tax return) is entitled to deduct at least some of the interest incurred by the estate starting on 1 October 2021 up to 31 March 2025 (if any) on any loans for the property that were still outstanding at the time of death of the owner.
- A beneficiary of the estate inheriting the DRP potentially also benefits from the transition period, as they will be able to deduct some of the interest on the grandparented transitional loan to 31 March 2025. This assumes the beneficiary will be repaying or taking over any loans for the property not fully repaid by the deceased's estate.

Example 97: Inherited property

Pat purchased a house as a private residence for himself in 2010 and borrowed $200,000 at that time to finance the purchase. In his will, Pat has provided that all his property is inherited by his son, Robin, when he dies.

At the time of Pat's death in July 2021, $40,000 is still owing on the loan. This loan is a grandparented transitional loan. Robin would like to keep Pat's house and use it as a rental property to supplement his income, so he agrees with the executors of Pat's estate that he will obtain a loan from another bank to repay the loan outstanding to Pat's bank.

Robin borrows $90,000 – of which $40,000 is used to repay Pat's bank and the remaining $50,000 is used to fund renovations before Robin finds tenants.

Rollover relief applies to the transfer of the property to Robin, meaning that Robin is deemed to have a grandparented transitional loan. However, the grandparenting rules only apply to $40,000 of Robin's loan, as that is the amount that was owing at the time of Pat's death.

Robin is entitled to deduct a reducing amount of interest for $40,000 of his loan over the transition period (1 October 2021 to 31 March 2025) as grandparented residential interest.

Family trusts

Section DH 5(5)(d) also provides rollover relief for transfers of DRP to or from trustees in certain situations. The section applies to every transfer of the DRP since the original owner acquired it that meets the requirements of sections FC 9B(a) or (b) (which link to sections CB 6AB(1) and (2) respectively), treating the relevant requirements of that section as applying to a transfer of DRP on after 27 March 2021 (rather than a transfer of residential land on or after 1 April 2022).

This means rollover relief applies in certain cases when DRP is transferred to the trustees of a family trust (section CB 6AB(1)) or is transferred from the trustees back to the person (original settlor) who originally settled it on the trust (section CB 6AB(2)).

Transfers to family trusts

Section DH 5(5)(d) applies by way of section CB 6AB(1) when a trustee receives a transfer of DRP to a "rollover trust". For transfers to a trust, a "rollover trust" is defined in section CB 6AB(5) to mean, at the time of a relevant transfer:

- all relevant transfers to trustees are by people who are beneficiaries of the trust, at least one of whom is a principal settlor of the trust
- all principal settlors are beneficiaries of the trust
- all principal settlors are close family associates, and
- all beneficiaries are either close family beneficiaries, or the trustees of another trust of which at least one beneficiary is a close family associate of a beneficiary of the trust in question.

"Close family beneficiary" is defined in section CB 6AB(6) as, for the relevant trust, a beneficiary that is at least one of the following:

- A principal settlor.
- A close family associate of another beneficiary who is also a principal settlor.
- A company in which a 50 percent or more voting interest (or a market value interest of at least 50 percent, if a market value circumstance exists) is owned by a beneficiary that is a close family associate of another beneficiary that is a principal settlor.
- A charity registered under the Charities Act 2005.

Under section CB 6AB(7), two persons are close family associates if one or more of the following applies:

- they are within four degrees of blood relationship (paragraph (a))
- they are married, in a civil union, or in a de facto relationship (paragraph (b)), or
- one person is within four degrees of blood relationship to the other person's spouse, civil union partner, or de facto partner (paragraph (c)).

This definition includes relatives by adoption, as section 16(2) of the Adoption Act 1955 deems adopted children to be the natural children of their adoptive parent. Section CB 6AB(7)(c) (the third bullet point above) also extends coverage of the association test to include stepchildren and in-laws.

The rules mirror the existing associated person rules in section YB 4 but with an expansion from two degrees to four degrees of association. This is to account for the fact that many family trusts include a wider range of family members than simply those only two degrees removed.

A non-exhaustive list of some common examples of familial relations that meet the "close family associates" test is as follows (references are to paragraphs in the section CB 6A(7) definition):

- The principal settlor's parents and children (one degree of blood relationship – paragraph(a)).
- The principal settlor's grandchildren, grandparents and siblings (two degrees of blood relationship – paragraph (a)).
- The principal settlor's aunts, uncles, nieces, nephews, great-grandchildren, and great-grandparents (three degrees of blood relationship – paragraph (a)).
- The principal settlor's cousins, great-nieces, great-nephews, and great-great-grandchildren (four degrees of blood relationship – paragraph (a)).
- The principal settlor's spouse or de facto partner (paragraph (b)).
- The principal settlor's stepparents, stepchildren, step-siblings, parents-in-law, brothers-in-law, sisters-in-law, daughters-in-law or sons-in-law (within four degrees of blood relationship to the spouse or de facto partner – paragraph (c)).

Further information on how degrees of association are determined in family situations can be found in IR620.[38]

Section CB 6AB(8) ensures that rollover relief does not apply when shares in an LTC holding DRP are transferred to or from trustees.

Example 98: Sale to family trust 1

Neo acquired a rental property and drew down a loan of $500,000 for the property on 3 March 2017. The rental property is DRP. The loan is a grandparented transitional loan.

On 29 October 2022, Neo sells the DRP to his family trust for $450,000. He and his son, Archie, are beneficiaries of the trust. Neo's outstanding balance of his loan at the time of transfer is $400,000. The trustee takes out a loan of $450,000 to purchase the property from Neo. Neo uses $400,000 of the sale proceeds to repay the outstanding balance of his loan.

The transfer of the DRP to the trust qualifies for rollover relief and therefore enables the trustee to deduct limited interest deductions until 31 March 2025. However, only interest on $400,000 of the trustee's loan is deductible as grandparented residential interest. Interest on the additional $50,000 borrowed does not qualify for rollover relief and is not deductible. This is because the $50,000 exceeds the balance of Neo's grandparented transitional loan at the time of transfer and is not part of the trustee's grandparented transitional loan.

Example 99: Sale to family trust 2

Maude acquired an investment property in 2017 using a combination of savings and a loan from the bank. In April 2021, Maude sold the property to her family trust, the beneficiaries of which are her and her adult children, Fran and Josiah. At the time of sale, the outstanding balance on Maude's grandparented transitional loan is $150,000. To finance the purchase of the property, the trustees of the trust borrow $150,000 from the bank.

Rollover relief applies to the transfer of the property. This means the trustees have a grandparented transitional loan with a balance of $150,000 and interest incurred on the loan is grandparented residential interest.

Transfers from family trusts to the original settlors

Section CB 6AB(2) applies if DRP is transferred back to a person (the original settlor) from a rollover trust that the person originally settled. For transfers from the trust, section CB 6AB(5) defines "rollover trust" to mean, at the time of a relevant transfer to the original settlor:

- all relevant transfers to original settlors are to people who are beneficiaries of the trust, at least one of whom is a principal settlor of the trust
- all principal settlors are beneficiaries of the trust

[38] IR620 *A guide to associated persons definitions for income tax purposes*, available at **ird.govt.nz**

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- all principal settlors are close family associates, and
- all beneficiaries are either close family beneficiaries, or the trustees of another trust of which at least one beneficiary is a close family associate of a beneficiary of the trust in question.

For section CB 6AB(2) to apply, subsection (3) provides that the DRP transferred back to the original settlor by the trustees of the trust must either be:

- the same DRP they originally settled, and all other original settlors also get their DRP back, or
- in part the same DRP they originally settled if that part and all other transfers back to other original settlors are in the same proportions as in the original settlement on the trust.

Relief under section CB 6AB(2) does not apply where DRP held on trust is transferred to a beneficiary who is not the original settlor of the DRP. For example, if a parent transfers a residential property to a family trust, the beneficiaries of which are that parent and their children, section CB 6AB(2) would only apply if the trustee transfers the DRP back to the parent, not if the DRP is transferred to the children.

Transfers to or from different capacity (LTCs, partnerships)

Relief may also apply in certain cases under section CB 6AB when:

- DRP is transferred from an LTC or partnership to a family trust (where DRP may be settled on the trust by a person in a different capacity to the capacity in which they are a beneficiary), or
- a person receives DRP back from a trust they settled it on, but in a different capacity to the capacity in which they settled it.

Section CB 6AB(3) provides that, for the purposes of applying subsection (1) (where a person transfers DRP to a trust) or subsection (2) (where an original settlor receives DRP back from a trust), the person may transfer DRP to, or receive it from, the trust in different capacities. For example, A and B may have settled the DRP on the trust in their own personal capacities, but they may have it transferred back to them in their capacity as shareholders in an LTC.

Example 100: Transfer from partnership to family trust

Susan and Rhiannon, a married couple, are the two partners in a partnership, the S & R Partnership (the Partnership) and the principal settlors of the S & R Trust (the Trust). Both Susan and Rhiannon are beneficiaries of the Trust, and all the other beneficiaries of the Trust are either associated with both Susan and Rhiannon within four degrees of blood relationship or are associated with Susan within four degrees of blood relationship. This includes their adult son, Mark (who is Rhiannon's biological son and was adopted by Susan, and so is treated under the law as Susan's natural child) and grandchildren, as well as Susan's children and grandchildren from her previous relationship.

The Partnership purchased an investment property in 2015 for $535,000. The Partnership settles the investment property on the Trust in August 2021, at which time the outstanding balance of the mortgage on the property is $100,000. The trustees of the Trust provide consideration of $900,000 to the Partnership for the property. The trustees borrow $300,000 from the bank for the purchase of the property and fund the remainder of the purchase price with equity.

Partial rollover relief applies to the transfer of the property, meaning that the trustees have a grandparented transitional loan balance of $100,000 (being the amount of the Partnership's grandparented transitional loan balance on the date of the transfer). The trustees' excess loan balance of $200,000 does not qualify for rollover relief.

Resettlements of trusts

It is intended that rollover relief should be available for trust resettlements when the trustees of the trust transfer the DRP to the trustees of another trust, provided that a principal settlor of the new trust is also a principal settlor of the first trust and the new trust satisfies all the requirements of section CB 6AB(5) in relation to its beneficiaries. However, the current legislation does not permit a direct resettlement to qualify for rollover relief, unless the trustee resettling the property is a beneficiary of the new trust. It is intended that an amendment should be included in the next available tax bill.

Māori family trust rule

Section DH 5(5)(d) provides rollover relief for transfers of DRP subject to Te Ture Whenua Māori Act 1993 to trustees in certain situations outlined in sections FC 9B(d) or (e) (which link to section CB 6AC(1) and (2) respectively). This recognises that land subject to Te Ture Whenua Māori Act 1993 has alienation restrictions that lead to interests in land being passed from generation to generation. These interests are often fragmented and can result in a large number of owners all belonging to the same iwi or hapū or who are all descendants of the same tipuna.

Section DH 5(5)(d) applies to every transfer of the DRP since the original owner acquired it that meets the requirements of section FC 9B(d) or (e), treating the relevant requirements as applying to a transfer of DRP on after 27 March 2021 (rather than a transfer of residential land on or after 1 April 2022).

This means rollover relief applies in certain cases when DRP is transferred to the trustees of a Māori family trust (section CB 6AC(1)) or is transferred from the trustees back to a person (the original settlor) who originally settled it on the trust (section CB 6AC(2)).

Transfers to Māori family trusts

Section CB 6AC(1) applies when a Māori trustee holds DRP subject to Te Ture Whenua Māori Act 1993 on a Māori rollover trust. For transfers to a trust, "Māori rollover trust" is defined in section CB AC(4) to mean, at the time of a relevant transfer:

- all relevant transfers to the trustees of the trust are by people who are beneficiaries of the trust
- all beneficiaries of the trust are either members of the same iwi or hapū, or descendants of the same tipuna (living or dead), and
- the DRP is subject to Te Ture Whenua Māori Act 1993.

Section CB AC(5) defines "Māori trustee" as a trustee of a trust that is either a Māori authority or eligible to be a Māori authority under existing section HF 2(3)(e)(i).

Example 101: Sale of property subject to TTWM Act to trust eligible to be a Māori authority

Rewi and several of his family members hold interests in a parcel of land that is subject to Te Ture Whenua Māori Act 1993. All the family members are descendants of Rewi's late great-great-grandfather. Several townhouses are on the land, and these are all rented out to tenants. In 2023, Rewi and his relatives decide to sell their interests in the land to a family trust that was settled by Rewi for the benefit of all surviving descendants of Rewi's great-great-grandfather. The trust is eligible to be a Māori authority under section HF 2(3)(e)(i), but it has not elected to be one.

Rewi and his relatives took out a loan in 2019 to finance improvements to some of the townhouses on the land. This loan is a grandparented transitional loan. At the time of the sale to the trustees in 2023, $120,000 was still outstanding on the loan.

The trustees take out a loan for $500,000 to fund part of the purchase price of $1m. Rollover relief applies to the transfer of the property, meaning that the trustees are deemed to have a grandparented transitional loan, but the amount of that loan is limited to the transferors' loan balance of $120,000 that was outstanding at the time of the sale. The interest incurred on the $120,000 is grandparented residential interest and is partially deductible until 31 March 2025. Interest on the remaining $380,000 balance of the trustees' loan is not deductible.

Transfers from Māori family trusts to the original settlors of the trust

Section CB 6AC(2) applies if DRP is transferred back to a person (referred to here as the "original transferor", although the legislation uses the term original settlor) from a trustee of a Māori rollover trust that was originally settled by that person. For transfers from a trust, a "Māori rollover trust" is defined to mean, at the time of a transfer to an original transferor:

- the original transferors are also beneficiaries of the trust
- all beneficiaries of the trust are either members of the same iwi or hapū or descendants of the same tipuna, and
- the DRP is subject to Te Ture Whenua Māori Act 1993.

For section CB 6AC(2) to apply, subsection (3) provides that the DRP transferred back to the original transferor by the trustees of the trust must either be:

- the same DRP they originally settled on the trust, and all other original transferors also get their DRP back, or
- in part the same DRP they originally settled on the trust if that part and all other transfers back to other original transferors are in the same proportions as in the original settlement on the trust.

Transfers to or from different capacity (LTCs, partnerships)

Relief may also apply in certain cases under section CB 6AC when DRP is transferred between a Māori rollover trust and an LTC or partnership. Section CB 6AC(3) provides that, for the purposes of applying subsection (1) (where a person transfers DRP to a Māori rollover trust) or subsection (2) (where an original transferor receives DRP back from a Māori rollover trust), the person may transfer DRP to, or receive it from, the trust in different capacities. For example, A and B may have settled the DRP on the trust in their own personal capacities, but they may have it transferred back to them as partners in a partnership.

Resettlements of Māori family trusts

It is intended that rollover relief should be available when DRP subject to Te Ture Whenua Māori Act 1993 is resettled on another family trust, provided certain conditions are met. That is, when the trustees of the trust transfer the property to the trustees of another trust that is also a Māori authority, or eligible to be one, provided the two trusts have a settlor in common and the beneficiaries of the new trust are all members of the same iwi or hapū, or descendants of the same tipuna. However, the current legislation does not permit a direct resettlement to qualify for rollover relief unless the trustee resettling the property is also a beneficiary of the new trust. It is intended that an amendment should be included in the next available tax bill.

Transfers by or to persons in their capacity as look-through company owners or partners in a partnership

Shareholders in LTCs are treated as directly holding the LTCs' assets, deriving income and incurring expenses in accordance with their shareholding percentage. In effect, LTCs are transparent for tax purposes, which means that the income tax consequences for someone who holds DRP through an LTC are generally the same as for someone who holds DRP directly. Partnerships are also transparent for tax purposes.

Section DH 5(5)(d) provides rollover relief for a transfer to which section FC 9B(c) applies (which, in turn, links to section CB 6AB(4)), treating the relevant requirements as applying to a transfer of DRP on after 27 March 2021 (instead of a transfer of residential land on or after 1 April 2022).

Relief applies if a person transfers DRP to themselves in a different capacity, and there is no intervening transfer to a third party. This provides rollover relief for transfers between LTCs and the LTC shareholders or between partnerships and the partners.

The section is intended to apply to transfers of DRP to or from LTCs and partnerships where each person transferring the DRP to the LTC or partnership (or acquiring it from the LTC or partnership) has the same ownership interest in the property before and after the transfer. It is also intended to apply when DRP is transferred from an LTC to another LTC with identical shareholding (meaning that the two LTCs have the exact same owners who each hold the exact same proportion of shares in the second LTC as they hold in the first LTC).

Example 102: Transfer to look-through company

Mary and Bob, a married couple, are the shareholders in a look-through company, Company X. They each hold 50 percent of the shares in Company X. Mary and Bob jointly own an investment property in equal shares. Mary and Bob had drawn down a loan in 2018 to purchase the property. In September 2021, the loan has an outstanding balance of $100,000 and is a grandparented transitional loan.

In September 2021, Mary and Bob sell the property to Company X for $850,000. Company X borrows $150,000 from the bank for the purchase of the property and uses its equity to fund the remainder of the purchase price. Partial rollover relief applies to the transfer of the property, meaning that Company X has a grandparented transitional loan balance of $100,000 (being the amount of Mary and Bob's grandparented transitional loan balance on the date of the transfer). Company X's excess loan balance of $50,000 does not qualify for rollover relief.

Interest limitation and mixed use assets

Sections DG 2(3B), DG 9(1), DG 10(1B), DG 11(1)(b), DG 14(4), and DH 6 of the Income Tax Act 2007

The interest limitation rules apply to property such as baches or holiday homes that are rented out on a short-term basis. For most such property, the apportionment of expenditure between income-earning and other uses is specifically provided for in subpart DG of the Act, which applies to expenditure incurred in relation to mixed use assets (MUAs). The interest limitation rules apply to determine whether the amount of interest apportioned to the income-earning use of a residential property MUA, either under subpart DG or otherwise, is deductible.

For most residential property MUAs, applying the interest limitation rules and the MUA rules concurrently should be relatively straightforward. However, in the unusual case where a residential property MUA is held by a close company, more complex rules must be applied. This is because the two sets of rules apply different approaches to determine what interest is allocated to the residential property MUA.

As a general principle, the interest limitation rules only apply to interest that relates to (in other words, can be traced to) ownership of mixed use residential property. Interest that is allocated to mixed use residential property under the special rules in sections DG 10 to DG 13 (which do not apply tracing) is not subject to the interest limitation rules

Key features

New section DG 2(3B) ensures the deductibility of interest subject to apportionment under sections DG 8 and DG 9 that is incurred in relation to disallowed residential property (DRP) is subject to denial under subpart DH.

New section DG 10(1B) provides that interest incurred in relation to DRP or to acquire an ownership interest in, or become a beneficiary of, an interposed residential property holder (IRPH), as well as the associated debt, is ignored for the purposes of sections DG 11 to DG 13. While it is not clear in the new legislation, it is intended that this interest will be apportioned using the formula in section DG 9, and an amendment to ensure this result should be introduced in the next available tax bill.

Interest incurred that relates to an interest in an IRPH for which a deduction is already denied under section DH 8(1)(c) is removed from the application of section DG 14.

MUAs are removed from the definition of "disqualified assets" in section DH 6(2)(a) to ensure that such assets give rise to a loss of a deduction for interest incurred by a shareholder only under the mixed use asset rules.

Application date

The new provisions came into force on 27 March 2021 with application to interest incurred on or after 1 October 2021.

Detailed analysis

When interest expenditure is subject to apportionment under sections DG 8 and DG 9 and it relates to DRP, new section DG 2(3B) ensures the deductibility of that expenditure is subject to the application of the new interest limitation rules in subpart DH (and not conclusively resolved by section DG 8(1)). A deduction is not allowed for that portion of the interest expenditure identified as deductible by section DG 8(1) that is denied under new section DH 8.

This treatment does not apply to interest expenditure subject to apportionment under sections DG 11 to DG 13 (referred to in those sections as the "reduced amount", see examples below). Those sections relate to assets held in corporate structures. Interest expenditure subject to those provisions does not relate to the asset under the tracing approach that applies for subpart DH. Instead, it is allocated to the asset under the "stacking" approach set out in sections DG 11 to DG 13. This means that the interest is not subject to denial under subpart DH.

In applying the stacking approach, interest incurred that relates to a DRP or acquiring an ownership interest in an IRPH, as well as the associated debt, is not taken into account, since the interest on the debt is already subject to apportionment under sections DG 8 and DG 9 and to denial under section DH 8.

Example 103: Mixed use assets held directly

RB Ltd is a close company. For the year ended 31 March 2023, RB Ltd owns a holiday home, which is both a MUA and DRP, and a boat, which is also a MUA. The holiday home has a rateable value of $180,000 and the boat has a depreciated value of $60,000. The company has debt of $150,000, $50,000 of which was used to acquire the holiday home and meet expenses related to it, and $100,000 of which was used to acquire the boat and meet miscellaneous expenses related to it. The holiday home debt bears interest at 5% and the remaining debt bears interest at 5.5%, giving RB Ltd a total interest expense of $8,000 for the year. The formulas in sections DG 8 and DG 11 produce an income-earning use percentage of 45% for the holiday house and 70% for the boat.

Section DG 8 will apply to determine the apportionment between private and income-earning purposes of the $2,500 of interest for the holiday home. The 45% (or $1,125) that is allocated to income-earning purposes, and is therefore deductible under section DG 8(1), would nevertheless be non-deductible under section DH 8(1)(a). If the loan is a grandparented transitional loan, the deduction may be progressively denied under section DH 8(2) until 31 March 2025. The non-deductible portion remaining (after any partial allowance under section DH 8(2)) may be allowed if the sale of the property is taxable.

Because RB Ltd is a close company and has debt that is not traced to DRP or an IRPH (that is, the $100,000), it must apply section DG 11. In applying section DG 11, RB Ltd disregards the $50,000 of traced debt and associated $2,500 of interest. RB Ltd can apply section DG 11 first to either the holiday home or the boat. Generally, it would apply the section first to the asset with the higher percentage of income-earning use. In this case, that is the boat.

Applying section DG 11 to the boat first, RB Ltd determines that its debt value of $100,000 exceeds its asset value of $60,000. Section DG 11(2) therefore requires RB Ltd to apply sections DG 11(4) to (6). Section DG 11(4) calculates a reduced amount of $5,500 x $60,000/$100,000, or $3,300. RB Ltd is therefore allowed a deduction of 70% of that amount under section DG 11(6), or $2,310.

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Because RB Ltd has a remaining MUA (that is, the holiday home), RB Ltd must undertake the same calculations for the holiday home and the remaining unallocated debt amount of $40,000. In this case, the asset value must be determined by reducing the value of the holiday home by the debt related to it under a tracing approach. The asset value is therefore $130,000. This is more than the remaining debt value of $40,000, and so section DG 11(3) applies. RB Ltd is allowed a deduction of $990, calculated as $2,200 (being $5,500 –$3,300) x 45%.

Of RB Ltd's total interest expenditure of $8,000 incurred in the year ended 31 March 2023:

- $1,375 is apportioned under section DG 8 to private use of the holiday home and is non-deductible.
- $1,125 is apportioned under section DG 8 to income-earning use of the holiday home and, under subpart DH, 25% of this amount, or $281.25, is non-deductible and 75%, or $843.75, is deductible.
- $3,300 is allocated to the boat under section DG 11 and 70%, or $2,310, of this is deductible.
- $2,200 is allocated to the holiday home under section DG 11 and 45% or $990 of this is fully deductible. Subpart DH does not apply to this interest because it is allocated to the holiday home under the stacking approach in section DG 11, not the tracing approach.

Example 104: Mixed use asset and interest incurred by a holding company

RB Ltd in example 103 had a net asset value of $90.000. Suppose that RB Ltd is 100% owned by HB Holdings Ltd, which has debt of $1M and interest expense of $50,000.

First variation: Interest does not relate to RB Ltd shares

Assume that none of HB Holdings' debt was borrowed to acquire the shares in RB Ltd. In this case, subpart DH does not apply to any of HB Holdings' interest. However, section DG 12 does apply. HB Holdings therefore has to split its $50,000 of interest into a portion that is subject to disallowance under DG 12 (being $90,000/$1M) and a portion that is not. The portion subject to disallowance is $4,500, and of this, 55% or $2,475 will be non-deductible. Subpart DH does not apply to deny a deduction for the remaining $2,025

Second variation: Interest does relate to RB Ltd shares which are not an interest in IRPH

Assume that $100,000 of HB Holdings' debt was borrowed to acquire shares in RB Ltd. Ordinarily, those shares would be an interest in an IRPH since the value of the holiday home is more than 10% of the value of all of RB Ltd's assets (see the definition of an "interposed residential property holder" in section DH 5(6)). On that basis, a portion of the interest on the traced debt would be non-deductible under section DH 8(1)(c). However, because of section DH 6(2)(a)(ii), an asset that is subject to subpart DG is not included in the numerator in determining a company's interposed residential property percentage.

However, section DG 12 still applies to deny a portion of HB Holdings' interest deduction as per the first variation.

Third variation: Interest does relate to RB Ltd shares which are an interest in IRPH

Assume the home is a long term rental, so not subject to subpart DG (see section DG 3(4)(b)). Section DG 11 only applies to the interest allocated to the boat under section DG 11, which is the product of RB Ltd's total interest cost ($8,000) x the value of the boat/the amount of all borrowing by RB Ltd ($60,000/$150,000) = $3,200. Since the private use percentage of the boat is 30%, $960 of RB Ltd's interest deductions will be denied under section DG 11.

If the home is a new build or otherwise not subject to subpart DH, there is no more interest to deny. However, assume that it is subject to subpart DH. In this case, because the home is not subject to subpart DG, HB Holdings' shares in RB Ltd are an interest in an IRPH. If none of HB Holdings' debt relates to the RB Ltd shares, there will be no interest disallowed under subpart DH. However, if $100,000 of HB Holdings' debt does relate to the RB Ltd shares under tracing, then the interest on that debt x RB Ltd's interposed residential property percentage will be denied by section DH 8(1)(c). This is a quarterly calculation. Assuming that the only assets in RB Ltd are the boat and the home, the interposed residential property percentage will be $180,000/$240,000, giving a percentage of 75%. Given the interest rate on the debt of 5%, this will result in disallowance of $100,000 x 5% x 75% = $3,750.

Fourth variation

Assume the facts are the same as the third variation, except that RB Ltd has no borrowing. Section DH 8(1)(c) applies, as in the third variation, to disallow $3,750 of HB Holdings' interest expense. The change in facts means that there is a net asset balance of $60,000 (the value of the boat) in RB Ltd. Assuming that HB Holdings is the company that applies section DG 12, this means that a further $60,000 of its debt is effectively related to the boat. Given the 5% interest rate and the 30% private use, this will result in additional interest denial of $60,000 x 5% x 30% = $900.

Example 105: Interposed residential property holder

Hinemoa owns 100% of the shares in Whare Limited. Whare Limited's only assets are three houses, as follows:

- 10 Moana Ave, which is a MUA and has a value of $1.5M. The private use percentage is 60%.
- 20 Cluny Rd, which is a non-new build long-term rental and has a value of $600,000.
- 33 Motuhara Rd, which is a new build long-term rental and has a value of $900,000.

Whare Ltd has no debt, but Hinemoa has borrowed $1M to acquire the shares in Whare Ltd. The interest on the debt for the relevant year is $40,000.

Whare Limited has an interposed residential property percentage under section DH 6 of $600,000/$3,000,000, since the MUA is excluded from the numerator under section DH 6(2). Since this is 20%, Hinemoa's shares are an interest in an IRPH (section DH 5(6)). This means 20% of the $40,000 of interest deductions for the year (or $8,000) is non-deductible under section DH 8((1)(c). This is equivalent to saying that $200,000 of the debt gives rise to non-deductible interest.

Whare Limited also has a net asset balance of $1.5M, being the value of 10 Moana Avenue less the debt of zero. This means that all Hinemoa's interest on the $1M used to buy the shares in Whare Ltd is subject to section DG 14, less the 20% already dealt with under subpart DH. That leaves $32,000 of interest to be dealt with. Under sections DG 11(3B), DG 13(5), and DG 14, this means allowing an interest deduction for only 40% of the $32,000, or $12,800, since that reflects the income earning use of 10 Moana Avenue.

Loans in foreign currency

Section CW 62C of the Income Tax Act 2007

Income arising from a foreign currency loan that is used for disallowed residential property (DRP) and denied interest deductions under section DH 8(1) is exempt income.

Application date

The amendment came into force on 27 March 2021 with application to income derived on or after 1 October 2021.

Detailed analysis

DRP may be financed by a loan denominated in a foreign currency. Unlike a New Zealand dollar loan, a loan in foreign currency can result in assessable income, under the financial arrangements rules, if the person has a foreign exchange gain for the year. To ensure symmetry between potential income and expenditure on the same loan, section CW 62C treats income arising from a foreign currency loan used for DRP as exempt income.

The effect of section CW 62C is that the treatment of foreign currency loans for DRP is consistent with New Zealand dollar loans, except that foreign currency loans are not eligible for the progressive denial of interest deductions between 1 October 2021 and 31 March 2025 under section DH 8(2). This is because a foreign currency loan cannot be a grandparented transitional loan, and therefore interest on the foreign currency loan will not be grandparented residential interest.[39]

[39] For more on this, see the "Grandparented residential interest" section.

Treatment of denied interest deductions on disposals of disallowed residential property

Section DH 11 of the Income Tax Act 2007

Interest that has been denied a deduction under the interest limitation rules may be deductible in the year of disposal of the disallowed residential property (DRP) if the disposal is taxable.

Key features

As a general rule, interest that has been denied a deduction under the interest limitation rules will be deductible in the year of disposal of the DRP if the disposal is taxable. However, the result may differ depending on whether the property is taxable under the bright-line test or is taxable under other tax rules. The difference arises primarily in relation to any tax loss on the sale of the DRP.

Specifically, if the amount derived on disposal of the DRP is taxed under the bright-line test, the amount of the previously denied interest is treated as if it were part of the cost of the property. This means that if the sale results in a net loss, the deduction for the net loss is limited under the existing rule that applies to losses from the disposal of bright-line property. Any excess net loss can be carried forward.

If, instead, the amount derived on disposal of the DRP is taxable because of the application of other rules, the amount of the previously denied interest is allowed as a deduction in the year of disposal. However, the interest, together with other expenditure for the property or portfolio, will be subject to the residential rental loss ring-fencing rules if they apply. This will usually be the case if the property is subject to interest limitation.

If the disposal of the DRP is not taxable, the interest previously denied a deduction under new section DH 8 remains non-deductible.

Note that none of the above is relevant if any of the exemptions for land business, development or new builds applies. In those situations, the interest is not subject to the interest limitation rules and is deductible in the year it is incurred, provided the general deductibility criteria are met. Also, note that any grandparented residential interest deductions previously allowed are not deductible again on disposition of the DRP.

Application date

The new provision came into force on 27 March 2021 with application to interest incurred on or after 1 October 2021.

Detailed analysis

General criteria

New section DH 11 allows interest that was previously denied a deduction under new section DH 8 to be deductible in the year of disposal of the DRP if the disposal is on revenue account. If the disposal is on capital account (that is, any gain is not taxable, and any loss is not deductible), any interest previously denied deductibility under new section DH 8 remains non-deductible.

The following scenarios are discussed in more detail below:

Interest not previously deductible under general rules is still non-deductible even when any gain on disposal of the DRP is taxed (for example, under the bright-line test).

- Interest denied a deduction when it is incurred under the interest limitation rules is added to the cost of the DRP on its disposal when it is taxed under the bright-line test.
- Interest denied a deduction when it is incurred under the interest limitation rules may be deducted on disposal of the DRP when it is taxed under another land sale provision (other than the bright-line test). However, the interest may be subject to the residential rental loss ring-fencing rules.
- Interest that can still be deducted when it is incurred, for example, because the property is exempt from the interest limitation rules or the interest is grandparented residential interest, continues to be deductible provided the general deductibility criteria are met.

Interest that is not deductible when it is incurred under general rules

For interest to be deductible, the interest must still meet the requirements of the ordinary rules of deductibility, such as satisfying the general permission in section DA 1 – that is, requiring interest to be earned in connection with earning income. This excludes interest denied under any of the general limitations in section DA 2, such as the private limitation. These rules all continue to apply even when the DRP is taxed on disposal under the bright-line test. If the interest was not deductible when it was incurred, it will not become deductible when the DRP is disposed of.

NEW LEGISLATION

Example 106: Sale of bach subject to the bright-line test

Jack and Aria buy a bach in November 2021 for $700,000. They borrow $400,000 at 4% interest to complete the purchase. Six years later, in October 2027, they sell the bach for $750,000. They paid a total of $96,000 interest.

Only Jack and Aria, and their friends and family, used the bach. They did not rent it out.

The amount derived on the sale of the bach will be taxable under the 10-year bright-line test. None of the $96,000 interest they paid is deductible in the year of sale because, regardless of section DH 8, the interest would not have been deductible when it was incurred. This is because the bach was used for personal purposes and was not used to derive taxable income. The result is that the gain on sale of $50,000 is income under the bright-line test and none of the interest is deductible.

Interest previously denied where disposal taxed under the bright-line test

If the amount derived on disposal of the DRP is income under the bright-line test, the amount of the interest previously denied under subpart DH is treated as if it were part of the cost of the DRP under section DB 23. If this results in a net loss, the deduction for the net loss is limited under the anti-arbitrage rule that applies to losses from the disposal of bright-line property.

The anti-arbitrage rule in existing section EL 20 provides that a net loss from a bright-line disposal may only be deducted to the extent of net taxable gains the taxpayer has from other land sales in the year of the disposal. Any excess net loss deduction (that is, the amount by which the net loss exceeds the net taxable land sale gains) is carried forward and may be used in future years against other taxable land sale gains of the taxpayer. This rule is necessary because, by choosing to dispose of the property before the end of the bright-line period, a taxpayer can ensure the disposal is on revenue account and therefore deduct a loss that could not be deducted if they waited until after expiration of the bright-line period.

Allowing a deduction for the previously denied interest expense in the year of a taxable disposal would raise the same arbitrage issue. Disposing of the DRP before the expiration of the bright-line period would mean the interest was deductible, whereas waiting until after the expiration of that period would mean that it was not. To address this, new section DH 11(1) provides that, for bright-line disposals, the previously denied interest is deemed to be part of the cost of the DRP, rather than being deductible. The cost of the DRP may be deductible in the year of disposal (under section DB 23), but the anti-arbitrage rule in section EL 20 will apply if there is a net loss on sale. However, the net loss can be carried forward and used in future income years.

Example 107: Sale of rental property subject to the bright-line test

Assume the same facts as example 106, except that Jack and Aria bought a rental property instead of a bach. The $96,000 interest they paid would have been deductible if section DH 8 had not applied, because the property was used to derive taxable income. Therefore, the interest is potentially deductible in the year of sale.

The property was bought for $700,000 and sold for $750,000 six years later. In the year of sale, the $750,000 sale price is income under the bright-line test, and the cost of the property may be deducted under section DB 23. Section DH 11(1) provides that the original cost of $700,000 is deemed to be increased by the disallowed interest of $96,000. However, section EL 20 provides that, in the year of sale, the amount of the deduction is limited to income from the sale ($750,000) plus net gains from other taxable land sales.

Assuming this is the only property Jack and Aria sell that year, the deduction is therefore limited to $750,000 (resulting in no net income to be taxed or loss deducted). This means only $50,000 of the disallowed interest is deductible. The excess amount of $46,000 is carried forward and applied against any taxable land sale gains Jack and Aria have in later years.

Interest previously denied where disposal taxed under another land sale provision

If the disposal of a DRP is taxable under another land sale provision, other than the bright-line test, there is not the same level of concern with arbitrage. The character of the disposal as taxable or non-taxable cannot usually be determined by choosing the time of the disposal. In this case, the anti-arbitrage rule does not apply, but the residential rental loss ring-fencing rules do (new section DH 11(2)).

In this case, the interest that has previously been denied a deduction under subpart DH retains its character as interest. It is not re-characterised as part of the cost of the property (as is the case if the disposal is taxed under the bright-line test). Any gain on sale of the DRP is taxable and any loss deductible. The previously denied interest is deductible, but it is subject to the residential rental loss ring-fencing rules.

Application of the residential rental loss ring-fencing rules means the previously denied interest, and any other expenditure, is netted off against the residential income from the property or portfolio. "Residential income" is defined in section EL 3 and includes the rental income and any net land sale income from the property or portfolio. If the total deductions exceed the residential income, the treatment of the excess deductions (that is, the net loss from the property or portfolio) depends on whether the residential rental loss ring-fencing rules are being applied on an individual property or portfolio basis.

If the rules are being applied on a portfolio basis (that is, together with other properties), the net loss in the year of a taxable disposal is deferred and carried into the next income year to be deducted against later residential property income. However, if the taxpayer is applying the rules on an individual property basis, the net loss is usually fully deductible in the year of the taxable disposal.

Interest that continues to be deductible when incurred

Interest that remains deductible when it is incurred includes:

- interest incurred before 1 October 2021
- grandparented residential interest, being interest relating to pre-27 March 2021 property and debt that is allowed partial deductions during the transition period from 1 October 2021 to 31 March 2025,[40] and
- interest not subject to the interest limitation rules because one of the land business, development, or new build exemptions applies.[41]

Such interest cannot be deducted again upon disposal of the property.

Interest may be deductible when incurred but contribute to a net rental loss that is suspended as a deduction and carried forward under the residential rental loss ring-fencing rules. Such interest is also not automatically deductible in the year of disposal. Refer to the discussions above for the treatment of the interest on disposal.

Interposed entity rules

Sections DH 5(6), DH 6 and DH 8(1)(c) of the Income Tax Act 2007

Subpart DH contains interposed entity rules to support the integrity of the interest limitation rules. The interposed entity rules ensure that a person cannot circumvent the interest limitation rules by borrowing indirectly through an interposed company or trust that holds the disallowed residential property (DRP).

Key features

The interposed entity rules deny interest deductions for a person who indirectly holds DRP through an interposed residential property holder (IRP holder). An IRP holder can be a company or a trust that is not a unit trust.[42]

The interposed entity rules do not generally apply to look-through companies (LTCs) and partnerships that have DRP.[43] Under the LTC and partnership tax rules,[44] LTCs and partnerships are treated as transparent, and a person with an ownership interest in the LTC or partnership is treated as directly holding any DRP that the LTC or partnership may hold (in proportion to their effective look-through interest or partnership share).

The interposed entity rules apply when a person incurs interest to acquire an ownership interest in a company or to become a beneficiary of a trust, and the company or trust has an interposed residential property percentage (IRP percentage) over the relevant threshold. The IRP percentage is the value of the company or trust's DRP (with some exclusions) as a percentage of the value of their total assets.

The relevant IRP percentage threshold differs depending on whether the DRP is held by a close company, a non-close company, or a trust. The relevant threshold is:

- For a close company, 10 percent at the end of a quarter in the income year.
- For a company that is not a close company, 50 percent at any time in the income year.
- For a trust, 10 percent at any time in the income year.

If the relevant threshold is exceeded, the company or trust is an IRP holder for the person.

[40] See the "Grandparented residential interest" section for more detail.

[41] See the "Exemptions for new housing supply – overview" and following sections for more detail.

[42] Unit trusts are treated as companies for tax purposes.

[43] An exception may apply if an interposed close company elects to become an LTC.

[44] In subpart HB (LTCs) and subpart HG (partnerships).

If the IRP holder for a person is a close company, the interest incurred by the person to acquire an ownership interest in the company is limited in proportion to the company's IRP percentage.

If the IRP holder for a person is a non-close company or a trust, all interest incurred by the person to acquire an ownership interest in the company or to become a beneficiary of the trust is denied.

Application date

The interposed entity rules came into force on 27 March 2021 with application to interest incurred on or after 1 October 2021.

Detailed analysis

Deduction denied

New section DH 8(1)(c) provides that a person is denied a deduction for interest if and to the extent to which the interest is incurred to acquire an ownership interest in, or become a beneficiary of, an IRP holder.

Interposed residential property holder

"Interposed residential property holder" is defined in new section DH 5(6).

An IRP holder for a person may be one of three types of DRP holders:

- A close company for which the person has voting interests or market value interests and the company has, at the end of any quarter in the income year, an IRP percentage of more than 10 percent.
- A non-close company for which the person has voting interests or market value interests and the company has, at any time during the income year, an IRP percentage of more than 50 percent.
- Trustees of a trust of which the person is a direct or indirect beneficiary, and the relevant trust has, at any time during the income year, an IRP percentage of more than 10 percent.

Interposed residential property percentage

"Interposed residential property percentage" is defined in new section DH 6. For an IRP holder, it is the amount calculated using the following formula and expressed as a percentage:

disqualified assets ÷ total assets

where:

- **Disqualified assets** is the value of the IRP holder's DRP but excluding property subject to the new build, land business or development exemptions. For a close company, it also excludes property subject to the mixed-use asset rules in subpart DG. This is because such property is dealt with separately under the regime in subpart DG.
- **Total assets** is the total value of the IRP holder's assets.

New section DH 6(3) contains a special rule to deal with the situation where a company holds interests in subsidiary companies that hold DRP. The company's "disqualified assets" and "total assets" are calculated by applying the existing look-through rule in section YC 4. For the purposes of the special rule, however, the company is treated as the ultimate shareholder and the assets held by the subsidiary companies are attributed to the company in proportion to its ownership interests in the subsidiary companies. For example, assume a person holds shares in Holdco Ltd and Holdco holds 50 percent of the shares in Subco Ltd. If Subco owns DRP and other assets, 50 percent of Subco's DRP and other assets are attributed to Holdco when calculating Holdco's IRP percentage.

Section DH 12 applies to determine the value of land and other property for the IRP percentage formula.

Valuation for purposes of subpart DH

Section DH 12 sets out the valuation rules for the purposes of subpart DH. For land not covered by the land business or development exemptions, it depends on whether the land was acquired before or after the most recent local authority valuation. Land acquired before the most recent local authority valuation is valued at its most recent capital or annual value set by a local authority. Land acquired after the most recent local authority valuation is valued at its acquisition cost, if it was acquired from a non-associated person, or its market value, if it was acquired from an associated person.

Other property, including land covered by the land business or development exemptions, is valued using its tax book value. However, if a person prepares financial accounts in accordance with relevant accounting or legislative standards, the property is valued using the financial accounts' valuation.

Interposed close companies

Interposed close companies present the greatest integrity concerns. This is because control can be concentrated in a single natural person, or a small group of natural persons, and a close company can be easily established to hold DRP indirectly. This concern is reflected in the 10 percent IRP percentage threshold and quarterly calculation requirement for close companies that hold DRP.

10 percent threshold

New section DH 5(6)(a) provides that a close company is an IRP holder for a person if the person has voting interests (generally, shares) or market value interests in the company and the company has, at the end of a quarter in the income year, an IRP percentage of more than 10 percent.

To reduce compliance costs, the 10 percent de minimis threshold ensures that shareholders of close companies with very small amounts of DRP as a proportion of their total assets do not have to apply the interposed entity rules.

Quarterly calculation and denial of interest in proportion to IRP holder's IRP percentage

New section DH 8(1)(c) provides that a person is denied a deduction for interest to the extent it is incurred to acquire an ownership interest in, or become a beneficiary of, an IRP holder. If the IRP holder is a close company, the amount of deduction denied is then limited under sections DH 8(3) and (4), so that the amount denied is in proportion to the close company's quarterly IRP percentage.

New sections DH 8(3) and (4) sets out the formula for the quarterly calculation as follows:

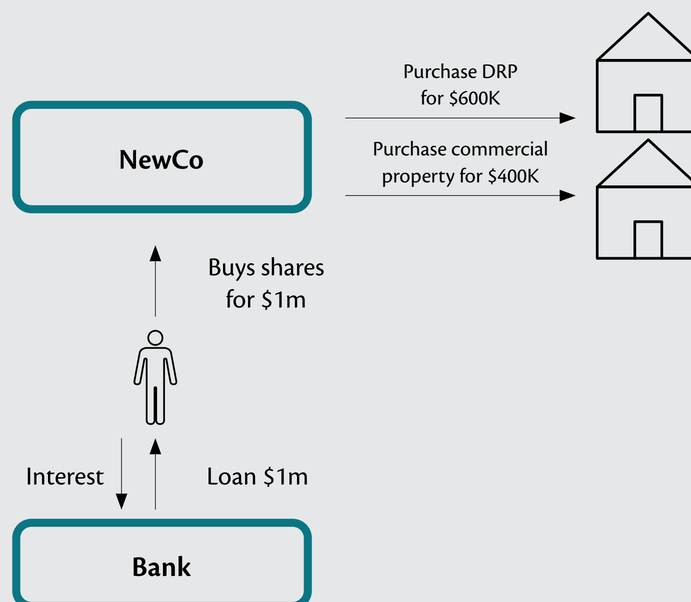
interposed interest × quarterly IRP percentage

where:

- **Interposed interest** is the amount of the interest incurred by the person in the relevant quarterly calculation period,
- **Quarterly IRP percentage** means the IRP percentage for the close company at the end of the relevant quarterly calculation period.

The total of the amounts denied in each quarter is the amount of interest that is denied under s DH 8(1)(c) for the income year.

Example 108: Interposed close company rule



Catherine borrows $1 million from Bank. She sets up a company, NewCo, and is issued 1,000 shares at $1,000 per share. NewCo buys a DRP for $600,000 and a commercial property for $400,000 using the share issuance proceeds at the start of the income year. Assume for simplicity that NewCo's assets do not change throughout the income year.

Under section DH 6, NewCo's disqualified assets are $600,000 and its total assets $1 million. NewCo's IRP percentage is 60 percent at the end of each quarter.

NewCo is an IRP holder for Catherine under section DH 5(6)(a). Applying section DH 8, 60 percent of the interest incurred by Catherine during the income year on the $1 million loan used to acquire shares in NewCo is denied.

Interposed non-close companies

50 percent threshold

Under new section DH 5(6)(b), a company that is not a close company will be an IRP holder for a person if the person has voting interests or market value interests in the company and the company has, at any time during the income year, an IRP percentage of more than 50 percent.

The higher IRP percentage threshold of 50 percent for non-close companies ensures that shareholders in non-close companies will not have to apply the interposed entity rules unless the company's assets consist mainly of disqualified assets. In practice, companies that do not hold DRP as a main part of their business are likely to have an IRP percentage well below the 50 percent threshold.

All interest denied

Under new section DH 8(1)(c), if a person incurs interest to acquire an ownership interest in an IRP holder that is a non-close company, all interest incurred by the person is denied.

The denial of all interest incurred by the person is a simplification measure to avoid an apportionment approach like the one that applies to interposed close companies under sections DH 8(3) and (4). Although apportionment is more accurate, it would usually be much more complex for shareholders in non-close companies to apply.

Interposed trusts

New section DH 5(6)(c) provides that the trustees of a trust (that is not a unit trust) are an IRP holder for a person who is a direct or indirect beneficiary of the trust if the trust, at any time in the income year, has an IRP percentage of more than 10 percent.[45]

For income tax purposes, a unit trust is treated as a company.[46] If a unit trust holds DRP and a person has incurred interest to participate as a beneficiary in the unit trust, the person would need to determine whether the unit trust was an IRP holder under either section DH 5(6)(a) or (b), rather than section DH 5(6)(c).

If a trustee (of a non-unit trust) is an IRP holder for a person, all interest incurred by the person to become a beneficiary of the trust is denied under new section DH 8(1)(c). Applying an apportionment approach, like the one for interposed close companies, to an interposed (non-unit) trust would usually be impossible, as a person's control or ownership of a trust cannot be readily measured. The denial of all interest incurred is therefore a simplification measure. In practice, it would be very uncommon for a person to incur interest to become a beneficiary of a (non-unit) trust.

Look-through companies and partnerships

The interposed entity rules do not apply to persons who borrow to acquire shares in a look-through company (LTC), or a partnership share in a partnership, that has DRP. This is because LTCs and partnerships are transparent for income tax purposes.

Under section HB 1, owners of LTCs are treated as holding any property held by the LTC in proportion to the owner's effective look-through interest[47] in the LTC, and the LTC is treated as not holding the property. If a person incurs interest to acquire shares in an LTC, the person is treated as incurring interest to acquire any DRP held by the LTC in proportion to their effective look-through interest.

Similarly, under section HG 2, partners of partnerships are treated as holding any property held by the partnership in proportion to the person's partnership share[48] in the partnership, and the partnership is treated as not holding the property. If a person incurs interest to acquire a partnership share, the person is treated as incurring interest to acquire any DRP held by the partnership in proportion to their partnership share.

[45] Existing subpart EL contains interposed entity rules for residential rental loss ring-fencing. Those rules also provide for the possibility of an interposed trust that is not a unit trust.

[46] The definition of "company" in section YA 1 includes a unit trust. "Unit trust" is defined in section YA 1 and means "a scheme or arrangement that is made for the purpose or has the effect of providing facilities for subscribers, purchasers, or contributors to participate, as beneficiaries under a trust, in income and capital and capital gains arising from the property that is subject to the trust".

[47] "Effective look-through interest" is defined in section HB 1(5). In broad terms, it is the number of shares held by a person in an LTC as a percentage of all the shares issued by the LTC.

[48] "Partnership share" is defined in section YA 1 and means, for property, the share that a partner has in the partnership.

Close company electing to be an LTC

It is possible for a close company that is an IRP holder to make an election to become an LTC. New section DH 6(4) provides that if a shareholder of a close company incurs interest on borrowings to acquire an ownership interest in that company, and the borrowings were drawn down before the effective date of the LTC election,[49] the shareholder is to apply the interposed close company rules[50] to determine the amount of interest that is denied after the effective date of the LTC election.

This is a simplification measure to avoid the complexities of transitioning pre-election borrowings to a look-through approach after the effective date of the LTC election.

After the effective date of the LTC election, if a person borrows to acquire an ownership interest in the LTC, the interposed close company rules will not apply to interest on those borrowings and the transparency rule in section HB 1 will instead apply. The person will be treated as incurring the interest to acquire DRP held by the LTC in proportion to their effective look-through interest.

Specific anti-avoidance rules

Sections GB 53B and GB 53C of the Income Tax Act 2007

New sections GB 53B and GB 53C are specific anti-avoidance rules to support the integrity of the interest limitation rules in subpart DH.

Key features

New section GB 53B addresses situations where a change in value affects the interposed residential property percentage (IRP percentage) calculation for an interposed residential property holder (IRP holder).[51] It applies if the change in value is caused by an act or omission, or is produced by an arrangement, that has a purpose or effect of defeating the intent and application of subpart DH. If section GB 53B applies, the change in value is ignored in calculating the IRP percentage of the IRP holder.

New section GB 53C addresses arrangements where a person (on-lender) on-lends borrowed money to an associated person who has DRP, and the on-lending is at a lower rate of interest than the rate payable by the on-lender. For the new section to apply, the arrangement must have a purpose or effect of defeating the intent and application of subpart DH. If the section applies, the amount of interest deductible by the on-lender is limited to, and calculated using, the lower rate, with the higher rate being ignored.

Application date

New sections GB 53B and GB 53C came into force on 27 March 2021.

Detailed analysis

Section GB 53B – Increases or decreases in value

The IRP percentage determines whether a company or trust is an IRP holder for a person. If it is, interest incurred by that person may be subject to limitation. The IRP percentage also determines the amount of interest denied if an IRP holder is a close company.

New section GB 53B addresses situations where:

- there is a change in value that affects, or would affect, the result of the IRP percentage calculation for an IRP holder, and
- the change in value has a purpose or effect of defeating the intent and application of subpart DH.

A change in value that defeats the intent and application of subpart DH could occur, for example, by a disposal shortly before a calculation date and a re-acquisition after that date. For example, a close company may dispose of DRP shortly before a quarterly calculation date so that its IRP percentage falls below the 10 percent threshold required for it to be an IRP holder. That company may then reacquire the same or similar DRP shortly after the calculation date. If the change in value is caused by an act or omission, or is produced by an arrangement, that has a purpose or effect of defeating the intent and application of subpart DH, the change in value is ignored when calculating the IRP percentage of the IRP holder.

[49] The effective date of an LTC election is determined under section HB 13.

[50] Sections DH 5(6)(a), DH 6, and DH 8(1)(c), (3) and (4).

[51] For detailed analysis on the IRP percentage and IRP holders, see the “Interposed entity rules” section.

Section GB 53C – On-lending at lower rate

New section GB 53C addresses situations where a person (the on-lender) indirectly funds DRP by borrowing money and on-lending the money at a lower rate to an associated person who either owns DRP or is associated with a person who owns DRP (the DRP holder).

Although the interest at the lower rate incurred by the DRP holder might be denied under subpart DH, the higher rate of interest paid by the on-lender on the borrowings that, in economic reality, funded the DRP might not be subject to any limitation in the absence of an anti-avoidance rule. The specific on-lending anti-avoidance rule in section GB 53C ensures that on-lending arrangements with a purpose or effect of lowering the amount of interest denied under subpart DH are not effective.

Section GB 53C applies when there is an arrangement that involves a person on-lending money at a lower rate to an associated person who owns DRP (or whose associate owns DRP) and the arrangement has a purpose or effect, not being a merely incidental purpose or effect, of defeating the intent and application of subpart DH. If the arrangement has such a purpose or effect, the amount of interest incurred by the on-lender for the purposes of Part D is limited to, and calculated using, the lower interest rate (payable by the DRP holder). The higher interest rate payable by the on-lender is ignored. This means the on-lender will not be able to claim a deduction for the higher interest rate.

Example 109: On-lending at a lower rate

Zeean is the sole shareholder of LandCo. She borrows $800,000 from her bank at a 5% interest rate and on-lends the money to LandCo, at a 1% interest rate. LandCo uses the money to acquire DRP.

LandCo's 1% interest expenditure on the loan from Zeean is subject to limitation under subpart DH because LandCo used the borrowed funds to acquire DRP.

In the absence of an anti-avoidance rule, Zeean's 5% interest expenditure on her loan from the bank may not be subject to limitation. This is because she used the borrowed funds to derive interest income from LandCo, rather than for DRP or to acquire a share in an interposed company.

If the particular facts indicate that the arrangement has a more than merely incidental purpose or effect of defeating the intent and application of subpart DH, Zeean's deductible interest expenditure will be limited to 1%, even though her actual interest expenditure is 5%.

Purpose or effect of defeating the intent and application of subpart DH

Sections GB 53B and GB 53C require a purpose or effect of defeating the intent and application of subpart DH. A considerable body of case law exists on when an arrangement has the purpose or effect of defeating the intent and application of the Income Tax Act, or a part of the Act. It is intended that this case law will inform the meaning and application of these sections.

BRIGHT-LINE TEST CHANGES

Background and overview

This section provides an overview of two sets of changes to the bright-line test. The first is the introduction of a new 5-year bright-line test for new build land (the 5-year new build bright-line test). The second relates to the exclusion from the bright-line test for main homes. Both sets of changes are only relevant to land acquired on or after 27 March 2021.

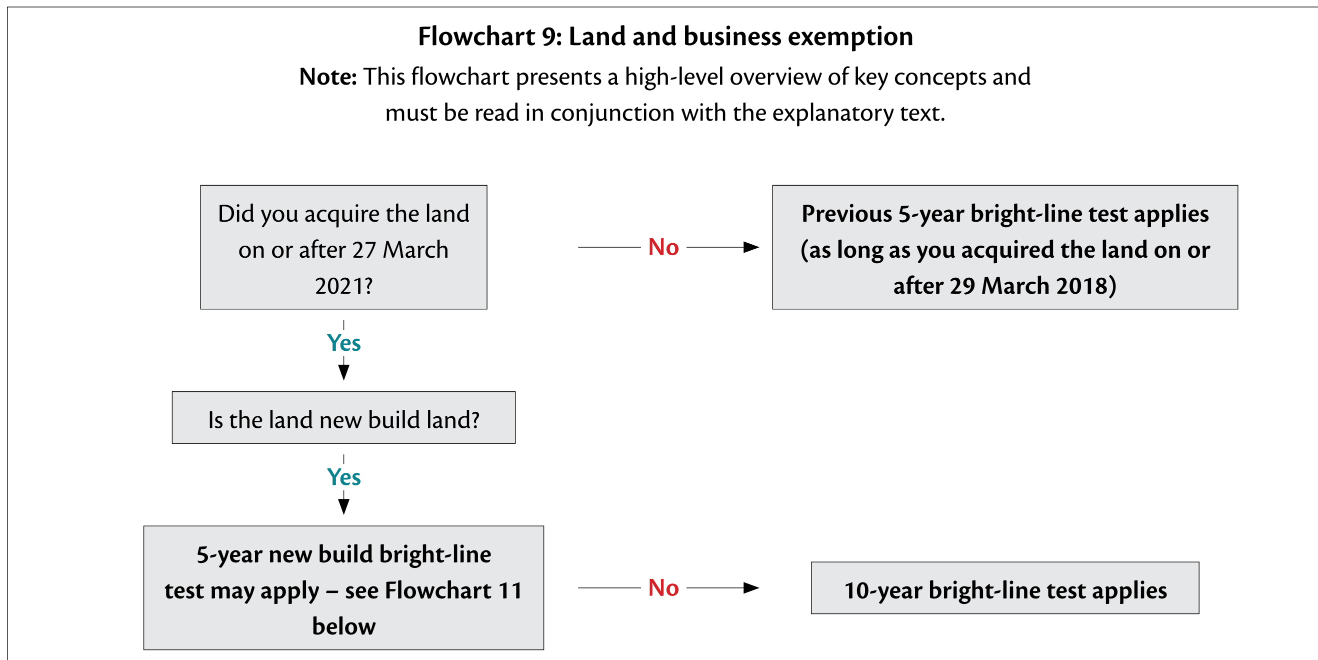
What is the bright-line test and how long does it apply for?

The bright-line test taxes gains from residential land disposed of within a specified period after acquisition. Land will be taxed if disposed of within five or ten years of acquisition unless an exclusion applies to the land.[52] The length of the bright-line period depends on when the land was acquired:[53]

Acquisition date	Length of bright-line period
29 March 2018 to 26 March 2021 (inclusive)	Five years
On or after 27 March 2021[54]	Five years for certain new build land
	Ten years for all other residential land

5-year new build bright-line test

A 5-year new build bright-line test has been introduced for new build land that meets certain criteria.[55] This test is only relevant for new build land that is acquired on or after 27 March 2021.



The new rules regarding main homes that were introduced for the 10-year bright-line test apply for the 5-year new build bright-line test.[56]

[52] Here are exclusions for main homes, inherited property, and land transferred under settlements of relationship property – see sections CB 6A(12), CB 16A, FB 3A, and FC 9.

[53] In a typical land purchase, the date of acquisition is the date a sale and purchase agreement is entered into, even if there are still some conditions to be satisfied – like obtaining finance or a building report.

[54] But not to residential land acquired on or after 27 March 2021 as a result of an offer made by the purchaser on or before 23 March 2021, provided the offer could not be revoked before 27 March 2021.

[55] See the "Definition of 'new build land'" section for more detail on what constitutes new build land.

[56] These new rules do not apply for the previous 5-year bright-line test, which applies to properties acquired between 29 March 2018 to 26 March 2021 (inclusive).

See the "5-year new build bright-line test" section for more information on the test.

The table below summarises the different tests.

Land acquired	Type of land	Bright-line test	Gains taxed if	Settings
On or after 29 March 2018 but before 27 March 2021	Any type of residential land	Previous 5-year bright-line test	Sold within 5 years of bright-line acquisition date	Old main home rules
On or after 27 March 2021	New build land, if certain criteria are met	5-year new build bright-line test	Sold within 5 years of bright-line acquisition date	New main home rules
On or after 27 March 2021	All residential land that doesn't qualify for 5-year new build bright-line test	10-year bright-line test	Sold within 10 years of bright-line acquisition date	New main home rules

Amendments to the bright-line test relating to main homes

Changes to the time apportionment rule for main homes

A person's main home is not taxed under the bright-line test because an exclusion for main homes applies (the main home exclusion). The main home rules determine whether a person qualifies for the main home exclusion. There are effectively two sets of main home rules – the old main home rules and the new main home rules.

The old main home rules apply to land acquired before 27 March 2021. Under the old main home rules, a person could qualify for the main home exclusion where their property was rented out for some of the time they owned it, provided the property was used predominantly as the owner's main home for more than 50 percent of the bright-line period.

The old main home rules apply to land that is subject to the previous 5-year bright-line test. They do not apply for land that is subject to the 10-year bright-line test or the 5-year new build bright-line test (that is, they do not apply to land acquired on or after 27 March 2021).

However, the current changes have only been made to the new main home rules.

The new main home rules only apply to land acquired on or after 27 March 2021. The introduction of the new main home rules ensured that the main home exclusion was still fit for purpose with the extension of the bright-line period to ten years.

Under the new main home rules, the bright-line test no longer applies on an all or nothing basis, but rather it applies only for the period a property is actually used as the owner's main home. The new main home rules require the gain on sale to be apportioned between main home use and non-main home use to ensure only the gain attributable to the non-main home use is taxed (sometimes referred to as the time apportionment rules). There is also a 12-month buffer within which the property can be used other than as the main home without tax implications. The 12-month buffer period can be used multiple times. Periods when the property is not used as a main home that exceed 12 months are taxed.

The 12-month buffer rule has now been amended so that where a person is constructing their main home and construction takes more than 12 months the main home exclusion can still apply, and the person is not subject to the bright-line test. This is provided the time they take to construct the home is reasonable.

New land apportionment rule for non-predominant main homes

A new land apportionment rule for land that is not predominantly used as the main home has also been introduced. This rule applies alongside the new main home rules (including the 12-month buffer) that apply to land acquired on or after 27 March 2021, discussed above.

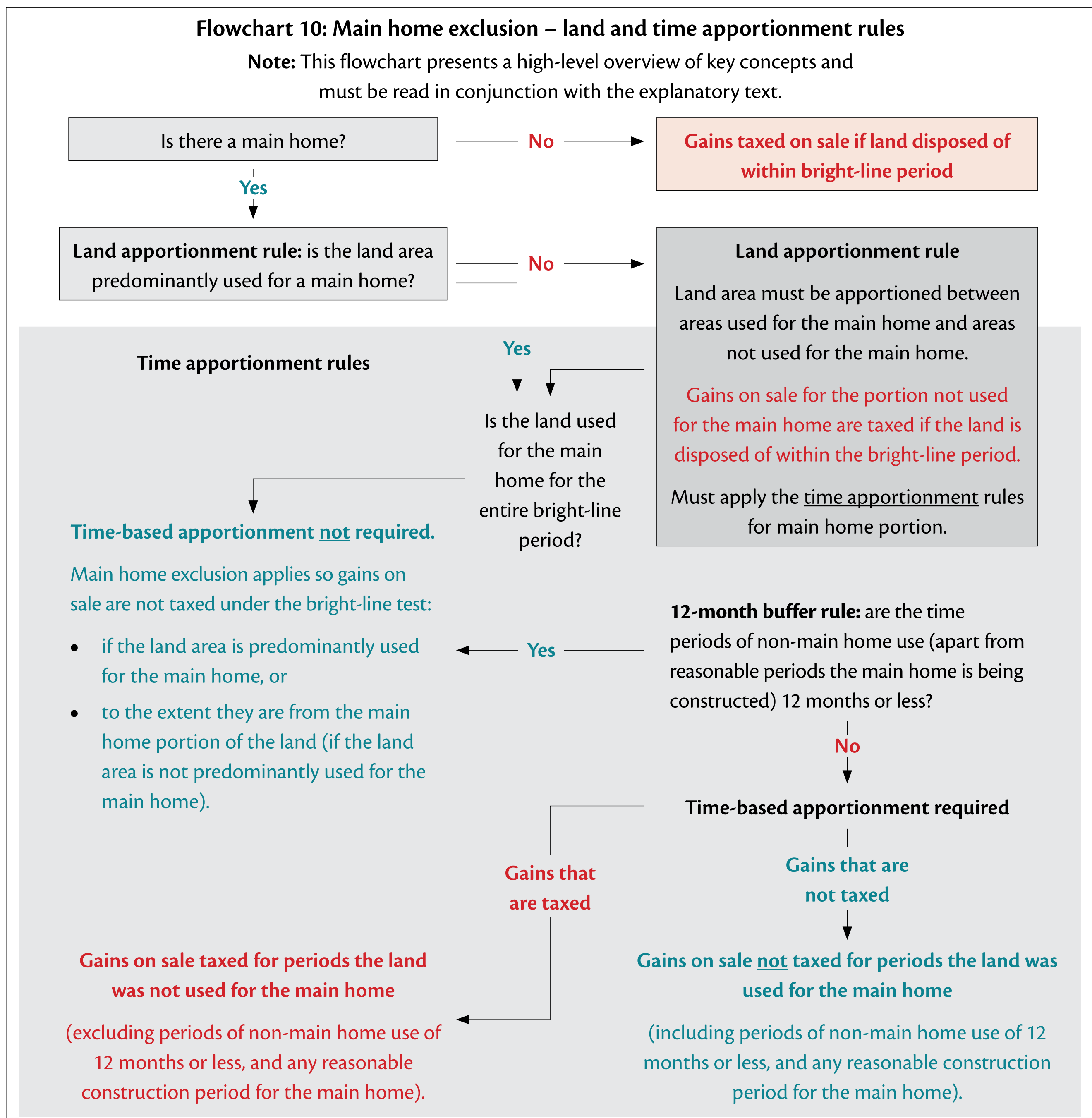
Previously, the main home exclusion applied where the land was used predominantly for the main home – meaning that more than half the land was used for the main home. This meant that a main home could fall outside the main home exclusion and be subject to tax under the bright-line test if less than half the land was used as a main home. For example, if two rental properties were built on the same title as a main home and those rental properties took up more than half the land, the previous main home exclusion would not apply. The whole gain on the sale of the property would be taxed if the land was sold within the applicable bright-line period, rather than just the gain attributable to the rental properties.

With the bright-line period having been extended significantly, from five years to ten years, these settings are no longer appropriate. A 10-year bright-line period makes it more likely that main homes that make up less than half of the land would be taxed on sale, such as in the scenario above, because the bright-line test applies for a longer period. Therefore, a land apportionment rule has been introduced for land not predominantly used as a main home to ensure the main home portion of the land is not taxed under the bright-line test.

For more information on these changes, see the "Amendments to the bright-line test relating to main homes" section.

The table and flowchart below summarise the main home rules tests.

Main home rule	Applies to land acquired	Time apportionment	Land apportionment
Old rules	Before 27 March 2021	Does not apply	Does not apply
New rules	On or after 27 March 2021[57]	Applies	Applies if the land is not used predominantly for the main home



[57] But not to residential land acquired on or after 27 March 2021 as a result of an offer made by the purchaser on or before 23 March 2021, provided the offer could not be revoked before 27 March 2021.

5-year new build bright-line test

Sections CB 6A, CB 16A, DH 5(7) and YA 1 of the Income Tax Act 2007

A 5-year new build bright-line test generally applies to land acquired on or after 27 March 2021 if there is a new build on the land when it is sold. The purpose of the 5-year new build bright-line test is to ensure investment in new housing supply is not negatively impacted by the 10-year bright-line test.

Key features

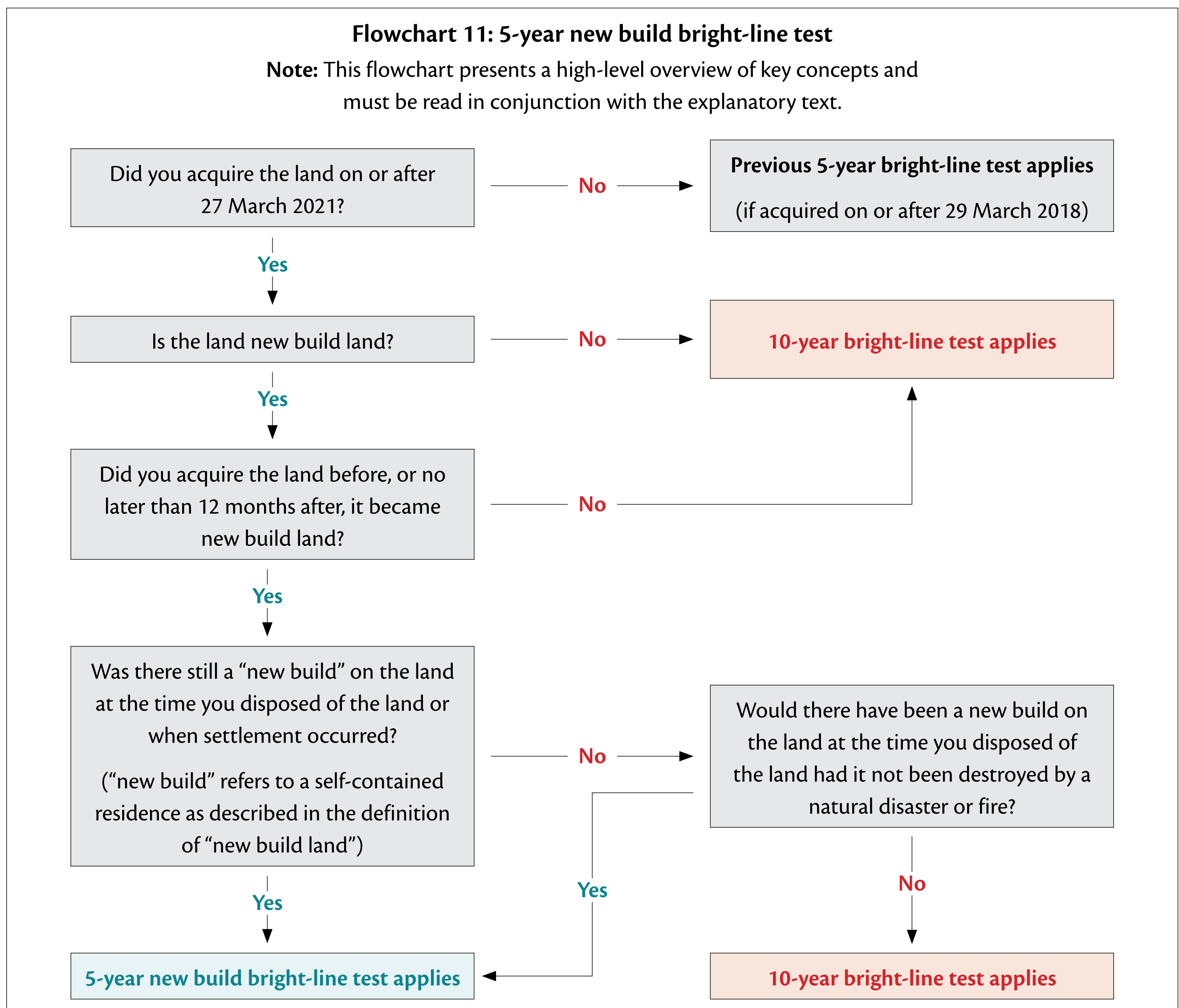
You should ensure you have read the "Bright-line test changes – background and overview" and "Definition of 'new build land'" sections before reading this section.

The 5-year new build bright-line test applies to residential land acquired on or after 27 March 2021 if the land:

- is new build land (as defined in section DH 5(7)),
- is acquired before, or no later than 12 months after, it became new build land, and
- there is a self-contained residence (new build), as described in the definition of new build land, on the land when it is disposed of or when settlement occurs, unless the new build was destroyed by a natural disaster or fire.

Land to which the 5-year new build bright-line test applies is called "5-year test land" in section CB 6A.

Sometimes only part of the land will satisfy the conditions of the 5-year new build bright-line test – for example, where the land has both a new build and an existing house on it. In these circumstances, a land area test must be applied to determine how much of the land is subject to the 5-year new build bright-line test. Other than the shorter 5-year period, the same settings as those that apply for the 10 year bright-line test apply for the 5-year new build bright-line test.



Application date

The 5-year new build bright-line test applies to residential land acquired on or after 27 March 2021 that satisfies the requirements of the test.[58]

Detailed analysis

Definition of "new build land"

Generally, "new build land" is defined under section DH 5(7) as land that has had a self-contained residence or abode added to the land, or a place on the land converted to a residence, and the code compliance certificate (CCC) for the residence was issued on or after 27 March 2020.[59]

Acquired no later than 12 months after meeting the new build land definition

To qualify for the 5-year new build bright-line test, a person must acquire[60] the land within 12 months of it becoming "new build land" (section CB 6A(1)(b)(i)). This includes the following situations:

- When a person acquires the land **after** it becomes new build land, provided the person acquires the land no later than 12 months after it becomes new build land. Generally, this means that when a person acquires an already constructed new build, the person must acquire the land no later than 12 months after the new build received its CCC.
- When a person already owned the land **before** it became new build land. For example, where a new build is constructed on land the person already owns.

Example 110: Land acquired no later than 12 months after becoming new build land

Catherine purchases an already constructed new build from a developer in May 2022. The property received its CCC in April 2022, before Catherine bought it. She sells the property to Peter in January 2023 and is taxed under the 5-year new build bright-line test. This is because she has sold the property within five years of acquiring it.

Peter is also subject to the 5-year new build bright-line test. This is because he has acquired the land within 12 months of April 2022, which is when the new build received its CCC.

Peter sells the property in December 2028. As he has sold the property more than 5 years after acquiring it, he would not be subject to tax under the 5-year new build bright-line test.

Fact variation: Peter acquires property in January 2024

If Peter acquires the property in January 2024, instead of January 2023, then the 10-year bright-line test would apply. Peter would not qualify for the 5-year new build bright-line test, because he acquired the land more than 12 months after the new build received its CCC. If he sells the property within 10 years of acquiring it, that is, before January 2034, any gain he makes on sale will be subject to tax under the 10-year bright-line test.

Land can qualify for 5-year new build bright-line test more than once

Where land has met the definition of "new build land" more than 12 months ago (for example, the CCC for a residence on the land was issued 20 months ago), if a person acquires that land, that person will not qualify for the 5-year new build bright-line test. The 10-year bright-line test will apply instead.

However, if that person then adds a new residence to the land, the 5-year new build bright-line test will apply for that person in relation to the portion of the land attributable to that new residence. The 10-year bright-line test continues to apply to the portion of the land attributable to the original residence.

Application to subsequent purchasers

If all the land (that is, including both the existing and new residences) is sold within 12 months of the new residence's CCC being issued, the purchaser will be subject to the 5-year new build bright-line test for the portion of the land attributable to the new

[58] But not to residential land acquired on or after 27 March 2021 as a result of an offer made by the purchaser on or before 23 March 2021, provided the offer could not be revoked before 27 March 2021.

[59] For more information, see the "Definition of 'new build land'" section.

[60] 'Acquire' has the same meaning as for the other existing bright-line tests, and generally means the date a sale and purchase agreement to buy land is entered into.

residence. The portion of the land attributable to the original residence will be subject to the 10-year bright-line test, as the purchaser has acquired that portion of the land more than 12 months after the original residence received its CCC.

However, if all the land is sold more than 12 months after the CCC for the new residence was issued, none of the land will qualify for the 5-year new build bright-line test for the purchaser. The entire parcel of land will be subject to the 10-year bright-line test.

Example 111: Apportionment where a second new build is added to the land

Gwenda acquired land in 2010 with an existing residence on it ('original residence'). Gwenda adds a second residence to the land that receives its CCC in February 2022 ('new residence'). She then sells the property to Vicki in November 2022. The 5-year new build bright-line and 10-year bright-line tests are not relevant to Gwenda, because she acquired the land before 27 March 2021.

Vicki has acquired the land more than 12 months after the original residence received its CCC, so the 10-year bright-line test will apply to Vicki for the portion of the land attributable to the original residence. However, Vicki has acquired the land within 12 months of the new residence receiving its CCC. Therefore, the 5-year new build bright-line test will apply to the portion of the land attributable to the new residence.

Vicki eventually sells the property in January 2028. As it has been more than five, but less than ten, years since she acquired the property, the gain on sale for the portion of the land attributable to the new residence will not be subject to tax under the 5-year new build bright-line test. However, the gain on sale for the portion attributable to the original residence will be subject to tax under the 10-year bright-line test.

Must have a new build on the land when disposal or settlement occurs

For the 5-year new build bright-line test to apply, there must be a new build on the land at the time the land is disposed of or when the instrument to transfer the land is registered (that is, the date settlement occurs), except where the new build was destroyed by a natural disaster or fire (section CB 6A(1)(b)(iii)). This is because the 5-year new build bright-line test is only intended to apply where there has been an increase in housing supply – if there is no new build on the land at the time the land is disposed of, then the objective of increasing housing supply has not been met. An exception exists where a new build has been destroyed by a natural disaster or fire. This is in recognition of the fact the housing supply was increased but the new build was destroyed through circumstances outside the taxpayer's control.

Example 112: New build must be on land when sold

Daniel acquires bare land in June 2025. A new build is added to the land and receives its CCC in December 2028, from which point the land would satisfy the definition of "new build land". Daniel sells the land in November 2031.

The 5-year new build bright-line test would apply rather than the normal 10-year bright-line test, because Daniel has sold "new build land". Daniel would not be taxed under the 5-year new build bright-line test as more than 5 years have passed since he acquired the land in June 2025.

Fact variation: New build destroyed in natural disaster

Same facts as above, except in March 2029 a flood severely damages Daniel's property and the new build is destroyed. David then sells the bare land in November 2031.

The 5-year new build bright-line will still apply to Daniel's property, as the new build was destroyed by a natural disaster. As more than 5 years have passed since Daniel acquired the land, any gain he makes will not be taxed on sale.

For the 5-year new build bright-line test to apply, it is not sufficient for there to be an agreement in place to construct a new build on the land. As noted above, there must actually be a new build on the land at the time of disposal, unless the natural disaster/fire exception applies. Therefore, land that only qualifies as "new build land" because of section DH 5(7)(c) (which includes land for which there is an agreement to add a self-contained residence) will not qualify for the 5-year new build bright-line test – that paragraph of the definition of "new build land" is only relevant for the interest limitation rules, not the 5-year new build bright-line test.

Example 113: No CCC before sale

Luke purchases bare land in May 2024. He and his brother Liam decide to add a new build to the land. Halfway through the project, Luke and Liam have a falling out. The partially constructed new build cannot get a CCC, as there is still major building work that needs completing. Luke decides he cannot finish construction of the new build on his own and sells the land in July 2030.

The 5-year new build bright-line test will not apply. The land has not satisfied the definition of "new build land" because the new build has not received its CCC by the time Luke disposes of the property. The 10-year bright-line test will apply to tax any gains Luke makes on selling the property.

Disposal within five years

To be subject to tax under the 5-year new build bright-line test, land must be disposed of within 5 years of the bright-line acquisition date (section CB 6A(1)(b)(ii)). In most situations, the bright-line acquisition date will be the date the transfer of the land to the person is registered.

Adding a new build to land after acquisition does not restart the bright-line period from the date the new build is added – the five-year period is still counted from the bright-line acquisition date. If land is disposed of after the 5-year new build bright-line period has passed, then the land will not be taxed under the test.

Example 114: Bright-line period does not restart when new build is added

James signs a sale and purchase agreement for a section in March 2023. Settlement occurs and title is transferred to James on 12 April 2023. James adds a new build to the section and receives a CCC confirming it has been added to the land on 15 June 2025. James sells the property in October 2029.

The bright-line period begins on 12 April 2023 (when title was transferred to James) and not from June 2025 (when the new build receives its CCC). The 5-year new build bright-line test applies to the land because James acquired the land on 12 April 2023, which is after 27 March 2021 and before 15 June 2026 (therefore not later than 12 months after the land met the definition of "new build land"), and there is a completed new build on the land when he sold the property. Therefore, James would only be taxed on the gains on sale under the 5-year new build bright-line test if he sells the property before 12 April 2028 (that is, within 5 years of title for the property transferring to James). Since James sells the land outside that period, the 5-year new build bright-line test would not apply to tax any gains he makes on sale.

Apportionment where only part of the land qualifies

Section CB 6A(2) provides that an amount from disposing of residential land is income to the extent to which the amount is for "10-year test land" or "5-year test land". The use of the words "to the extent" allows for apportionment where all the land disposed of is not 5- or 10-year test land. This applies for land acquired on or after 27 March 2021.

Section CB 6A(1) defines "10-year test land" as residential land to the extent to which, using a land area test, it is not new build land, and it was disposed of within 10 years of the bright-line acquisition date.

"5-year test land" is defined as residential land to the extent to which, using a land area test, it is new build land and:

- the person acquires it within 12 months of it becoming "new build land"
- it is disposed of within 5 years of the bright-line acquisition date, and
- when it is disposed of, it meets the definition of "new build land" under any of sections DH 5(7)(a), (b), (d), (e), or (f), or would have but for destruction caused by a natural disaster or fire.

In the straightforward case of new build land being acquired and sold within 5 years (and satisfying the other requirements mentioned above), the 5-year new build bright-line test applies to tax the entire piece of land.

Example 115: Simple application of 5-year new build bright-line test

Florence buys a section of bare land in July 2021. She constructs a new build on the land, which receives its CCC on 21 October 2022. Florence then sells the land in March 2023 to Fred. As Florence has disposed of the land within five years of acquisition, she will have to pay tax on any gain on sale under the 5-year new build bright-line test.

However, in cases where the land only partially qualifies for the 5-year new build bright-line test (such as where a new build is added to a property that has an existing residence on it), "to the extent" and the reference to a "land area test" mean that:

- The portion of the land with the relevant new build on it is subject to the 5-year new build bright-line test. This includes the land immediately beneath the new build, outdoor areas exclusive to the new build, and a reasonable proportion of shared areas.
- The remaining portion of the land is subject to the 10-year bright-line test.

The "land area test" means that apportionment must be based on the square meterage of the land attributable to the relevant new build and the remaining portion of the land. A valuation-based apportionment method may not be used.

Example 116: Apportionment where a new build and existing residence are on the same title

Charlotte purchases a 600m² section of land for $1m in February 2022. There is an original residence on the land, as well as a new build that received its CCC in December 2021. Charlotte rents out both residences.

The land is comprised of the following areas:

- the original residence, which covers 150m²
- exclusive areas attributable to the original residence, which cover 100m²
- the new build, which covers 200m²
- exclusive areas attributable to the new build, which cover 100m², and
- a shared driveway (that is available to the occupants of both the original residence and new build) of 50m².

Charlotte sells the land in April 2028 for $2.5m and makes a total gain of $1.5m.

Charlotte's calculations under the bright-line tests are as follows:

New build

As Charlotte acquired the land less than 12 months after part of the land became new build land, the portion of the land attributable to the new build is subject to the 5-year new build bright-line test. The portion of the land attributable to the new build is 325m² (comprised of the land under the new build, the land exclusively used by the new build, and a half share of the common driveway). This is 54.2% of the total 600m² land area.

Tax on sale

Charlotte sells the property more than five years after she first acquired it. Therefore, 54.2% of the gain is not taxed on sale under the bright-line test because the land is taxed outside the 5-year new build bright-line period.

Original residence

The portion of the land attributable to the original residence is subject to the 10-year bright-line test. The original residence makes up 275m² of the total land (comprised of the land under the residence, the land exclusively used by the residence, and a half-share of the common driveway). This is 45.8% of the total 600m² land area.

Tax on sale

Charlotte is required to pay tax on the following amount of her gain on sale:

($2,500,000 - $1,000,000) x 45.8% = $687,000

At her marginal tax rate of 39%, she must pay tax of $267,930 on her $687,000 taxable gain on sale.

Amendments to the bright-line test relating to main homes

Sections CB 6A, CB 16A, DB 23C and YA 1 of the Income Tax Act 2007.

- The bright-line test has been amended to ensure that:
- the existing new main home rules that apply for the 10-year bright-line test also apply for the 5-year new build bright-line test
- a land apportionment rule applies, so that a main home that takes up less than half the land (and therefore cannot benefit from the existing main home exclusion) is not taxed under the bright-line test while it is used as a main home, and
- the main home exclusion applies to the entire construction period of a main home.

NEW LEGISLATION

Key features

You should ensure you have read the "Bright-line test changes – background and overview" section before reading this section.

Land apportionment rule for main homes

Extension of new main home rules to 5-year new build bright-line test

The changes ensure that the same rules apply for both the 10-year bright-line test and the 5-year new build bright-line test.[61] The two existing new main home rules (also known as the time apportionment rules) that apply for the 10-year bright-line test have been extended to also apply for the 5-year new build bright-line test, and a new land apportionment rule has been introduced to apply to both tests.

The two rules that have been extended to apply to the 5-year new build bright-line test are as follows:

- If more than half the land was used for the main home, and the property was the person's main home for all the ownership period (including days in the 12-month buffer period), the main home exclusion applies.
- If more than half the land was used for the main home, but the main home exclusion does not apply because the property was not the person's main home for the whole ownership period, any gain on sale that relates to periods the land was used as a main home will not be taxed. Only the gain that relates to periods the land was not used as the main home will be taxed.

New land apportionment rule

The new land apportionment rule introduced for both the 5-year new build bright-line test and the 10-year bright-line test applies if:

- the land was used for both a main home and a non-main home, and
- less than half the land was used for the main home (so the usual main home exclusion, which applies where land is predominantly used for a main home, does not apply).

Under the apportionment rule, only the non-main home portion of the land is taxed under these two bright-line tests. Thus, the main home is not taxed while it is being used as a main home.[62]

A person who builds a second residence on the same land as their main home (for example, a granny flat) continues to benefit from the existing main home exclusion where that second residence takes up less than half the land. The time apportionment rules, which apply when a property is not used as the main home for more than 12 consecutive months, continue to apply regardless of whether the main home takes up more or less than half the land. These rules ensure that tax is paid on any periods of non-main home use that exceed 12 months at a time – for example, while a residence is used as a rental property for more than 12 months.

If land is used for both a main home and business premises (for example, a hair salon and main home on the same land), the existing rules continue to apply:

- If the land is used predominantly as business premises, the bright-line test does not apply.
- If the business premises take up less than half the land, and the existing main home exclusion does not apply, the business premises portion of the land is taxed. For example, this could occur where a parcel of land has a main home that takes up less than half the land, a small business premises that also takes up less than half the land, as well as a rental property. While the business premises and rental property portions of the land are taxed under the bright-line test, the main home portion of the land is not taxed because of the changes set out above.

Test for main home that takes longer than 12 months to construct

The period during which a person constructs a dwelling that they then use as their main home is not subject to the bright-line test, even if it exceeds 12 months, provided the period is reasonable. Whether the period is reasonable is fact specific. However, it is highly likely that the period taken will be considered reasonable in most cases given there is no incentive for a person to delay construction to obtain a longer buffer period, due to the cost and the fact that a main home falls outside the bright-line test anyway.

[61] Note that there are different rules for the 5-year bright-line test that applies to land acquired on or after 29 March 2018 but before 27 March 2021.

[62] With the existing exceptions of situations where the main home exclusion has been used twice in the last two years or there is a regular pattern of acquiring and disposing of residential land.

Application date

The changes apply to residential land acquired on or after 27 March 2021.[63] This means the changes apply to the 10-year bright-line test and the 5-year new build bright-line test, but not the previous 5-year bright-line test (which applies to land acquired on or after 29 March 2018 but before 27 March 2021).

Detailed analysis

Land apportionment rule for main homes

The land apportionment rule for main homes has been added to the two formulas that determine the amount of taxable income a person has under the bright-line test – in section CB 6A(8) to apportion income, and in section DB 23C to apportion the deduction that may be claimed.

Income reduction (section CB 6A(8))

Under section CB 6A, the amount a person derives from disposing of residential land within the bright-line period is, prima facie, income. This amount is then adjusted by the quantification provision in section CB 6A(8). The quantification provision in the bright-line test has been amended to include the land apportionment rule. The purpose of the quantification provision is to determine the amount attributable to the use of the property as a main home and then subtract that from the person's income on disposal of the property.

The land apportionment rule is given effect through "exempted non-predominant main home days x main home percentage", which is bolded in the formula below. The rest of the formula below is from the existing time apportionment rules that were introduced in 2021, although the terms in the formula have been renamed so that they are more intuitive.

The amended quantification provision in section CB 6A(8) is as follows:

$$\text{unadjusted income} \times \frac{(\text{exempted non-predominant main home days} \times \text{main home percentage}) + \text{exempted predominant main home days}}{\text{total days}}$$

[63] But not to residential land acquired on or after 27 March 2021 as a result of an offer made by the purchaser on or before 23 March 2021, provided the offer could not be revoked before 27 March 2021.

The below table explains the key terms used in the formula:

Key terms	Meaning	Further explanation
Unadjusted income (s CB 6A(10))	The full amount of income the person derives from disposing of the land.	This is generally the amount the person receives from selling the property.
Exempted non-predominant main home days (s CB 6A(11))	The sum of: the total number of days in the bright-line period where the land has been used for a dwelling (to some extent, but not predominantly) that was the main home for one or more main home persons,[64] and days that are in a period (or periods) equal to or shorter than the exempt main home period limit[65] where the land has not been used for a dwelling that was the main home for one or more main home persons, provided the start and end of the period adjoins either a period of main home use or the start or end of the land's bright-line period, but excluding any exempted predominant main home days	This term covers days where less than half the land has been used as a main home (including days of non-main home use under 12 months). For example, where a person has a house and a granny flat on the same title, and they live in the granny flat.
Main home percentage (s CB 6A(11B))	The percentage area of the land that, during the exempted non-predominant main home days, has been used as a main home.	Whether all the land is to be included in the main home percentage will be a question of fact to be determined by considering whether all the land is used for or in connection with the main home. Land that has been used for a dwelling is not limited to the land on which the dwelling is situated or to the surrounding curtilage (like a yard or garden) and can, depending on the facts, include other areas used in connection with or for the benefit of the dwelling.

Continued...

[64] Main home person means the homeowner, or a beneficiary of a trust in certain circumstances (sections CB 16A(1D) and YA 1).

[65] The exempt main home period limit is 365 days or, where a person constructs a dwelling used as their main home, the length of that period provided it is reasonable (sections CB 16A(1C) and YA 1).

Key terms	Meaning	Further explanation
Exempted predominant main home days (ss CB 6A(11C) and CB 16A(1B))	The sum of: The total number of days in the bright-line period where the land has been used predominantly for a dwelling that was the main home for one or more main home persons. Days in a period (or periods) equal to, or shorter than, the exempt main home period limit where the land has not been used predominantly for a dwelling that was the main home for one or more main home persons, but the start and end of the period adjoins either a period of main home use or the start of end of the land's bright-line period.	This definition is the almost same as the definition for "exempted non-predominant main home days". The key difference is that this definition covers where the land has been used predominantly (that is, more than 50%) for a main home.
Total days (CB 6A(11D))	The total number of days in the bright-line period.	

The quantification formula only needs to be used if the property is the person's main home for only some of the time it was owned, or if the main home and relevant outdoor areas take up less than half the land (for example, because part of the land is also used for a rental property).

The effect of the formula is to evenly apportion the sale proceeds from the property over the period it is held and over the areas used for different purposes (that is, main home and other purposes), with the result that:

- The amount attributable to the part of the property used for the main home, and to the period for which it was used as the main home, is not income for tax purposes.
- The amount attributable to the part of the property not used for the main home, or to any period of more than 365 consecutive days when the property was not used as the taxpayer's main home, is income for tax purposes.

There is no option to pay tax based on the actual valuations of the property at the start and end of the period the property was not the taxpayer's main home.

Example 117 illustrates how the formula works for both the existing time apportionment rule and the new land apportionment rule.

Example 117: Apportionment of time and space under the bright-line test

Daniel purchased a property for $750,000. It was transferred to him on 15 June 2021. He sold the property on 28 June 2027 for $1.8 million (2,205 days of ownership). The property is made up of his main home (65% of the land, including outdoor areas) and a minor dwelling (35% of the land, including outdoor areas). He:

lived in the main home for 656 days

went overseas for 258 days and rented the main home out while away

returned to live in the main home for 293 days

went overseas for 398 days and rented the main home out

returned from overseas and stayed in the minor dwelling for 400 days (which therefore became his main home during this period), and

moved out and left the minor dwelling vacant for 200 days before selling.

Daniel's income calculation

The formula in new section CB 6A(8) is:

$$\text{unadjusted income} \times \frac{((\text{exempted non-predominant main home days} \times \text{main home percentage}) + \text{exempted predominant main home days}}{\text{total days}}$$

Applying the formula to Daniel's facts:

- **Unadjusted amount is $1.8 million**. This is the full amount Daniel sold his property for.
- **Exempted non-predominant main home days is 600**. This is the 400 days Daniel lived in the minor dwelling plus the 200 days it was vacant before he sold it (because the non-main home use is 365 days or less and the start and end of the 200-day period adjoin a period of main home use / the end of the bright-line period).
- **Main home percentage is 35%**. This is the portion of land taken up by the minor dwelling while Daniel lived in it.
- **Exempted predominant main home days is 1,207**. This is the sum of the 656 days Daniel lived in the main home, the 258 days he rented the main home out while he was away (because the non-main home use is 365 days or less and the start and end of the 258-day period adjoin periods of main home use), plus the remaining 293 days Daniel lived in the main home after returning from his first period overseas. The 398 days Daniel rented out the property while he was overseas a second time do not count as exempted predominant main home days because they exceed 365 days.
- **Total days is 2,205**. This is the total days in the bright-line period.

So, applying the formula to the facts in this example:

$$\$1,800,000 \times \frac{((600 \times 35\%) + 1207)}{2205} = \$1,156,735$$

The $1,156,735 is then subtracted from Daniel's sale price to give him total income of **$643,265** under section CB 6A(1) ($1,800,000 – $1,156,735 = $643,265). The discussion and continuation of this example below explains what deduction Daniel can claim for the cost of the land.

Cost of residential land reduced (section DB 23C)

The Income Tax Act 2007 operates on a gross basis, with the income and deduction provisions in different subparts. Therefore, to ensure the correct portion of the gain is taxed under the bright-line test, it is necessary to reduce both the income and deduction that may be claimed.

The quantification provision in section CB 6A(8) reduces the income from the land to the extent it was used as a main home. Section DB 23C reduces the cost base (which is deducted against the sale proceeds).

Section DB 23(1) allows a person a deduction for the acquisition cost of the land and any capital improvements. New section DB 23C(2) reduces the deduction a person can claim under section DB 23 if the new quantification provision in section CB 6A(8) applies.

If the income is reduced under section CB 6A(8) because there was some main home use of the land, then section DB 23C ensures that the amount the person is allowed to deduct is correspondingly reduced to the extent the cost of the land relates to the main home.

The rationale for this is that some of the cost was incurred for a private benefit (that is, main home use) and should not be deductible. This is in line with general tax principles, but the specific reduction calculation makes it clear what can be deducted.

Section DB 23C(2) reduces the amount a person can deduct under section DB 23 as follows:

$$\text{Cost} \times \frac{((\text{exempted non-predominant main home days} \times \text{main home percentage}) + \text{exempted predominant main home days}}{\text{total days}}$$

The formula effectively mirrors the formula in section CB 6A(8) but adjusts the cost base (deduction) rather than income base. Where the terms are the same, they have the same meaning in both provisions. “Cost” means the cost of the residential land, which would include the purchase price and any capital improvements.

Example 117 continued: Cost of residential land reduced

This example uses the same facts as the previous example.

Daniel bought his property for $750,000 and sold it for $1.8 million. For the formula in new section DB 23C(2):

- Cost is the $750,000 Daniel paid for the property.
- Exempted non-predominant main home days is 600.
- Main home percentage is 35%.
- Exempted predominant main home days is 1,207.
- Total days is 2,205.

Using the formula in section DB 23C(2) gives the following amount that must be subtracted from the amount Daniel would otherwise have been able to deduct under section DB 23:

$$\$750{,}000 \times \frac{((600 \times 35\%) + 1207}{2205} = \$481{,}973$$

Daniel’s deduction under section DB 23, after subtracting the $481,973, would therefore be **$268,027** ($750,000 – $481,973 = $268,027).

Combined impact of changes to sections CB 6A and DB 23C

The combined impact of sections CB 6A and DB 23C ensures the net gain on sale that is taxed excludes amounts attributable to main home use of the land.

Example 117 continued: Combined impact of sections CB 6A, DB 23 and DB 23C

This example uses the same facts as the two previous examples:

- Daniel's **income** under section CB 6A is $643,265.
- Daniel's **deduction** for the cost of the property under section DB 23 (after applying section DB 23C) is $268,027.

His net income from the sale is therefore **$375,238** ($643,265 – $268,027). Daniel's income from other sources is $70,000, so he would pay income tax on his gain as follows:

- At 33% (total income between $70,001 and $180,000): $36,300, being $109,999 of Daniel's gain multiplied by 33%.
- At 39% (remaining total income exceeding $180,000): $103,443, being the remainder of Daniel's gain that was not taxed at 33% ($265,239), multiplied by 39%.

From the sale, Daniel would therefore have tax to pay of **$139,743**.

This example does not include any other deductions that Daniel may be entitled to, for example certain interest expenses or rates and insurance.

Test for main home that takes longer than 12 months to construct

The 12-month buffer rule in section CB 16A has been rewritten to make it more user friendly. The effect of the legislation is unchanged, except for a change to the way the construction period for a main home is treated.

Previously, land on which a main home was constructed would be taxed for some of the ownership period if the construction period took longer than 12 months and the property was sold within the bright-line period. The rewrite of the rule ensures that the buffer period applies for the length of construction, even if it exceeds 12 months, provided the period is reasonable.

The definitions of "exempted predominant main home day" and "exempted non-predominant main home day" in sections CB 6A and CB 16A allow a period of non-main home use to qualify under the definitions, provided the period is equal to or shorter than the "exempt main home period limit".

The "exempt main home period limit" is defined in section CB 16A(1C) as 365 days or, in the case of a period during which a person is constructing their main home, the length of that period, provided it is reasonable.

Example 118: Construction taking a reasonable amount of time

John purchased bare land in April 2021 to construct his main home on the land. Because of the workload at his local council, supply constraints for building materials and a shortage of qualified builders, it took two years before John's house was completed and he finally moved in. He then sold the property two years later.

The two years that John was building his house meet the definition of exempt main home period limit. Whilst two years to construct a house is longer than usual, it was reasonable in the circumstances. The period the house was built meets the definition of exempt predominant main home day, as it meets the definition of exempt main home period limit and John lived in the house after it was built. Therefore, John has no tax to pay under the 5-year new build bright-line test as the main home exclusion applies.

Rollover relief – bright-line test

Sections CB 6A(5B), (5C), (5D), (7), (7B), (7C), (15), CB 6AB, CB 6AC, CB 6AE, CZ 39(5B), (5C), (5D), (6B), (6C), (6D), FC 9B, FC 9C, FC 9D and FM 15(2B) of the Income Tax Act 2007

Rollover relief already available for certain transfers or disposals of residential land under the bright-line test has been extended to provide relief for certain transfers to or from family trusts, look-through companies and partnerships, and within wholly-owned, consolidated groups of companies, as well as for certain transfers of land subject to Te Ture Whenua Māori Act 1993 or made as part of a settlement of a claim under te Tiriti o Waitangi – the Treaty of Waitangi (te Tiriti).

Additional amendments ensure that transfers to effect a change in co-ownership do not reset the start of the bright-line period in certain cases.

Background

The bright-line test provides that when residential land is disposed of within 10 years of the instrument of title being registered under the Land Transfer Act 2017,[66] the income is taxable under section CB 6A. The bright-line test was originally introduced as a two-year test. The two-year bright-line period applied for residential land acquired on or after 1 October 2015 and up to 28 March 2018. A five-year test applies for residential land acquired on or after 29 March 2018 and up to 26 March 2021, and the 10-year bright-line test applies to residential land acquired on or after 27 March 2021.

Under current tax rules, when land subject to the bright-line test is gifted or sold below market value, the deemed gross income for the disposal is the market value of the land. This is an integrity measure, but in some circumstances this disposal may not be an appropriate taxing point and it can be justified to apply rollover treatment to ignore the disposal for the purposes of the bright-line test. In other circumstances, it might be appropriate to provide partial relief by limiting the value of the deemed disposal so it is taxed based on the actual amount of consideration provided (rather than the market value of the land). In either situation, the bright-line clock would not reset for the purchaser or recipient (so the bright-line period – assume 10 years – does not start again).

Rollover relief is not an exemption from income tax. In the context of the bright-line test, rollover relief defers the taxing point until a subsequent disposal of the land occurs that does not qualify for rollover relief. To achieve this, rollover relief disregards an intervening disposal by treating the transfer as a disposal and acquisition for an amount that equals the total cost of the residential land to the transferor. For the bright-line test, the recipient is deemed to take on the transferor's original date of acquisition along with the transferor's cost base.

Rollover relief ensures the recipient can benefit from the transferor's years of ownership of the residential land to determine whether their disposal of the land is inside or outside the bright-line period.

Previously, only limited rollover relief was available under the bright-line test. As the test was originally introduced as a two-year test, extensive rules providing for rollover relief were not designed. Under the previous settings, rollover relief was only provided for residential land transferred under a relationship agreement and for certain company amalgamations, although full relief was available for inherited residential land. These types of relief continue to be available under the new settings.

Key features

The amendments provide rollover relief for certain transfers or disposals of residential land for the purposes of the bright-line test in section CB 6A. Partial relief is provided when a disposal of residential land is made for more than the transferor's cost of the land. Full rollover relief is provided when a disposal of residential land is made for the transferor's acquisition cost or less.

Relief is provided for some transfers to or from family trusts, look-through companies and partnerships, and for transfers within wholly-owned, consolidated groups of companies. Specific relief also applies to transfers to trusts constituted under Te Ture Whenua Māori Act 1993 and transfers to land trusts as part of settling claims under te Tiriti.

The amendments primarily ensure the bright-line test is not triggered in certain common situations when there is a legal transfer of residential land, but no change in economic substance. In those situations, the transfer will not create an income tax liability under the bright-line test. The amendments providing partial relief from the bright-line test ensure that, in certain circumstances, the transferor is taxed under the bright-line test based on the actual sale price, rather than the market value of the land, and that the bright-line clock is not reset for the purchaser.

Family trusts

Relief applies to transfers of residential land to or from family trusts, provided that:

- each transferor (in the case of transfers to a trust) or each recipient (in the case of transfers from a trust back to a settlor) of the land is also a beneficiary of the trust
- at least one of those transferors or recipients of the land is also a principal settlor of the trust
- all principal settlors are beneficiaries
- all principal settlors are close family associates (broadly, have a close family connection with one another), and
- each beneficiary is either a close family beneficiary (broadly, a principal settlor, has a close family connection with a principal settlor, is a company controlled by a family member beneficiary, or is a charity registered under the Charities Act 2005) or trustee of another trust with at least one beneficiary that is a close family associate of a beneficiary of the first trust.

[66] In some cases, a different start date may apply.

NEW LEGISLATION

For relief to apply when the trustees of a family trust of the type described above transfer the land back to its original settlors, each recipient's proportionate interest in the land has to be the same as in the original settlement of the land on the trust.

Relief is available when residential land is transferred back to the original owner and then settled on a new trust, so rollover relief should also be available for a pure resettlement transaction where the trustees of the trust transfer the land to a new trust. While this is not currently provided for in the new legislation, it is intended that rollover relief for such resettlement transactions should be introduced in the next available tax bill.

Specific rule for Māori family trusts

Different conditions apply for transfers of residential land to a Māori authority (or a person eligible to be a Māori authority) as the trustee of a trust. Relief applies if:

- the land is subject to Te Ture Whenua Māori Act 1993
- the transferors of the land are beneficiaries of the trust, and
- all beneficiaries are either:
  - members of the same iwi or hapū, or
  - descendants of the same tipuna (living or dead).

Similar to the rule for general family trusts, relief is also available when the trustees of a Māori trust of the type described above transfer the residential land back to the settlors of the land on the trust, provided those settlors are beneficiaries. For relief to apply in those circumstances, each recipient's proportionate interest in the land must be the same as in the original settlement.

It is intended that where residential land is directly resettled on a new trust, rollover relief should be available. While this is not currently provided for in the new legislation, it is intended that rollover relief for such resettlement transactions should be introduced in the next available tax bill.

Land that is part of a settlement of a claim under te Tiriti and is transferred to a trust

Relief is provided for transfers of residential land to a trust if the land is part of the settlement of a claim under te Tiriti. This will apply where a post-settlement governance entity transfers residential land that is part of the settlement of a claim under te Tiriti to a trust for the benefit of members of the claimant group, for example, hapū. The requirements for this relief are that the land is:

- subject to Te Ture Whenua Māori Act 1993
- part of the settlement of a claim under te Tiriti, and

transferred to a trustee of a trust that is a Māori authority, or eligible to be a Māori authority, under section HF 2(3)(e)(i) (that is, on behalf of Māori claimants, the trustee receives and manages assets that are transferred by the Crown as part of the settlement of a claim under te Tiriti).

Transfers to or from look-through companies (LTCs) and partnerships

Relief applies to transfers of residential land to or from LTCs and partnerships. This is intended to apply where each person transferring the land to the LTC or partnership (or acquiring it from the LTC or partnership) has the same ownership interest in the land before and after the transfer.

Transfers for less than market value deemed to be for higher of transferor's cost or sale price

In situations that meet the conditions outlined above, full rollover relief is only available if the transfer is made for an amount of consideration that is less than or equal to the total cost of the residential land to the transferor. Where that is the case, the rollover relief applies to deem the transfer to be at cost (which is generally part of what is meant when "full rollover relief" being available is referred to).

Partial rollover relief applies if the transfer is for more than the transferor's total cost but less than the market value of the land at the date of the transfer. "Partial relief" means that, instead of deeming the transfer to be at market value (as would be the case under existing section GC 1 if no relief were provided) or deeming it to be at cost (which would be the case if "full rollover relief" were available), the transfer is treated for the purposes of the bright-line test as being for the amount of consideration provided.

Another aspect of rollover relief – whether full or partial – is that the recipient is treated as having the same bright-line acquisition date that the transferor had. This ensures that the transfer does not reset the start date of the bright-line period (the bright-line clock).

Transfers between companies within a consolidated group

Relief also applies to transfers of residential land within a wholly-owned, tax consolidated group of companies. This ensures that the start of the bright-line period is not reset upon the registration of the transfer instrument and is available regardless of the consideration for the transfer.

Remedial amendments to the bright-line test – changes in co-ownership

Remedial amendments ensure that transfers to effect a change in co-ownership do not reset the bright-line clock to the extent they do not change a person's proportional or notional proportional interest in the land. These remedial amendments apply to all transactions involving residential land, not just the new categories of rollover relief discussed here.

Application date

The amendments apply to disposals of residential land occurring on or after 1 April 2022. Relief is available for such a disposal even if the land was originally acquired before the introduction of the bright-line test in 2015.[67]

New sections CB 6A(5B), (5C) and (5D), and CZ 39(5B) and (5C), which ensure that certain transfers to effect a change in co-ownership do not reset the bright-line clock to the extent the respective co-ownership shares remain unchanged, apply from 27 March 2021.

Detailed analysis

Family trusts

Under the current bright-line test, a transfer of residential land on trust (via settlement or sale) constitutes a disposal by the transferor and an acquisition by the trustee of the trust. Depending on the circumstances, this can create an income tax liability under the bright-line test or restart the bright-line clock even if the transferor originally acquired the land before 1 October 2015.[68] New section CB 6AB provides relief when residential land is transferred to or from a family trust on or after 1 April 2022, provided certain conditions are met.

Transfers to family trusts

Section CB 6AB(1) provides that if a trustee holds residential land on a "rollover trust", the bright-line acquisition date for the land, when the trustee disposes of it, is the bright-line acquisition date that the settlor had for the land before they transferred it to the trustee. For transfers to a trust, "rollover trust" is defined in section CB 6AB(5) to mean, at the time of a relevant transfer:

- all relevant transfers to trustees of the trust are by people who are beneficiaries of the trust, at least one of whom is a principal settlor of the trust
- all principal settlors are beneficiaries of the trust
- all principal settlors are close family associates, and
- all beneficiaries are either close family beneficiaries, or the trustees of another trust of which at least one beneficiary is a close family associate of a beneficiary of the trust in question.

"Close family beneficiary" is defined in section CB 6AB(6) to mean, for the relevant trust, a beneficiary that is at least one of the following:

- A principal settlor.
- A close family associate of another beneficiary who is also principal settlor.
- A company in which a 50 percent or more voting interest (or a market value interest of at least 50 percent, if a market value circumstance exists) is owned by a beneficiary that is a close family associate of another beneficiary that is a principal settlor.
- A charity registered under the Charities Act 2005.

Under section CB 6AB(7), two persons are "close family associates" if one or more of the following applies:

- they are within four degrees of blood relationship (paragraph (a))
- they are married, in a civil union, or in a de facto relationship (paragraph (b)), or

[67] Under the provisions as drafted, the transferor and recipient may be subject to different bright-line tests. However, the intention is that if rollover relief applies, the recipient should be subject to the same bright-line test as the transferor. Officials will recommend an amendment to clarify this at the earliest opportunity.

[68] The original two-year bright-line test applied to residential land acquired on or after 1 October 2015.

- one person is within four degrees of blood relationship to the other person's spouse, civil union partner, or de facto partner (paragraph (c)).

This definition includes relatives by adoption, as section 16(2) of the Adoption Act 1955 deems adopted children to be the natural children of their adoptive parent. Section CB 6A(7)(c) (the third bullet point above) also extends coverage of the association test to include stepchildren and in-laws.

The rules mirror the existing associated person rules in section YB 4 but with an expansion from two degrees to four degrees of association. This is to account for the fact that many family trusts include a wider range of family members than simply those only two degrees removed.

A non-exhaustive list of some common examples of familial relations that meet the "close family associates" test is as follows (references are to paragraphs in the section CB 6A(7) definition):

- The principal settlor's parents and children (one degree of blood relationship – paragraph(a)).
- The principal settlor's grandchildren, grandparents and siblings (two degrees of blood relationship – paragraph (a)).
- The principal settlor's aunts, uncles, nieces, nephews, great-grandchildren, and great-grandparents (three degrees of blood relationship – paragraph (a)).
- The principal settlor's cousins, great-nieces, great-nephews, and great-great-grandchildren (four degrees of blood relationship – paragraph (a)).
- The principal settlor's spouse or de facto partner (paragraph (b)).
- The principal settlor's stepparents, stepchildren, step-siblings, parents-in-law, brothers-in-law, sisters-in-law, daughters-in-law or sons-in-law (within four degrees of blood relationship to the spouse or de facto partner – paragraph (c)).

Further information on how degrees of association are determined in family situations can be found in IR620.[69]

Example 119: Characteristics of a family trust qualifying as a rollover trust

Joan has no children of her own, but she wants to set up a family trust for the benefit of her nephew, George, and his family. The trust's assets include Joan's house in Auckland, a holiday home in Waihi and some other financial assets. The beneficiaries of the trust are Joan, George, George's de facto partner, Charlotte, their two children, Jack and May, along with George's son, Eli, from a previous relationship. Joan loves animals and has been a long-time volunteer for the SPCA, so she also lists the SPCA as a beneficiary of the trust.

The relationships of the beneficiaries are as follows:

- George: three degrees of blood relationship from Joan
- George's partner, Charlotte: four degrees of blood relationship from Joan
- George's children, Jack, May and Eli: four degrees of blood relationship from Joan
- SPCA: registered charity under the Charities Act 2005

All the beneficiaries are close family beneficiaries and Joan's trust qualifies as a rollover trust.

Transfers from family trusts to the original settlors

Where a trust is a rollover trust, section CB 6AB(2) provides for rollover relief if residential land is transferred back by the trustees to the person (the original settlor) that originally transferred the land to the trust. In this situation, the original settlor's bright-line acquisition date for the land is the bright-line acquisition date that the trustee had for the land before they transferred it back to the original settlor.

Where land is settled on a rollover trust on or after 1 April 2022, the combination of sections CB 6AB(1) and (2) mean that an original settlor who receives land back from the trust will have the same bright-line acquisition date they had for the land before it was transferred into the trust. This is because the trustee of the rollover trust will have the bright-line acquisition date the original settlor had before the land was transferred into the trust.

For transfers from the trust, "rollover trust" is defined in section CB 6AB(5) to mean, at the time of a relevant transfer:

- all relevant transfers to original settlors are to people who are beneficiaries of the trust, at least one of whom is a principal settlor of the trust

[69] IR620 *A guide to associated persons definitions for income tax purposes*, available at **ird.govt.nz**

- all principal settlors are beneficiaries of the trust
- all principal settlors are close family associates, and
- all beneficiaries are either close family beneficiaries, or the trustees of another trust of which at least one beneficiary is a close family associate of a beneficiary of the trust in question.

For section CB 6AB(2) to apply, subsection (3) provides that the residential land transferred back to the original settlor by the trustees of the trust must either be:

- the same land they originally settled, and all other original settlors also get their land back, or
- in part the same land they originally settled if that part and all other transfers back to other original settlors are in the same proportions as in the original settlement on the trust.

In other words, rollover relief is available only where residential land held on a family trust is transferred back to the original owner (or owners) in the same proportions they had before.

Rollover relief is not available where residential land held on a family trust is subsequently transferred or distributed to a different beneficiary (for example, a child). Such transfers or distributions of trust property remain subject to the bright-line test, as would be the case if a person transferred residential land directly to their child.

Transfers to or from different capacity (LTCs, partnerships)

Relief may also apply in certain cases under section CB 6AB when:

- residential land is transferred from an LTC or partnership to a family trust (where land may be settled on the trust by a person in a different capacity to the capacity in which they are a beneficiary), or
- a person receives land back from a trust they settled it on, but in a different capacity to the capacity in which they settled it.

Section CB 6AB(3) provides that, for the purposes of applying subsection (1) (where a person transfers residential land to a trust) or subsection (2) (where an original settlor receives residential land back from a trust), the person may transfer land to, or receive it from, the trust in different capacities. For example, A and B may have settled the land on the trust in their own personal capacities, but they may have it transferred back to themselves in their capacity as shareholders in an LTC.

Transfers of shares in LTCs

Section CB 6AB(8) provides that relief does not apply when shares in an LTC are transferred to a rollover trust, nor when such shares are transferred back to the original settlors.

Determination of transferor's net income and recipient's cost base

If the above requirements are met for either a transfer to or from a rollover trust, new sections FC 9B and FC 9C provide that the transfer is treated as being for the greater of:

- the total cost of the residential land to the transferor, or
- the amount of any consideration provided by the recipient.

This applies for calculating both the transferor's net income arising from the disposal under the bright-line test (see section FC 9B(a) and (b)) and the recipient's cost base and thus their net income arising under the bright-line test from a future disposal of the land (see section FC 9C).

This means that if the amount of consideration for the transfer is less than or equal to the cost of the land to the transferor (in other words, the original owner has not realised a gain), the transfer is deemed to be for the transferor's cost – thus, full rollover relief applies.

If the amount of consideration exceeds the cost of the land to the transferor (in other words, the original owner has realised a gain even if it is not a full market value profit), then only partial relief applies. In this case, the transfer is treated as being for the amount of consideration provided. This overrides existing section GC 1 so that the transfer is not deemed to be for the market value of the land at the time of the transfer. In other words, the transferor is only taxed on the actual profit realised on the sale of the land, and the recipient's cost base is what they paid for the land.

Example 120: Settlement on family trust – full rollover relief applies

Married couple Sunita and Ronald purchase residential land in their own names for $1 million on 9 November 2021. On 20 July 2023 Sunita and Ronald decide to settle the land on a trust with Sunita's sister and her sister's spouse as the trustees. Sunita, Ronald and their children are beneficiaries of the trust. The only property settled on the trust is the residential land and the trustees provide consideration of $1 million (even though, in that intervening period, the market value of the property has increased to $1.2 million). The trustees then sell the residential land for $1.7 million on 31 January 2027.

Sunita and Ronald are both beneficiaries of the trust. Sunita and Ronald are also both principal settlors, given that the trust has no other property and Sunita and Ronald have each made the greatest equal settlements. Sunita and Ronald are associated through marriage, and both non-settlor beneficiaries (the two children) are associated with a principal settlor (in this case, both settlors) within the required four degrees of blood relationship (being within one degree of blood relationship). This means they satisfy the requirements of new section CB 6AB.

Full rollover relief applies, as the consideration paid by the trustees to Ronald and Sunita is equal to the price they originally paid for the property. Sunita and Ronald are not subject to tax under the bright-line test on the disposal of their residential land to the trustees of their family trust on 20 July 2023. This is because they are treated as disposing of the land at cost, which means their net income arising under the bright-line test is zero.

The trustees are deemed to have a bright-line acquisition date of 9 November 2021 for the residential land (being Sunita and Ronald's bright-line acquisition date for the land) and a cost base of $1 million. The trustees' bright-line period ends on 31 January 2027 when the land is sold for $1.7 million. As this is within the 10-year period for the bright-line test (9 November 2021 to 8 November 2031), the sale is subject to income tax under the bright-line test. Ignoring other income tax deductions, the trustees have net bright-line income of $700,000.

Example 121: Disposal to yourself as a trustee of a trust – partial relief applies

Neo acquired residential land on 3 March 2017 for $500,000. On 29 October 2022, Neo settles the residential land on a trust with him and his son, Archie, as beneficiaries of the trust. Neo's outstanding mortgage is $400,000. The trustee provides consideration of $600,000, of which Neo uses $400,000 to discharge his outstanding mortgage.

Neo is subject to the two-year bright-line test for the land.[70] The settlement on the trust is a disposal, but there is no tax liability under the bright-line test because Neo held the land for more than two years.

Partial relief applies to ensure the bright-line clock is not restarted, meaning the trustee takes on Neo's bright-line acquisition date of 3 March 2017 but not Neo's acquisition cost of $500,000. The trustee's cost base is instead the amount of consideration it provided, being $600,000.

Example 122: Transfer from family trust to LTC – partial relief applies

Melissa owns 100 percent of the shares in Mel Co, a look-through company. Melissa is also the principal settlor and a beneficiary of the Melissa Family Trust. All the other beneficiaries of the Melissa Family Trust, aside from her husband, Dan, are associated with Melissa within four degrees of blood relationship, being her parents and her and Dan's children.

Melissa purchased an investment property in 2012 for $250,000 and sold it to Mel Co the following year on 6 April 2013 for $275,000.

In October 2022, Mel Co sells the property to the Melissa Family Trust for $700,000. Melissa does not pay tax under the bright-line test in her capacity as shareholder of Mel Co, as the land was acquired by the company before the introduction of the original two-year bright-line test.

Partial relief applies to the transfer of the property from Mel Co to the Melissa Family Trust. This means that the transfer does not reset the start of the bright-line period for the Melissa Family Trust.

[70] The two-year test applied to residential land acquired between 1 October 2015 and 28 March 2018.

Application of land-rich trust anti-avoidance rule

After a transfer of residential land that qualifies for relief is made to a trust, if new beneficiaries are added with the purpose of defeating the bright-line test, the land-rich trust anti-avoidance rule in existing section GB 53 applies to reverse the relief by deeming the recipient to have disposed of the land at market value.

Resettlements of trusts

It is intended that relief should be available for trust resettlements when the trustees of a trust transfer residential land to the trustees of another trust, provided that a principal settlor of the new trust is also a principal settlor of the first trust and the new trust satisfies all the requirements of section CB 6AB(5) in relation to its beneficiaries. However, the current legislation does not permit a direct resettlement to qualify for relief, unless the trustee resettling the property is a beneficiary of the new trust. It is intended that an amendment should be included in the next available tax bill.

Disposals from trusts to beneficiaries

The relief provided by new section CB 6AB does not cover disposals from trustees to beneficiaries that are not also settlors. Disposals of residential land from the trustee to a beneficiary within the relevant bright-line period for the trustee may still be subject to the bright-line test and may produce income for the trustee.

Māori family trust rule

Rollover relief is provided for transfers of residential land on or after 1 April 2022 that is subject to Te Ture Whenua Māori Act 1993 in certain situations. This recognises that land subject to Te Ture Whenua Māori Act 1993 has alienation restrictions that lead to interests in land being passed from generation to generation. These interests are often fragmented and can result in a large number of owners all belonging to the same iwi or hapū or who are all descendants of the same tipuna.

Transfers to Māori family trusts

New section CB 6AC(1) applies when a Māori trustee holds residential land subject to Te Ture Whenua Māori Act 1993 on a Māori rollover trust. For transfers to a trust, "Māori rollover trust" is defined in section CB 6AC(4) to mean, at the time of a relevant transfer:

- all relevant transfers to the trustees of the trust are by people who are beneficiaries of the trust
- all beneficiaries of the trust are either members of the same iwi or hapū, or descendants of the same tipuna (living or dead), and
- the land is subject to Te Ture Whenua Māori Act 1993.

Section CB 6AC(5) defines "Māori trustee" as a trustee of a trust that is either a Māori authority or eligible to elect to be a Māori authority under existing section HF 2(3)(e)(i).

If the above requirements are satisfied, section CB 6AC(1) provides that the Māori trustee's bright-line acquisition date for the land is the bright-line acquisition date that the settlor had for the land before they transferred it to the Māori trustee.

Transfers from Māori family trusts to the original settlors of the trust

Section CB 6AB(2) applies if a person (referred to here as the "original transferor", although the legislation uses the term "original settlor") holds residential land that was transferred back to them from a trustee of a Māori rollover trust that was originally settled by that person. For transfers from a trust, a "Māori rollover trust" is defined to mean, at the time of a transfer to an original transferor:

- all relevant transfers to the original transferors are to people who are beneficiaries of the trust
- all beneficiaries of the trust are either members of the same iwi or hapū or descendants of the same tipuna, and
- the land is subject to Te Ture Whenua Māori Act 1993.

For section CB 6AC(2) to apply, subsection (3) provides that the land transferred back to the original transferor by the trustees of the trust must either be:

- the same land they originally settled on the trust, and all other original transferors also get their land back, or
- in part the same land they originally settled on the trust if that part and all other transfers back to other original transferors are in the same proportions as in the original settlement.

If the above requirements are satisfied, section CB 6AC(2) provides that the original transferor's bright-line acquisition date for the land is the bright-line acquisition date that the Māori trustee had for the land before they transferred it back to the original transferor.

NEW LEGISLATION

Example 123: Transfer from trustee of Māori family trust back to the settlors of the trust

Before August 2010, John and several members of his extended whānau, who are all members of the same iwi, held interests in a parcel of residential land subject to Te Ture Whenua Māori Act 1993. In August 2010, John and members of his whānau sold their interests in the land to a trust that was settled by John and his sister, Mere, for $5 million. John, Mere and the rest of the whānau that held interests in the land were at this time beneficiaries of the trust (and still are).

On 28 May 2022, the trustees of the trust sell the interests in the land back to members of the whānau for the $5 million the trustees originally paid for the land. The market value of the land at this time is $10 million.

In the absence of relief, John, Mere and the rest of the whānau who purchased their interests in the land back from the trust would have a bright-line acquisition date of 28 May 2022. However, because the transfer was made at cost, rollover relief applies. This means that the whānau who purchased their interests back have a deemed bright-line acquisition date of August 2010, being the transferors' bright-line acquisition date (that is, when the land was transferred to the trustees of the trust), with a total cost base in the land of $5 million (being the total cost of the interests in the land to the trustees). In other words, the bright-line clock is not reset for John and Mere and their fellow interest holders who repurchased their interests in May 2022. As their bright-line acquisition date is August 2010, a future disposal by the interest holders will not be subject to the bright-line test.

Transfers to or from different capacity (LTCs, partnerships)

Relief may also apply in certain cases under section CB 6AC when:

- residential land is transferred from an LTC or partnership to a Māori rollover trust (where land may be settled on the trust in a different capacity to the capacity in which they are a beneficiary), or
- a person receives land back from a Māori rollover trust in a different capacity to the capacity in which they settled it.

Section CB 6AC(3) provides that, for the purposes of applying subsection (1) (where a person transfers residential land to a Māori rollover trust) or subsection (2) (where an original transferor receives residential land back from a Māori rollover trust), the person may transfer land to, or receive it from, the trust in different capacities. For example, A and B may have settled the land on the trust in their own personal capacities, but they may have it transferred back to them as partners in a partnership.

Determination of transferor's net income and recipient's cost base

If the above requirements are met for either a transfer to or from a Māori rollover trust, new sections FC 9B and FC 9C provide that the transfer is treated as being for the greater of

- the total cost of the residential land to the transferor and
- the amount of any consideration provided by the recipient.

This applies for calculating both the transferor's net income arising from the disposal under the bright-line test (see section FC 9B(d) and (e)) and the recipient's cost base and thus their net income arising under the bright-line test from a future disposal of the land (see section FC 9C).

This means that if the amount of consideration is less than or equal to what the transferor originally paid (in other words, the original owner has not realised a gain), the transfer is deemed to be for the transferor's cost – thus, full rollover relief applies.

If the amount of consideration exceeds the cost of the land to the transferor (that is, the transferor has realised a gain, even if it is not a full market value profit), then only partial relief applies. In this case, the transfer is treated as being for the amount of consideration provided. In other words, the transferor is only taxed on the actual profit realised on the sale of the land to the recipient, and the recipient's cost base is what they paid for the land.

Resettlements of Māori family trusts

It is intended that rollover relief should be available when residential land that is subject to Te Ture Whenua Māori Act 1993 is resettled on another family trust, provided certain conditions are met. That is, when the trustees of the trust transfer the property to the trustees of another trust that is also a Māori authority, or eligible to be one, provided the two trusts have a settlor in common and the beneficiaries of the new trust are all members of the same iwi or hapū, or descendants of the same tipuna. However, the current legislation does not permit a direct resettlement to qualify for rollover relief unless the trustee resettling the property is also a beneficiary of the new trust. It is intended that an amendment should be included in the next available tax bill.

Disposals from trusts to beneficiaries

Similar to section CB 6AB for general family trusts, the relief provided by new section CB 6AC for transfers to or from certain Māori trusts does not cover disposals from trustees to beneficiaries that are not also settlors. Disposals of residential land from the trustee to a beneficiary within the relevant bright-line period for the trustee may still be subject to the bright-line test and may produce income to the trustee.

Transfers of residential land as part of a settlement under te Tiriti

Settlements of claims under te Tiriti can be a multi-stage process. The Crown will transfer Treaty settlement property to a single governance entity (post-settlement governance entity or PSGE) that may act on behalf of several groups, for example, different hapū, or as a collective for a number of iwi groups. The PSGE will then transfer settlement assets to different members of the claimant group as required under the deed of settlement or settlement legislation.

This transfer from the PSGE to a member of the claimant group could be subject to income tax under the bright-line test for the PSGE. It could also start the bright-line clock for the member to whom the residential land has been transferred. The transfer of residential land from the PSGE to a claimant group member was less likely to trigger the bright-line test under the previous two-year and five-year tests. However, with the extension of the test to ten years, this could become an impediment for iwi to transact efficiently with settlement assets involving residential land.

New section CB 6AE applies when residential land that is subject to Te Ture Whenua Māori Act 1993 and is part of the settlement of a claim under te Tiriti is transferred to a trustee of a trust who:

- is a Māori authority, or is eligible to be a Māori authority, and
- on behalf of Māori claimants, receives and manages assets that are transferred by the Crown as part of the settlement of a claim under te Tiriti, in accordance with the requirements of existing section HF 2(3)(e)(i).

This is to provide rollover relief for the transfer of Treaty settlement residential land from the PSGE to a member of the claimant group, for example, hapū.

New section CB 6AE(2) provides that the recipient trustee has the transferor's acquisition date.

Determination of transferor's net income and recipient's cost base

If the above requirements are met for the transfer of Treaty settlement residential land, new section FC 9D sets out that the recipient trustee is deemed for the purposes of the bright-line test to have acquired the land for its market value at the time the land was transferred by the Crown. It may not be feasible to determine the market value at the exact time of the Treaty settlement – a reasonable estimate shortly thereafter (for example, determined for insurance purposes) would be acceptable.

Section FC 9B(f) provides that the transferor (the PSGE) is treated as disposing of the land for the greater of its cost to the PSGE or the amount of consideration received (if any) from the member of the claimant group to whom they transfer the land.

Transfers by or to persons in their capacity as look-through company owners or partners in a partnership

Shareholders in LTCs are treated as directly holding the LTCs' assets, deriving income, and incurring expenses in accordance with their shareholding percentage. In effect, LTCs are transparent for tax purposes, which means that the income tax consequences for someone who holds residential land through an LTC are generally the same as for someone who holds residential land directly. Nonetheless, the process of transferring residential land from an individual shareholder into the LTC (or vice versa) currently constitutes a bright-line disposal and acquisition.

Partnerships are also transparent for tax purposes. Equally, the process of transferring residential land from an individual partner to the partnership (or vice versa) constitutes a bright-line disposal and acquisition.

Relief applies under new section CB 6AB(4) if a person transfers residential land to themselves in a different capacity (such as a shareholder in an LTC or a partner in a partnership) and there is no intervening transfer to a third party. The section provides that the person's bright-line acquisition date for the land when they ultimately dispose of it to a third party is the bright-line acquisition date they first had for the land.

This is intended to apply to transfers of residential land to or from LTCs and partnerships where each person transferring the land to the LTC or partnership (or acquiring it from the LTC or partnership) has the same ownership interest in the land before and after the transfer. It is also intended to apply when residential land is transferred from an LTC to another LTC with identical shareholding (meaning that the two LTCs have the exact same owners who each hold the exact same proportion of shares in the second LTC as they hold in the first LTC).

Determination of transferor's net income and recipient's cost base

If the above requirements are met for a person's transfer of residential land to themselves in a different capacity, new sections FC 9B and FC 9C provide that the transfer is treated as being for the greater of:

- the total cost of the residential land to the transferor, and
- the amount of any consideration provided by the recipient.

This applies for calculating both the transferor's net income arising from the disposal under the bright-line test (see section FC 9B(c)) and the recipient's cost base and thus their net income arising under the bright-line test from a future disposal of the land (see section FC 9C).

This means that if the amount of consideration is less than or equal to the cost of the land to the transferor (or in other words, the original owner has not realised a gain), the transfer is deemed to be for the transferor's cost – thus, full rollover relief applies.

If the amount of consideration exceeds the cost of the land to the transferor (that is, a partial gain has been realised, even if it is not a full market value profit), then only partial relief applies. In this case, the transfer is treated as being for the amount of consideration provided. In other words, the transferor is only taxed on the actual profit realised on the sale of the land, and the recipient's cost base is what they paid for the land.

Transfers between companies within a wholly-owned tax consolidated group

An amendment provides rollover relief for transfers of residential land within a wholly-owned group of companies that is a consolidated group under subpart FM. New section FM 15(2B) provides that the recipient company (company B) is treated as having the same bright-line acquisition date for that transferred land as the transferor company (company A). This ensures that the transfer to company B does not reset the bright-line clock.

The restriction of relief to tax-consolidated groups effectively limits the rollover relief to New Zealand resident companies, as non-residents cannot be part of a consolidated group. Similar to the rollover rule for company amalgamations, this ensures that relief is only available on the condition that the property remains within the New Zealand tax base.

Example 124: Transfer within consolidated group

First Co and Second Co are companies that are both members of the same wholly-owned group of companies, of which all the members are New Zealand resident companies. The group is a consolidated group under subpart FM of the Income Tax Act 2007.

First Co acquired residential rental property in the form of an apartment complex in central Hamilton on 12 January 2019 for $15 million. On 23 May 2022, First Co transfers the property to Second Co for $20 million.

Under the consolidation rules, income does not arise to First Co under the bright-line test. However, in the absence of relief, the bright-line clock would reset on the transfer of the property to Second Co.

Relief applies to the transfer, meaning that Second Co. is treated as having a bright-line acquisition date for the property of 12 January 2019.

Start of bright-line period when effecting a change in co-ownership

Under New Zealand law, it is possible for a person to transfer land to themselves by changing the form of co-ownership of the land (for example, changing from holding land as tenants in common to holding it as joint tenants), or by transferring it from co-ownership to sole ownership (or vice versa).

Changing the form of co-ownership

While the registration of a transfer instrument to effect a change in the **form** of co-ownership of land should not be considered a disposal for the bright-line test, registration of a transfer instrument under the Land Transfer Act 2017 sets the start date of the bright-line period.[71] As such, a question arose as to whether the registration of a transfer instrument to change the form of co-ownership of a parcel of land would reset the bright-line "clock", meaning the bright-line period would start again from that point.

[71] For further information, see draft interpretation statement PUB00411: "Income tax – application of the land sale rules to changes to co-ownership, subdivisions, and changes of trustees", published on 28 September 2021, available at **taxtechnical.ird.govt.nz/consultations/draft-items/pub00411**

New sections CB 6A(5B) and (5C) clarify that, to the extent to which the economic ownership of the land has not changed, the bright-line clock is not reset when a transfer instrument is registered to effect a change in the form of co-ownership of land.

Section CB 6A(5B) applies when a joint tenancy is converted to a tenancy in common. The section provides that, to the extent to which residential land is held as a tenant in common in a share equal to all the other joint owners and to the extent that it was previously held under a joint tenancy with each of the same joint owners holding equal nominal shares, the bright-line acquisition date is the date the joint tenancy was acquired.

Section CB 6A(5C) applies in the reverse situation when a tenancy in common is converted to a joint tenancy. It provides that, to the extent to which residential land is held under a joint tenancy with each of the joint owners holding equal nominal shares and to the extent that it was previously held under a tenancy in common with all the same joint owners holding equal shares, the bright-line acquisition date is the date the tenancy in common in equal shares was acquired.

Example 125: Change from a joint tenancy to a tenancy in common

Tony and Greta started a relationship in 2015. Both have children from previous relationships. In 2019, Tony and Greta purchased a rental property together as joint tenants. Two years later, they decide that in the event of one of them dying, they want to financially assist their children, so want the share of the partner who dies to go to that partner's children. They submitted a land transfer, which LINZ registered in June 2021, to change their ownership of the property from a joint tenancy to a tenancy in common (50:50).

For the bright-line test to apply, there needs to have been a disposal of residential land by Tony and/or Greta. In this case, there has not been a disposal of land by either of them.

Tony and Greta own the same land (the estate in fee simple) before and after the transfer. Before the transfer, they each had an interest in the whole of the property, and a notional equal separate share (that is, 50 percent) that they had the right to sever during their lifetime. After the transfer, they each still have an interest in the whole of the property, and they each now have a present entitlement to a 50 percent share. No land has passed from one party to another.

The bright-line clock is **not** restarted in June 2021 when LINZ registered the transfer to change the form of co-ownership of the property. Tony and Greta's bright-line period still starts on the date in 2019 when the property was originally transferred to Tony and Greta.

Changes in co-ownership proportions

When a share in residential land is disposed of, the disposal of that share may be subject to tax under the bright-line test. The bright-line clock should reset only for the ownership share that has changed hands (despite the fact the registration of the transfer instrument may effect a transfer of the whole of the land from the parties to themselves in different proportions). For example, if co-ownership shares held by two people change from 50:50 to 25:75, the bright-line clock should reset only for the 25 percent share transferred.

Inland Revenue recently published a draft interpretation statement to clarify the treatment of such arrangements (see PUB00411: Income tax – application of the land sale rules to changes to co-ownership, subdivisions, and changes of trustees).[72] The draft interpretation statement noted that the registration of an instrument of transfer under the Land Transfer Act 2017 resulted in the start date of the bright-line period for all the land being reset. This meant the bright-line clock for the portion of land not disposed of was reset on each disposal of a part share, in addition to the portion that was disposed of.

New section CB 6A(5D) clarifies that the bright-line clock is reset only for the newly acquired share when there is a change in ownership proportions. The section applies when a transfer of residential land that is co-owned by two or more persons results in a change in co-ownership proportions (but not necessarily in the form of co-ownership), or when ownership of residential land changes from sole ownership to a form of co-ownership, or vice versa. It provides that, to the extent to which land is either:

- transferred by a person and, immediately before the transfer, the land was part of other land (referred to as "pre-existing land") that a person owned, or
- transferred to a person and, after the transfer, the land merges with other land that the person owns (also referred to as "pre-existing land"),

the instrument of transfer for that transfer is treated as not being for the pre-existing land.

[72] Available at **taxtechnical.ird.govt.nz/consultations/draft-items/expired-items/pub00411**

As outlined above, sections CB 6A(5B) and (5C) respectively apply when the form of co-ownership changes from joint tenants to tenants in common and vice versa. Both these sections still apply in the situation when there is a change in co-ownership proportions that occurs simultaneously with the change in the form of co-ownership. This means that the bright-line clock is reset only to the extent to which there is a change in co-ownership proportions – the same result as in the case where only the co-ownership proportions change and not the form of co-ownership.

Example 126: Change of the proportional share of co-owners who are tenants in common

In July 2018, Sarah and Hans bought a rental property as tenants in common, Sarah as to 50 percent, Hans as to 50 percent. Sarah's financial position changes in 2020 and so she asks Hans if he is interested in buying out part of her share of the property. He is keen to do this, so he buys half of Sarah's 50 percent interest at market value. LINZ registers the transfer in December 2020, and the register shows that the land is now held by Sarah as to 25 percent, and Hans as to 75 percent. This means that, for the purposes of the bright-line test, Sarah has disposed of a 25 percent interest in the land. The amount that Sarah sold the 25 percent interest to Hans for is income to Sarah under the bright-line test, as the disposal was within the relevant bright-line period (five years). Sarah can deduct half the amount she paid for her original 50 percent share of the property, because she has sold half of her original share.

Hans' bright-line clock is **not** restarted in December 2020 in relation to his original 50 percent share, nor is Sarah's in relation to the 25 percent share she has retained. However, the bright-line clock **does** restart for the 25 percent share transferred by Sarah to Hans, with Hans having a December 2020 bright-line acquisition date in relation to that 25 percent share.

Amendment to definition of "dwelling"

Section YA 1 of the Income Tax 2007

The definition of "dwelling" in section YA 1 of the Income Tax Act 2007 has been amended to replace the word "boardinghouse" with a new defined term, "boarding establishment".

Background

The definition of "dwelling" previously included an exclusion for a "boardinghouse". However, a "boardinghouse" was not defined in the Income Tax Act 2007, and it ultimately depended on the facts and circumstances. This could make it difficult for taxpayers to ascertain whether they were subject to the bright-line test or residential rental loss ring-fencing rules without seeking professional advice.

The new term, "boarding establishment", has been introduced to provide clarity to commercial boardinghouse operators and to minimise potential confusion for landlords who may own a "boarding house" under the terms of the Residential Tenancies Act 1986. This is also relevant for the interest limitation rules in new subpart DH of the Income Tax Act 2007.

The definition of "dwelling" has therefore been updated to refer to a "boarding establishment" instead of a "boardinghouse" to improve clarity and better target the exclusions from a "dwelling" towards commercial-scale accommodation.

See the "Excepted residential land – schedule 15" section for more information.

Key features

The definition of "dwelling" given in section YA 1 of the Income Tax 2007 has been amended to refer to a "boarding establishment" instead of a "boardinghouse". "Boarding establishment" is a new term also defined in section YA 1.

A "boarding establishment" is defined as premises that:

- are used in a business of supplying accommodation
- are managed by the business
- consist of at least ten boarding rooms that are not self-contained (that is, they do not contain all the necessary features for living, such as a full kitchen or bathroom), and
- include shared living facilities (which provide the necessary features for living not delivered in the residents' boarding rooms) that are available to all residents.

All these requirements must be satisfied for premises to satisfy the "boarding establishment" definition.

Example 127: Property rented out on a room-by-room basis

Gordon owns a six-bedroom villa in central Auckland that he previously rented out on a single tenancy contract. Gordon decides it is better for him and more convenient for the tenants to rent the house on a room-by-room basis.

Each occupant signs a contract for exclusive use of their individual room and shared use of common areas, like the lounge, kitchen and two bathrooms. Under the Residential Tenancies Act 1986, the bedrooms are boarding rooms, and the house is a boarding house.

Gordon's property is not a boarding establishment. Because it has fewer than ten boarding rooms that are not self-contained, there is no need to consider whether it satisfies the other limbs of the definition.

Therefore, Gordon's property is not excluded from being a "dwelling". This means the property is subject to the residential rental loss ring-fencing rules in subpart EL, and Gordon will not be permitted to offset excess deductions against his non-property income. Gordon will also be subject to income tax under the bright-line test in section CB 6A if he sells the property within the relevant bright-line period.

Management by the business is intended to encompass a range of scenarios, including, for example, where a manager lives on-site and has a permanent office, or where someone travels between multiple establishments operated by the business across different locations in a city.

Premises refers to a single site or location, although the relevant facilities may be in multiple buildings on the same site. Buildings located on different pieces of land do not satisfy the requirements, even if the sections are adjacent.

A taxpayer might operate several establishments at different locations. Each location needs to satisfy the "boarding establishment" requirements to be considered excepted residential land. This means that a taxpayer could have multiple boarding establishments for the purposes of the dwelling definition.

Provided the establishment contains at least ten boarding rooms that are not self-contained, other boarding or cabin-style rooms on the same site would form part of the "boarding establishment" and therefore be excluded from the term "dwelling".

Example 128: Boarding establishment

Carl and Emily own C&E Boarding Lodge, a commercial establishment in New Plymouth. C&E Boarding Lodge consists of

- 12 rooms that are not self-contained, with no additional private facilities
- a further six rooms with individual ensuites, and
- six pre-fab cabins with basic bathroom and kitchen facilities.

Occupants sign the same contract, regardless of the type of room, and all occupants have access to shared living facilities, including communal lounges, a commercial-sized kitchen, bathrooms and a coin-operated laundry. Electricity and gas are included in the weekly rent.

Occupants are expected be neat and tidy, although C&E Boarding Lodge cleans and maintains the communal areas and ensures that furnishings in the boarding rooms are in reasonable working order.

C&E Boarding Lodge qualifies as a "boarding establishment" and is therefore excluded from the definition of "dwelling" and not subject to the bright-line test or residential rental loss ring-fencing rules.

However, the premises must still have at least ten boarding rooms that are not self-contained. If there are fewer than ten rooms that are not self-contained, the balance required cannot be satisfied by other rooms.

Example 129: Fewer than ten boarding rooms that are not self-contained

Ivy owns "City View Lodge" in Auckland, which consists of a large house and some self-contained studio units at the back of the section. There are:

- six boarding rooms that are not self-contained, with no additional private facilities, and
- four self-contained studio units with basic bathroom and kitchen facilities.

Occupants sign the same contract, regardless of the type of room, and all occupants have access to shared living facilities in the main house, including a communal lounge, a kitchen, bathrooms and a laundry. Electricity and gas are included in the weekly rent.

City View Lodge does not qualify as a "boarding establishment", because even though it has a total of ten rooms for accommodation, only six satisfy the requirement that they are not self-contained. It is therefore a "dwelling".

Application date

The amendment to the definition of "dwelling" applies for the 2022–23 and later income years.

Administration

Guidance and tools

The new rules largely apply from 1 October 2021. This means that residential rental property owners, tax agents and third parties will have to consider and, if relevant to their circumstances, apply the new interest limitation and bright-line rules from the 2022 income tax return.

Inland Revenue has provided guidance and tools to help taxpayers and others assess whether the interest limitation and bright-line rules apply to their circumstances and to help them comply with the new rules. The guidance and tools can be accessed through Inland Revenue's website at **ird.govt.nz/property/renting-out-residential-property**

Tools available include:

- an updated property tax decision tree **myir.ird.govt.nz/eservices/home/?link=clcproptree**
- an online guided help tool "Can I claim interest on my residential rental property?"
- a property interest-phasing calculator, and
- a new build apportionment calculator.

Filing income tax returns

To support the administration and integrity of the new rules, additional information is required in affected taxpayers' income tax returns about the total interest on residential rental property and the interest expense claimed for residential rental property, as well as any reason(s) for the interest expense claimed (a series of tick boxes).

Where relevant, updated income tax return guides reflecting the interest limitation and bright-line changes will be available from April 2022. In addition, the following Inland Revenue guides have been updated or created with guidance on the new rules and will be available from April 2022:

- IR264 Rental income
- IR314 I have bought and sold a property at a profit. Do I have tax to pay?
- IR361 Tax and your property transactions
- IR1021 Tax rules for holiday homes
- IR1095 Deducting residential land withholding tax (RLWT)
- IR1227 Bright-line property tax (new guide)

No reduction if the main home exclusion does not apply

Section CB 6A(11E) of the Income Tax Act 2007

The bright-line test has been amended so that income derived on the sale of a property used as a main home is not reduced where the person has used the main home exclusion twice in a two-year period or has engaged in a regular pattern of acquiring and disposing of residential land.

Background

The income calculation provision in the bright-line test disregards any period of main home use (including certain periods of 12 months or less where the property is not used as the person's main home) where the main home exclusion does not apply (section CB 6A(8)).

A person is only allowed to use the main home exclusion twice in a two-year period and only if they are not engaged in a regular pattern of acquiring and disposing of residential land (section CB 16A(3)).

Where the main home exclusion does not apply because of section CB 16A(3), periods of main home use and non-main home use of 12 months or less should not be disregarded and should be included for the purposes of calculating income, otherwise the person could essentially access the main home exclusion more than twice in a two-year period. The amendment addresses this issue.

Key features

Section CB 6A(11E) provides that section CB 6A(8) does not apply to a person described in section CB 16A(3).

In other words, a person may not use the income calculation provision to reduce their income from the sale of their property to the extent their property has been used as a main home, if the main home exclusion does not apply because either:

- the person has used the main home exclusion twice in the last 2 years, or
- they have engaged in a regular pattern of acquiring and disposing of residential land.

Application date

The amendment applies to residential land acquired on or after 27 March 2021.[73]

[73] But not to residential land acquired on or after 27 March 2021 as a result of an offer made by the purchaser on or before 23 March 2021, provided the offer could not be revoked before 27 March 2021.

GST REMEDIALS

Modernising information requirements for GST

Sections 2, 12C, 19E to 19Q, 20, 21, 21B, 24, 24BA, 24BAB, 24BAC, 24B, 25, 25AA, 25AB, 25A, 53, 55, 55B, 60, 75, 75B, 78AA, 78B and 78BA of the Goods and Services Tax Act 1985; sections 143 and 143A of the Tax Administration Act 1994

The amendments to the tax invoicing rules reform the way in which the goods and services tax (GST) system interfaces with 21st century business record-keeping, both digital and manual, by simplifying record-keeping requirements for GST purposes.

The reforms are permissive in nature, so invoicing practices or systems that complied with the previous rules will also be compliant with the new information rules, which are less prescriptive.

The amendments achieve this simplification in two main ways, by:

- requiring the supplier and recipient of a taxable supply to retain a minimum set of information relating to that supply, and
- repealing the rules that required formal documents (tax invoice, credit note, and debit note) to support output tax and input tax information included in a GST return for a taxable period.

All section references below are to the Goods and Services Tax Act 1985 unless otherwise stated.

Background

A GST Issues Paper released in February 2020 proposed modernising the invoicing requirements in the Goods and Services Tax Act 1985 (GST Act). The main objective identified was to allow a wider range of ordinary business-to-business information to be used to support GST output tax and input tax

The two main purposes underlying this proposal were:

- to reduce compliance costs for businesses, and
- to facilitate the introduction of e-invoicing.

Submissions received were supportive of modernising the invoicing requirements in the GST Act. The amendments address this proposal.

Key features

The modernised invoicing rules permit the form and manner of creating, providing and retaining supply information to be determined by registered persons as part of their normal record-keeping processes. These amendments also extend to record-keeping requirements for GST groups and companies electing to use the shared invoices under the simplified supplier group provisions. The amendments are also consistent with e-invoicing initiatives and electronic record-keeping.

The reforms relate mainly to information about a taxable supply that is:

- recorded by a supplier and provides evidence for output tax returned
- subsequently corrected, due to an inaccuracy in the original information recorded
- recorded by the recipient under an agreement with the supplier (buyer-created taxable supply information)
- recorded under a shared invoicing arrangement (supplier groups – not being a GST group), or
- made available for the recipient for use as evidence for an input tax deduction.

The minimum set of information required to be retained in business records under the modernised invoicing rules for a taxable supply are generally consistent with the requirements of commercial and contract law relating to invoicing and record-keeping. Under commercial and contract law, an invoice notifies an obligation to pay an amount for a supply of goods and services.

Suppliers and recipients must continue to comply with commercial and contract law relating to invoicing, even though tax invoices are no longer required to be issued for GST purposes. This means invoices must still be used to notify the recipient of their obligations for payment for a taxable supply. The main technical change is that an invoice no longer needs to have the words “tax invoice” in a prominent place on the invoice.

The GST record-keeping requirements for the modernised invoicing rules are set out within the new rules. The reforms:

- no longer require tax invoices, credit notes, or debit notes to be issued, but this simplification does not displace invoicing and record-keeping requirements under general law
- do not disturb the process for calculating and paying GST for each taxable period, and
- set out how the terms tax invoice, credit note, and debit note referred to in existing documents and contracts are to be read in the context of the modernised invoicing rules.

In transition, registered persons can use up their stock of tax invoices, credit notes and debit notes. The information contained on those documents will generally meet the new record-keeping requirements.

Going forwards, invoices required under commercial and contract law for taxable supplies will provide the information required to support the integrity of the GST system. This results in a seamless transition to the new rules for supply information.

The changes reduce compliance costs relating to record-keeping, in particular by placing reliance on business records to contain:

- relevant transactional information (including GST charged on the supply) about a taxable supply
- information about correcting transactional information for a taxable supply, not just correcting information about the amount of GST charged (which is a change from the previous law), and
- information relating to the use of the buyer-created or shared invoicing frameworks.

In addition, the modernised invoicing rules:

- provide consistency on how information for taxable supplies and corrections are used within the GST group rules
- simplify the information requirements for taxable supplies not having a value exceeding $1000, and
- increase the low-value transaction threshold for taxable supplies from $50 to $200 to simplify record-keeping requirements for a larger number of low-value transactions.

Application dates

The amendments to the information rules for a taxable supply apply for taxable periods starting on or after 1 April 2023.

However, some compliance cost reduction measures relating to buyer-created invoices (s 24(2)), information to support an input tax deduction (s 20(2)), supply correction information (s 25), and supplier groups (shared invoices) (s 55B) have an earlier implementation date and apply for taxable periods starting on or after 30 March 2022.

Detailed analysis

The modernised invoicing rules for GST are based on:

- record-keeping requirements under contract and commercial law, and
- a minimum set of information that must be retained in business records to support the integrity of the GST system.

The minimum set of information required to be retained for taxable supplies of goods and services is described in the definitions of "supply information" and "taxable supply information". The specifics of the information required to be retained for a taxable supply is dependent on whether the supply relates to:

- certain imported supplies
- secondhand goods
- a GST group or a supplier group, or
- in all other cases, the value of the supply.

Supply information

"Supply information", for both a supplier and a recipient of a supply of goods or services, means, at a minimum, all the following information:

- the name and registration number of the supplier
- the date of the supply
- a description of the goods or services, and
- the amount of the consideration for the supply.

This definition is used to support the information requirements for taxable supplies with a value not exceeding $200. Till receipts that contain this information are expected to satisfy the definition of "supply information".

Taxable supply information

Taxable supply information is defined in section 19E. This definition sets out the minimum information required to be retained for all types of taxable supply. The information requirements differ according to either:

- the value of the supply, or
- the fact the supply is one of several specified types of supplies, each of which have their own information requirements due to the nature of the supply.

The meaning of "taxable supply information" differs for different value thresholds of taxable supplies. These thresholds do not apply for certain imported supplies, secondhand goods, supplies by either a GST group or a supplier group, and distantly taxable supplies. The information requirements for these types of supplies are set out in sections 19G, 19H, 19J, 19L, and 19M.

Given the information recorded for a taxable supply is by its nature factual, it is unnecessary for a business record containing one or more elements of taxable supply information to include any wording that indicates it is taxable supply information. This is a change from the previous prescriptive requirement that a valid tax invoice must have the words "tax invoice" shown prominently on the invoice.

Section 19F requires both the supplier and recipient of a taxable supply to have a record of the taxable supply information for that supply.

Taxable supply information is not required to be retained in a single business record. For example, customer records, inventory systems and a sales system may, in combination, contain different elements of taxable supply information.

Taxable supply information based on value of the supply

There are three value thresholds for the general meaning of "taxable supply information". The information requirements for each are mutually exclusive, and the thresholds for the value of the supplies are as follows:

- exceeding $1,000
- not exceeding $1,000 but exceeding $200, and
- not exceeding $200.

Note that these thresholds only apply to supplies that do not fall within the specific information requirements in sections 19G, 19H, 19L and 19M for the specified types of supplies (discussed below).

Taxable supplies having a value exceeding $1,000 (sections 19E(2)(a) and 19F)

A supplier and recipient must retain all the following information in their business records for supplies exceeding $1000:

- the name and registration number of the supplier
- recipient details for the recipient
- the address of a physical location for the recipient, if the address is available to the person and not otherwise included in the recipient details
- the date of the supply
- a description of the goods or service, and
- for tax charged on the supply, either:
  - if the amount of tax charged is the tax fraction of the consideration for the supply, the amount of the consideration for the supply and a statement that the amount includes a charge in respect of GST, or
  - the total amount of tax charged for the supply, the consideration for the supply excluding the tax, and the consideration for the supply including the tax.

This set of information is comparable to the information previously required for a tax invoice for supplies in excess of $1,000. The main difference in the definition of "taxable supply information" is that it is no longer necessary, for GST purposes, to keep details relating to the quantity or volume of the supply. This change is because this information is already included in business records for commercial reasons, given modern inventory and sales systems and processes.

In most cases, it is expected that commercial invoicing processes will satisfy the taxable supply information requirements for an invoice issued for a supply having a value exceeding $1,000.

Recipient details

"Recipient details" are defined in section 2 as the name of the recipient and one or more of the following contact points for the recipient:

- an address of a physical location for the person, such as a mailing or billing address
- a telephone number
- an email address
- a trading name other than the name of the recipient
- a New Zealand business number, or
- a Uniform Resource Locator address for a web site.

Retaining information about recipients for taxable supplies made on deferred payments terms is normal commercial practice, particularly in the context of required processes for enforcing payment of an outstanding debt.

Taxable supplies having a value exceeding $200 but not exceeding $1,000 (sections 19E(2)(b) and 19F)

The taxable supply information that must be retained by both the supplier and the recipient for a supply that has a value exceeding $200 but not exceeding $1,000 is:

- the supply information for the supply, and
- a statement that the amount of consideration includes tax charged for the supply, or a statement of the amount of tax charged for the supply.

The information requirements for this threshold are simpler than the previous simplified tax invoice rule. Depending on the digital point of sales system used by the supplier, in many cases the record of the sale will contain the relevant taxable supply information. For example, a till record and an associated till receipt are likely to contain the necessary information.

Manual invoices or receipts may need to be prepared if the supplier does not use digital point of sale systems to comply with contract and commercial law.

Taxable supplies having a value not exceeding $200 (sections 19E(2)(c) and 19F)

The taxable supply information that must be retained by both the supplier and the recipient for a supply that has a value not exceeding $200 is the supply information for the supply.

In most cases, depending on digital point of sales systems, a record of the sale will contain the relevant taxable supply information. A registered recipient is entitled to request a manual receipt if no till receipt is available.

Taxable supply information for certain imported goods or services (sections 19E(2)(d), 19F and 19G)

The registered recipient of a supply of imported goods or services that is either:

- treated as being made in New Zealand, or
- a supply where the recipient is required to pay output tax for the supply

must retain the following information about the supply:

- the name and address of the supplier
- the date on which, or the period during which, the supply was received
- a description of the goods or services supplied
- the consideration for the supply
- the time by which payment of the consideration for the supply is required
- the amount of the consideration for the supply that represents salary or wages the registered person has treated as not affecting the value of the supply (in reliance on section 10(15C)(a))
- the amount of the consideration for the supply that represents interest the registered person has treated as not affecting the value of the supply (in reliance on section 10(15C)(b)).

Taxable supply information for supplies of secondhand goods (sections 19E(2)(e), 19F, 19H, and 21B(3)(a))

A registered person who receives a supply of secondhand goods having a value in excess of $200 (not being a taxable supply) must have a record of the following information about the supply:

- the name and address of the supplier
- the date on which the secondhand goods were supplied
- a description of the secondhand goods
- the quantity or volume of the secondhand goods, and
- the consideration for the supply.

The above list of information is the taxable supply information to be recorded when acquiring secondhand goods by way of a sale transaction.

This information requirement extends to a person or partnership who becomes registered after they have acquired the secondhand goods for use in making taxable supplies (section 21B(3)(a)) (for example, loose tools that are then used in carrying on a car mechanic business).

Taxable supply information for members of a GST group or a supplier group (sections 19E(2)(f), 19F, 19J, 19L, 55 and 55B)

The GST group and supplier group rules (shared invoices) provide that one member of the group is to keep a record of the taxable supply information and supply correction information for all supplies by a member of a GST group or supplier group.

Taxable supply information for a GST group and a supplier group relies on the definition of "taxable supply information" in sections 19E(2)(a) to (c) and (f) and section 19L. Section 19L effectively provides that the taxable supply information in these circumstances is:

- the relevant information under sections 19E(2)(a) to (c) based on the value of the supply (as discussed above), and
- the name and registration number of the representative member for the GST group or of the issuing member for the supplier group.

Taxable supply information for a member supply made by an active member of a GST group or a supplying member of a supplier group is treated as being provided by the issuing member for the GST group or the supplier group, or in the case of a GST group, the representative member if the GST group does not have an issuing member.

In addition, where taxable supply information has been issued for a supply by an active member of a GST group or a supplying member of a supplier group, the issuing member must also have a record of the name, address, and the registration number of the active member or supplier member actually making the supply (section 19J).

These record-keeping changes for taxable supply information for GST groups are also discussed in more detail later in this TIB under the heading "GST groups".

Early application of recordkeeping rules for GST groups and supplier groups

The changes relating to information about taxable supplies made by GST groups and supplier groups apply for taxable periods starting on or after 1 April 2023. However, as part of the transition from the old rules to the new, to reduce compliance requirements a GST group or supplier group may apply the same principles for record-keeping relating to tax invoices, credit notes, and debit notes for taxable periods starting on or after 30 March 2022 (sections 55(1AM), 55(1AN), and 55B).

Supplies of distantly taxable goods (sections 12C, 19E(2)(g), 19F, and 19M)

For taxable supplies of distantly taxable goods, including other goods imported with them, on which tax is charged at a rate greater than 0%, the registered supplier must take reasonable steps to ensure that the New Zealand Customs Service has available, by the time of the importation of the goods (section 12C):

- the name and registration number of the registered person
- information indicating the items included in the supply, or imported with the supply, for which the amount of tax included in the price of the supply is more than zero
- information indicating the items included in the supply, or imported with the supply, for which the amount of tax included in the price of the supply is zero
- information that is acceptable to the Commissioner in substitution for information referred to in the first three bullet points above.

Note that the content of section 12C is the same as the existing section 24BAC of the GST Act. The provision is simply being relocated.

The registered supplier is also required to provide the recipient of the supply with the following taxable supply information:

- the taxable supply information that would be required if the goods supplied were not distantly taxable goods and not imported with distantly taxable goods (that is, the relevant information under sections 19E(2)(a) to (c) based on the value of the supply)
- the date upon which the receipt is issued
- identification of the goods that are charged tax at more than 0%
- Identification of the goods that are charged tax at 0%.

The consideration for the goods may be expressed in the currency of the consideration received by the supplier. In addition, the Commissioner has a discretion to allow alternative information particulars to those stated above.

Buyer-created taxable supply information (section 19K(4))

Buyer-created taxable supply information was formerly known as a buyer-created tax invoice. The modernised invoicing provisions contain reforms to the framework that permits a recipient of a supply to create taxable supply information for a supply. The taxable supply information that is to be recorded relies on the value threshold provisions.

New section 19K(4) provides the following changes for buyer-created taxable supply information:

- It is no longer necessary to obtain the Commissioner's pre-approval to use the buyer-created taxable supply information provision.
- The requirement for pre-approval by the Commissioner is replaced by a requirement that the supplier and recipient must agree that:
  - the supplier will not issue taxable supply information for taxable supplies to the recipient to which the buyer-created arrangement applies, and
  - the recipient will issue taxable supply information for each taxable supply by the supplier to the recipient.
- The taxable supply information does not need to include a statement that it is created by the recipient.
- If the terms of the agreement are not part of the normal terms of business between the supplier and recipient, the parties must record the reasons for entering the agreement for buyer-created taxable supply information.
- The taxable supply information for the supply must be retained by both the supplier and recipient in business records as part of GST record-keeping requirements (section 19F).
- The Commissioner may invalidate the agreement before a supply because the Commissioner considers either:
  - the supplier and the recipient have not complied with the agreement, or
  - they have not recorded the reasons for the agreement where it is not part of their normal terms of business.

The new provisions apply for taxable periods starting on or after 1 April 2023.

Early implementation for buyer-created tax invoices

As part of the transition from the old rules to the new rules, the changes relating to buyer-created taxable supply information have also been extended to buyer-created tax invoices for taxable periods starting on or after 30 March 2022 under new section 24(2).

Existing approvals by the Commissioner to use buyer-created tax invoices made before the replacement of section 24(2) are not intended to be affected. No savings provision was considered necessary, given the effect of section 17 of the Interpretation Act 1999 (which remains in force until the corresponding provision in the Legislation Act 2019 comes into force). In particular, section 17 has the effect that:

- a Commissioner-approved buyer-created tax invoice (BCTI) will continue to be valid after the replacement of section 24(2)
- the right to use a Commissioner-approved BCTI process is not affected, and
- the status of a BCTI is unaffected.

Taxable supply information for supplies to nominated recipients (section 19I)

Section 19I relates to certain taxable supplies of goods under section 60B where a person (person A) enters a contract to supply goods to a person (person B) who directs person A to deliver the goods to a nominated person (person C).

For a supply to a nominated person where:

- the consideration is fully paid by person C, or
- persons B and C each pay part of the consideration, or
- the supply consists wholly or partly of land,

the nominated person (person C) must retain the following information for that supply:

- the name and address of the supplier
- the date on which payment for the supply is made
- a description of the goods, and
- the consideration for the supply.

Providing taxable supply information to the recipient (section 19K)

For integrity reasons, the supplier making a taxable supply is required to provide taxable supply information to a registered recipient, unless a provision states otherwise. Previously, a tax invoice only had to be provided at the request of the recipient. This change is not expected to create additional compliance costs as, under the previous law, registered recipients invariably requested tax invoices to support input tax claims. The rules for the provision of taxable supply information are set out below. The exceptions to these rules are also discussed below.

A taxable supply to a registered person having a value greater than $200

For a taxable supply made to a registered person having a value of greater than $200, the supplier must provide taxable supply information for the supply to the recipient either:

- within 28 days of the day of the supply, or
- by an alternative date agreed between the supplier and the recipient (sections 19K(1) and (5))

A taxable supply to an unregistered recipient having a value greater than $200

For a taxable supply made to an unregistered recipient, the taxable supply information must only be supplied to the recipient if requested. If such a request is made, the taxable supply information must be provided within 28 days of the request (section 19K(3)).

Taxable supplies having a value of not more than $200

In general, a supplier is not required to provide taxable supply information for supplies having a value of not more than $200. However, the supplier must keep a record of such low-value supplies.

Contract and commercial law considerations for such low-value supplies will generally require the supplier to provide supply information to a recipient, such as a digital or manual receipt. In addition, section 19F requires a registered recipient to have a record of taxable supply information, which is the same as was previously required under section 75. It is expected that a registered recipient will normally request the supply information for a low value supply.

Buyer-created taxable supply information

A recipient of a supply must provide the supplier with the buyer-created taxable supply information within 28 days of the supply or by an alternative date agreed between the supplier and the recipient (sections 19K(4) and (5)).

Supplies of goods made under the exercise of a power

If a supply of goods made under the exercise of a power is treated under section 5(2) as being a taxable supply made by a person (for example, goods sold in satisfaction of a debt where the debtor is treated as the supplier), the person exercising the power is required under section 19K(6) to:

- issue taxable supply information for the person treated as being the supplier, as if the supplier were a registered person, and
- if the supplier is not a registered person, include the supplier's tax file number in the information instead of a registration number.

The person exercising the power must provide the taxable supply information to the recipient of the supply within the relevant time frame discussed above, depending on whether the recipient is registered or not.

Distantly taxable goods and remote services

The supply of distantly taxable goods by a non-resident supplier to a registered person in New Zealand for the person's taxable activity will be treated as being made outside New Zealand unless the non-resident supplier elects otherwise (section 8(4E)). The non-resident supplier can elect under section 8(4F) to treat the supply as made in New Zealand if, at the time of the election, the supplier expects that more than 50 percent of the value of supplies made to persons in New Zealand in the 12 months from the election will be made to non-registered persons, and the value of the supply does not exceed $1,000. If the non-resident supplier elects to treat the supply of distantly taxable goods as made in New Zealand, the non-resident supplier is required to provide taxable supply information to the recipient (section 19K(8)).

However, a non-resident supplier of distantly taxable goods or remote services that are treated as supplied in New Zealand (under sections 8(3)(ab) or (c) respectively) may also choose to provide taxable supply information for the supply to the recipient, if all the following apply (section 19K(9)):

- the supply is not a contract of insurance
- the supply of goods or services was incorrectly treated either as being made in New Zealand when it should have been treated as being made outside New Zealand, or as not being zero-rated when it should have been
- the value of the supply, in New Zealand currency as at the time of the supply, does not exceed $1,000, and
- the recipient notifies the supplier that they are a registered person and/or provides the supplier with their registration or New Zealand business number.

When taxable supply information is not required to be provided to the recipient

A supplier is not required to provide taxable supply information for a taxable supply to a recipient in the following circumstances (section 19K(7)):

- the consideration for the supply is $200 or less
- the supplier is a non-resident supplier who makes a supply of distantly taxable goods that is treated as being made in New Zealand under section 8(3)(ab) (except where the non-resident supplier has elected under section 8(4F) to treat the supply as made in New Zealand – see discussion above), or
- the supplier is a non-resident supplier who makes a supply of remote services that is treated as being made in New Zealand under section 8(3)(c).

In addition, if the Commissioner is satisfied that there are or will be sufficient records available to establish the particulars of any supply or class of supplies, and that it would be impractical to require taxable supply information to be provided, the Commissioner may determine that taxable supply information is not required to be provided, subject to any conditions the Commissioner considers necessary.

Supply correction information (section 19N)

What is supply correction information? (section 19E(1))

Supply correction information is defined for a taxable supply for which taxable supply information containing an inaccuracy has been issued as the following:

- the name and the registration number of the supplier
- information identifying the taxable supply information
- the date of the supply correction information
- the correction to the taxable supply information, with a correction to the amount of tax charged for the supply being expressed as:
  - where GST is shown as a separate charge:
    - the amount of consideration shown in the taxable supply information for the supply
    - the correct amount of consideration for the supply
    - the difference between those two amounts, and
    - the correction to the amount of tax charged resulting from the amount of that difference, or

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- where the total consideration is shown as a GST-inclusive amount:
  - the amount of consideration shown in the taxable supply information for the supply
  - the correct amount of consideration for the supply
  - the difference between those two amounts, and
  - a statement that the amount of that difference includes an amount of tax charged.

Effect of the supply correction information provisions

The supply correction information provisions replace the prescriptive requirements for credit notes and debit notes. The changes reduce compliance costs by expanding the scope for making corrections to taxable supply information and requiring that these corrections be retained in business records instead of issuing formal credit notes and debit notes.

The supply correction rules apply when taxable supply information has been issued and it is subsequently discovered that the information contains an inaccuracy. The supplier may issue supply correction information to the recipient. In some circumstances, the issue of supply correction information is mandatory.

While these provisions apply for taxable periods starting on or after 1 April 2023, the credit note and debit note provisions in section 25 of the GST Act have also been correspondingly amended with effect for taxable periods starting on or after enactment (30 March 2022) to provide early access to the reduced compliance costs arising from the expanded ability to make corrections to inaccuracies.

Inaccuracies

The following is a non-exhaustive list of examples of matters that may cause an inaccuracy in taxable supply information:

- the supply has been cancelled
- part, or all, of the supplied goods have been returned to the supplier
- part of the supplied goods has not been delivered to the recipient
- an incorrect description of the supply
- incorrect taxable supply information about the supplier
- incorrect recipient details
- an incorrect date of the supply
- an incorrect rate of tax has been applied to calculate the tax charged, and
- an incorrect amount of tax has been charged for reasons other than the incorrect rate being applied.

Providing supply correction information (sections 19N(2), (3), (4) and (5))

The rules relating to the provision of supply correction information are discussed below. Note that these rules also apply to the record-keeping member of a GST group or a supplier group, and a person who uses buyer-created taxable supply information.

When supply correction information must be provided to the recipient (sections 19F and 19N(2))

Subject to the exclusions discussed below, supply correction information **must** be provided by a registered supplier to the recipient of a taxable supply if either:

- the taxable supply information previously provided for that supply has an inaccuracy in the amount of tax charged, or
- the supplier has included the incorrect output tax amount in a GST return.

The supply correction information for the supply must be provided:

- by a date agreed between the supplier and the recipient, or
- if no date has been agreed between supplier and recipient, within 28 days of the date of the taxable supply information that contained the inaccuracy.

When supply correction information is not required to be provided to the recipient (sections 19N(3), (4), (5), (6) and (8))

Supply correction information for a taxable supply is **not** required to be provided to the recipient in the following circumstances:

- The tax shown in the taxable supply information for the supply exceeds the tax charged on the supply and the excess arises from either a prompt payment discount stated in the taxable supply information or an agreed discount between the supplier and the recipient that is part of the usual business terms or recorded by the parties.

- Part of the consideration shown in the taxable supply information has been rebated under a Pharmac agreement.

In addition, supply correction information **may** be provided in the following circumstances:

- If the registered recipient of a supply has provided buyer-created taxable supply information to the supplier and either:
  - that taxable supply information has an inaccuracy in the amount of tax charged, or
  - the supplier has included the incorrect output tax amount in a GST return.
- If the supply correction information relates to taxable supply information for taxable supplies, or a class or classes of taxable supplies, made to the recipient, or to a class or classes of recipients that include the recipient, and either:
  - that information has an inaccuracy in the amount of tax charged, or
  - the supplier has included the incorrect output tax amount in a GST return.
- When a person claims to have lost previously issued supply correction information, the registered person who issued the information may provide a copy.

When supply correction information issue may not be provided (section 19N(7))

Supply correction information for a taxable supply **may not** be provided to a recipient after whichever of the following dates, or the earliest of the dates, that is applicable to the supply:

- if the supply resulted in an overpayment of tax that is refundable under sections 45(1), (2), or (3) of the GST Act and the Commissioner is satisfied that the registered person took due care to avoid errors in the taxable supply information, the date that is 4 years from the end of the 4-year period referred to in the relevant subsection of section 45
- if the supply does not fall within the above, the date that is 4 years from the end of the taxable period in which the registered person provides the return for the taxable period in which the supply was made
- if the supply was not zero-rated because section 11(1)(mb) was incorrectly applied to the supply, the date that is 7 years from the date of settlement of the transaction relating to the supply.

Shared invoices and supplier groups (section 55B)

New section 55B(1) applies for taxable periods starting on or after 30 March 2022 and allows a group of 2 or more registered persons (supplier group) to enter into an agreement that requires one member of the group (the issuing member) to issue tax invoices, credit notes and debit notes for each supply of goods and services (other than sales of goods in satisfaction of debt) made by a member of the group (the supplying member).

To function as a supplier group under section 55B(1), the members of the supplier group must not be members of the same GST group and must comply with the requirements prescribed in section 55B(2). That section requires an agreement between the members that:

- provides only the issuing member must issue tax invoices, credit notes and debit notes for each supply by a supplying member
- includes the name, address and registration number for each member
- where the agreement differs from normal commercial terms previously agreed by the members, records an explanation from each member as to the circumstances of the agreement, and
- has not been invalidated by the Commissioner because she considers that these requirements are not met.

Section 55B(3) provides that the issuing member is responsible for all obligations under the GST Act for a supplying member. This includes filing GST returns, making elections for the supplier group, and all record-keeping for the group.

Section 55B(4) further provides that when a supplier group agrees to change the issuing member, this change must be notified to the Commissioner and the new issuing member must notify the Commissioner and provide an undertaking to meet the obligations of an issuing member for the supplier group.

Note that for taxable periods starting on or after 1 April 2023, the references to "tax invoices, credits notes, and debit notes" in section 55B are changed to the new "taxable supply information" (see discussion above).

Input tax deductions (section 20(2))

Section 20(2) sets out what records a registered person is required to hold to support a claim for an input tax deduction. With effect for taxable periods starting on or after 30 March 2022, section 20(2) no longer requires a tax invoice to be retained.

Instead, the provision requires only that the registered person meet the requirements of section 75 for a taxable supply. This will generally mean it is necessary to have a record of the taxable supply that shows the GST charged on the supply for which input tax is claimed.

For taxable periods starting on or after 1 April 2023, section 20(2) requires the registered person to meet the requirements of new section 19F for a taxable supply. Section 19F provides that a registered person who makes or receives taxable supplies of goods or services must have a record of the taxable supply information and supply correction information for all those taxable supplies. See the discussion above for what constitutes "taxable supply information" and "supply correction information" for particular types of supplies.

Input tax deductions for secondhand goods must continue to meet the information requirements of section 24(7) (section 19H for taxable periods starting on or after 1 April 2023). Input tax deductions for supplies treated as being within section 5B must continue to have a record of the supply showing it meets the requirements of section 5B and that the registered person accounts for output tax on the supply, and for a supply to a nominee under section 60B, the record of the supply must contain the required information about the nominee arrangement.

Penalties for claiming multiple input tax deductions

Previously, if a person knowingly issued two tax invoices for the same taxable supply, they could be convicted of a knowledge offence under section 143A(1)(f) of the Tax Administration Act 1994 (TAA), which could carry a sanction of a fine not exceeding $25,000 on the first occasion and not exceeding $50,000 on every other occasion.

This penalty was misdirected because it applied to the person who issued the invoice, as opposed to the person who was claiming multiple input tax credits. A person could issue multiple invoices due to mistake, which would not warrant such a harsh penalty. If a person issued multiple invoices because they were taking an abusive tax position, or undertaking evasion or fraud, then these offences would carry their own penalties.

Section 143A(1)(f) has been repealed and replaced with a strict liability offence. New section 143(1)(d) of the TAA provides that a person who claims more than one amount of input tax for a taxable supply commits a strict liability offence.

However, new section 143(2D) of the TAA provides that no person may be convicted of an offence under section 143(1)(d) if the person took reasonable care when claiming the input tax or corrected the amount claimed under section 113A of the TAA.

A person who is convicted of an offence under section 143(1)(d) is liable for a scale of fines (up to a maximum of $12,000), depending on how many times the person is convicted.

Consequential amendments to terminology in other provisions

The term "tax invoice" is replaced by "taxable supply information" and the terms "credit note" and "debit note" are replaced with the term "supply correction information", with effect for taxable periods starting on or after 1 April 2023, in the following provisions in the GST Act (unless otherwise stated):

- section 20(3), and the proviso to section 20(3)
- section 20(4C)
- section 25(4), (5)
- section 25AA
- section 25AB(1)
- section 53(2)
- section 55(1AB), (1AM), (1AN)
- section 55B(1), (2)
- section 60(1), (2), (3)
- section 75(1), (2)
- section 78AA(11), (12), (13)
- section 78B(2A), (2), and
- section 143(1) Tax Administration Act 1994.

References to tax invoice, credit note, or debit note in a document (section 19Q)

Commercial documents commonly refer to tax invoices, credit notes or debit notes. Section 19Q provides that a reference in a document to a:

- tax invoice is to be read as a reference to taxable supply information.
- a credit note or a debit note is to be read as a reference to supply correction information.

This means that these documents do not need to be updated or reissued to reflect the new terminology.

Secondhand goods input tax credit – associated persons supplies

Sections 3A(2)(a) and 3A(3)(a)(i) of the Goods and Services Tax Act 1985

The amendments allow an input tax credit for a supply of secondhand goods from an associated person by reference to the last known supply from a non-associated person. The amendments do not apply to a supply of goods that were acquired by the supplier before GST was introduced.

Background

The input tax deduction for a supply of secondhand goods to an associated person is intended to have the same outcome for input tax that would be allowed if the supplier had, instead of making an associated person transaction, started using the secondhand goods in their own taxable activity. In this situation, the owner of the secondhand goods would receive an input tax deduction that takes into account previous GST costs embedded in the purchase price of those goods.

The February 2020 GST Issues Paper proposed amending the law to allow an input tax credit if a registered person was denied a secondhand goods input tax credit in circumstances where previous GST costs have been embedded in the transactional cost of the asset. Submitters on the issues paper supported an input tax credit based on the tax fraction of the cost of secondhand goods paid between associated persons.

Key features

A registered person was previously prevented from claiming an input tax credit for secondhand goods acquired from an associated person who had not previously acquired those goods as a taxable supply.

The amendments to section 3A allow an input tax credit for secondhand goods acquired from an associated person as follows:

- If the associated supplier has purchased the secondhand goods from a non-associated person, the input tax deduction allowed is equal to the tax fraction of that earlier purchase price from the non-associated person.
- If the associated supplier has purchased the secondhand goods from an associated person, an input tax deduction is allowed only if an earlier supply with a non-associated person can be identified after 1 October 1986. In this situation, the input tax deduction allowed is equal to the tax fraction of that earlier purchase price from the non-associated person.

The amendments also ensure that a chain of associated person supply transactions is looked through to determine the first non-associated supply introduced to that chain.

Example 130: Secondhand goods input tax credit

A developer sells a property to Sam for $1.15 million, including $150,000 of GST. Sam is not registered for GST (or, if registered, does not use the property to make taxable supplies). The developer and Sam are not associated persons.

Two months later, Sam sells the property for $1.2 million to John. As this sale is not subject to GST, there is no GST included in the sale price to John. Sam and John are not associated persons.

John lives in the property for five years and then sells the property for $1.5 million to his sister, Jasmine, who intends to re-develop the property to use it as the premises for her business of making taxable supplies. John and Jasmine are associated persons, but Jasmine and Sam are not associated persons.

Prior to the amendments, the secondhand goods input tax credit was limited to the GST included in the original cost to John, which was zero – therefore Jasmine would have been unable to claim any secondhand goods input tax credit. This was despite GST being embedded in the chain of transaction costs.

Following the amendments, Jasmine is able to claim a secondhand goods input credit based on the tax fraction (3/23rds) of the original cost to John. The input tax deduction allowed under the new provisions is therefore $156,522.

This result ensures that Jasmine receives the same input tax deduction (in total) overall that John would have received if, instead of selling the secondhand goods to Jasmine, he had applied the goods 100% in a taxable activity. Under the current adjustment rules, if the property had been applied 100% to a taxable activity by John, the total amount of input tax deduction allowed to John would have been equal to the tax fraction of the cost of the property to him when purchased from Sam.

Application dates

The amendments apply to a supply of secondhand goods made:

- in a taxable period starting on or after 30 March 2022, or
- under an agreement entered into after 8 September 2021 and paid for on or after the start of the first taxable period starting on or after 30 March 2022.

GST input tax recovery for non-resident business

Sections 20(3L), (3LB) and (3LC) of the Goods and Services Tax Act 1985

A GST-registered non-resident business may claim input tax deductions for all their GST costs for goods purchased in New Zealand that are used to make taxable supplies outside New Zealand.

A GST-registered non-resident business cannot claim a GST input tax deduction for any GST paid to Customs on imported goods that are supplied to a final consumer in New Zealand.

Background

A GST-registered non-resident business may send their goods to New Zealand for work to be done on them by a New Zealand resident business. Once work is complete, the non-resident will often export some of the goods outside of New Zealand. Before the current amendment, the non-resident may have needed to establish a fixed or permanent place in New Zealand to claim input tax deductions for their New Zealand inputs that related to the exported goods. This is because section 8(2) deems the supply of these goods to occur outside New Zealand.

Key features

The amendments allow a GST-registered non-resident business to claim input tax deductions for their New Zealand inputs that relate to the exported goods.

The amendments achieve this by expanding the scope of the existing input tax deduction rule in section 20(3L), which allows deductions for certain non-resident businesses, so it applies to all GST-registered non-residents.

Amendments to sections 20(3LB) and 20(3LC) prevent an input tax deduction from being claimed by the non-resident for Customs GST paid on any imported goods that are:

- supplied to a person in New Zealand who is not a GST-registered person, or who is a GST-registered person and the supply is not for use in their taxable activity, and
- outside New Zealand at the time of supply.

Application date

The amendments came into force on 30 March 2022.

Export of goods delivered to a recipient's vessel in New Zealand

Section 11(1)(eb)(i) of the Goods and Services Tax Act 1985

Key features

The amendment allows a supplier to zero-rate the supply of goods to a recipient's vessel for export, regardless of whether the vessel is operated by a resident or a non-resident. This is achieved by expanding section 11(1)(eb)(i) so that it is not limited to cases where the recipient exporter is a non-resident.

The other conditions of section 11(1)(eb)(ii)-(vi) remain in place and must be met for the supply of goods to the recipient to be zero-rated. For example, a supplier who delivers logs to the ship of a recipient who then exports the logs outside of New Zealand would be able to zero-rate the supply of logs.

Application date

The amendment came into force on 30 March 2022.

Ground leases paid via a unit title body corporate

Section 5(8A) of the Goods and Services Tax Act 1985

A GST-registered unit title body corporate is deemed not to be making taxable supplies to its members for any portion of a levy charged by the body corporate for supplies that would be exempt supplies if they were provided directly to the member.

Background

When a GST-registered unit title body corporate charges a levy to its members, section 5(8A) deems there to be a taxable supply of services to the members. This means that a GST-registered unit title body corporate must charge and remit output tax on the levy to Inland Revenue. Previously, section 5(8A) deemed there to be a taxable supply for the whole of the levy or other amount paid, even though a portion of that levy may be used to purchase exempt supplies, such as a lease on leasehold land to the extent that land is used for the principal purpose of accommodation in a dwelling erected on that land.

Key features

Section 5(8A) has been amended so that the portion of a unit title body corporate levy that relates to the purchase of exempt supplies is not treated as consideration for services supplied to the member. This means that GST would not be charged on the portion of the levy that represents payment for exempt supplies. For example, where a unit title body corporate charges its members a levy of $500, and $300 of that levy is paid to the leasehold landowner for ground rent on land that is used for the principal purpose of accommodation in a dwelling erected on that land, the body corporate would only be making a taxable supply of the $200 that does not represent consideration for the exempt supply.

Application date

The amendment came into force on 30 March 2022.

GST B2B compulsory zero-rating of land rules

Sections 5(23), 25AB(1)(a) and 25AB(2) of the Goods and Services Tax Act 1985

Amendments made to the GST business-to-business compulsory zero-rating of land rules apply in cases where a registered person has incorrectly zero-rated a supply of land and is required to make subsequent adjustments. It has been clarified that the adjustment should be made in the period the error became apparent, rather than the period when the original supply took place. In addition, a non-taxable supply that has been incorrectly zero-rated may now be correctly adjusted to be a non-taxable supply.

Key features

Timing of an adjustment under section 25AB

A registered person may claim a secondhand goods input tax deduction when they purchase land that was not sold as a taxable supply of land.

If, subsequent to the supply of land, it was found that the supply should have been zero-rated under section 11(1)(mb), the recipient of the supply was previously required to make an output tax adjustment for the underpaid GST in the taxable period in which the "event" occurred under section 25AB. In this case, the "event" was the incorrect treatment of the supply of land as a non-taxable supply for which the recipient claimed a secondhand goods input tax deduction. The output tax was therefore owing in the taxable period in which the land was supplied. This meant that the recipient was liable to pay penalties and use of money interest, and there was a risk that the necessary adjustment may have since become time barred.

The amendment addresses these concerns by ensuring that the liability to pay output tax only arises on the date it is found that the amount of input tax deducted by the recipient was incorrect. This has been achieved by amending section 25AB(2) so that it refers to the time the error in the amount of input tax was discovered when determining the adjusted tax liability of the recipient of the supply.

A consequential amendment has also been made to section 25AB(1)(a) to retain the original scope of events that the supply must be affected by for the section to apply.

Timing of an adjustment under section 5(23)

A registered person must zero-rate a supply of land to another registered person when the requirements under section 11(1)(mb) are met. If, subsequent to the supply of land, it is found that the supply did not meet the requirements for zero-rating under section 11(1)(mb), the recipient of the supply was previously required to return output tax on the purchase price. This output tax liability was attributed to the taxable period in which the date of settlement occurred. This meant that the recipient was liable to pay penalties and use of money interest, and there was a risk that the necessary adjustment may have since become time barred.

The amendment addresses these concerns by ensuring the liability to pay output tax only arises in the taxable period where the recipient becomes aware the zero-rating rules did not apply to the original supply. This has been achieved by amending section 5(23) so the supply of land by the recipient is deemed to occur on the date on which the error in application of the zero-rating rules is discovered. This means the recipient's output tax liability occurs in the same taxable period that they are entitled to claim an input tax deduction (to the extent to which they are using the land to make taxable supplies).

Limiting application of section 5(23) to taxable supplies

A supplier must zero-rate a supply of land to a recipient when the requirements of section 11(1)(mb) are met. If, subsequent to the supply of land, it is found that the supply was incorrectly zero-rated and should have instead been treated as a non-taxable supply for which the recipient could claim a secondhand goods input tax deduction, the recipient was previously unable to claim this deduction.

The amendment allows the recipient to claim a secondhand goods input tax deduction where they meet the requirements of section 3A(2). This has been achieved by limiting the application of section 5(23), so that it only applies where there has been a taxable supply of goods (such as land).

Application date

The amendments to section 25AB apply for taxable periods starting on or after 1 April 2023. The amendments to section 5(23) came into force on 30 March 2022.

GST – deduction notices

Section 43 of the Goods and Services Tax Act 1985

The amendments ensure that deduction notices can be used to recover outstanding GST debt from members of unincorporated bodies and persons who are no longer registered for GST.

Background

The Commissioner of Inland Revenue has the power to issue deduction notices as a means of collecting outstanding tax debts. Under the Goods and Services Tax Act 1985 (GST Act) the Commissioner can issue deduction notices that require a person (usually an employer or a bank) who owes an amount to a debtor to extract from that amount an amount in satisfaction of the debtor's tax debt and pay this to the Commissioner.

However, before the current amendments, the Commissioner could only issue deduction notices for outstanding GST owed by a **registered person**. This meant that deduction notices could not be used to recover outstanding GST from:

- persons who were no longer registered for GST, or
- members of unincorporated bodies (such as partners in partnerships, or trustees of trusts) because the unincorporated body is the registered person and the members themselves are not registered persons under the GST Act.

Amendments to the GST Act were therefore required to ensure the Commissioner can collect outstanding GST debts by way of deduction notice in these circumstances.

Key features

The amendments enable the Commissioner to use a deduction notice to recover GST debt from:

- members of unincorporated bodies (such as partners in a partnership or trustees of a trust), and
- persons who are no longer registered for GST.

Application date

The amendments apply from 30 March 2022.

Detailed analysis

New section 43(2AA) provides that the Commissioner can issue a deduction notice to recover outstanding GST of a registered person (the defaulting person) from a liable person.

A person is a "liable person" if they are liable to meet the obligations under the GST Act of the defaulting registered person. This would be the case in the following situations:

- The person is, or was, a member of an unincorporated body registered for GST. This is because members of unincorporated bodies are jointly and severally liable for the tax payable by the unincorporated body, whether they are still a member or not.
- The person is no longer a registered person but nevertheless continues to be liable for the obligations and liabilities they incurred while they were a registered person. This also applies to members of unincorporated bodies where the unincorporated body is no longer a registered person.

Consequential amendments have also been made to refer to "the registered person or the liable person" throughout section 43 to give effect to this change.

GST groups

Section 55 of the Goods and Services Tax Act 1985

The amendments to the GST group rules:

- resolve an ambiguity in the existing law relating to the relationship of the GST group provision with the other rules underpinning the GST system
- improve the relationship between the GST group rules and the modernised invoicing rules, and
- relax the scope of the joint and several liability rules for GST groups.

Background

An ambiguity was identified in an issues paper released in February 2019 by Inland Revenue's Public Rulings Unit on the consequences of GST group registration (IRUIPP 13). This ambiguity potentially led to different outcomes depending on which entity was treated as the supplier or recipient of goods and services within a GST group. These amendments address this ambiguity, as well as making other amendments to improve the operation of the GST group rules.

Key features

The amendments to the GST group rules:

- treat the representative member for a GST group as the supplier for all supplies made by any member of the GST group
- treat the representative member as being the recipient of all taxable supplies made to any member of the GST group
- treats the group as a single registered person for all activities carried on by any member within the group for supplies made to third parties
- provide for the representative member to make all elections under the Goods and Services Tax Act 1985 (GST Act) on behalf of the group
- disregard most intra-group supplies in determining the group's GST liability for each taxable period
- clarify which intra-group supplies are included in the group's GST return
- allow a group to nominate a member to create and issue all supply information records for taxable supplies
- apply joint and several liability on the same basis as for consolidated groups in the Income Tax Act 2007, and
- are consistent with the amendments to modernise information requirements for the GST system.

Application date

The amendments apply for taxable periods starting on or after 30 March 2022. The changes on the responsibilities and liabilities of a GST group member (section 55(1AO)) and those relating to members who leave a GST group (sections 55(1AP) and 55(1AQ)) additionally apply to transactions entered after 8 September 2021 and completed on or after 30 March 2022.

Detailed analysis

Entities other than companies

A GST group is a group of persons that have elected to become a GST group. Although the amendments, and the discussion of them below, primarily refer to GST-grouped companies, it is noted that they also apply to other entities (that are not companies) that register as a GST group in accordance with section 55(8).

Treatment as a single entity

The amendments clarify that a GST group is treated, for GST purposes, as a single entity that:

- operates each activity (taxable or exempt) carried on by any member of the group)
- makes each supply to a person that is not a member of the group (this includes exempt supplies) and is treated as receiving supplies to a group member
- treats the representative member as the person acting on behalf of the group for elections, giving notices, keeping records, and accounting for GST for the group
- can choose to issue taxable supply information for taxable supplies to third parties in the name of either the representative member or a member company (which allows GST groups more flexibility in their GST systems)
- means the representative member and members of the group are to jointly bear responsibilities and liabilities arising from each member's business activity
- is required to have a common taxable period and accounting basis from the time of registration as a GST group, and
- is not required to account for GST in a GST return for taxable supplies made between members of the group, unless there is a specific requirement to account for those intra-group supplies.

Treating a GST group as a single entity operating each activity carried on by any member of the group also means that a supply made by an unregistered member of the group to a person outside the group will be a taxable supply, unless the supply is an exempt supply.

Representative member treated as carrying on all activities

The amendments provide that the representative member:

- carries on all taxable activities and exempt activities that are carried on by any member of the group — each of those activities are to be treated in the same manner as if they were carried on by a branch within a single company that is registered for all its taxable activities

- as a registered person, makes all supplies by a member of the GST group to a person outside the group — this ensures all supplies by a GST group are either taxable supplies or exempt supplies
- is treated as receiving, and paying tax on, all supplies of goods and services made to members of the GST group from persons outside the GST group
- is treated as receiving all information provided to a member of the GST group under section 78F of the GST Act (relating to certain supplies of land)
- disregards supplies made between members of the GST group, unless another provision requires that supply to be taken into account in the group's GST return, and
- is responsible for all GST returns, payments, elections and record-keeping, as well as attending to information requests from the Commissioner, for the group. However, record-keeping functions may be carried out by either the member company making a supply or by an administrative company (see below).

The amendments also ensure that apportionments and adjustments are calculated by reference to the total activities carried on within the group, including exempt activities.

Intra-group supplies

Sections 55(1AC) to (1AI) provide that taxable supplies made in New Zealand between members of the GST group are disregarded in the preparation of the group GST return for each taxable period.

An exception to this rule is for a supply of services that is treated by section 8(4B) as being made in New Zealand.

Section 55(1AC) also allows other exceptions to this rule if another provision explicitly provides otherwise. This provides flexibility if other GST rules seek to include the GST effects of a supply in a GST group return.

Information requirements

Until the modernised invoicing rules begin to apply (see discussion under the heading "Modernising information requirements for GST" above), the GST group rules continue to refer to tax invoices, credit notes and debit notes. Under the previous law, each member of the GST group was required to issue tax invoices and keep records for all taxable supplies (including credit notes and debit notes).

As a simplification measure, a group may now choose that information for taxable supplies is to be issued and retained by either:

- the representative member, or
- a nominated company (for example, an administration company that maintains all record-keeping functions for the group), or
- the supplying member itself.

The form of creating and retaining and issuing that information would be determined by the group. However, if a group chooses to have an administration company maintain all record-keeping functions for the group, the amendments require the identity of this company, and its role, to be notified to the Commissioner of Inland Revenue.

Whichever company issues and retains information for taxable supplies and any related subsequent adjustments, that company would need to meet the minimum information requirements under, initially, the existing tax invoicing framework and, subsequently, as set out in the rules for modernising GST record-keeping processes. The representative member remains responsible for ensuring the record-keeping processes are complied with.

Joint and several liability

The amendments align the joint and several liability provisions in the GST Act with the joint and several liability provisions for consolidated groups of companies in the Income Tax Act 2007.

Joint and several liability generally continues to apply for GST obligations incurred while a company is a member of the group. However, the Commissioner may grant an exiting company relief from joint and several liability if all the following are satisfied:

- the Commissioner makes an assessment for a taxable period while the exiting company was still a member of the GST group
- that assessment is made after the later of:
  - the date the exiting company leaves the GST group, or
  - the date of the event that results in that member being treated as having left the group

- the amount assessed is more than an earlier assessment of the group for that taxable period, and
- the Commissioner considers the removal of joint and several liability will not significantly prejudice the recovery, or likely recovery, of the amount assessed and has notified the member and the representative member of this conclusion.

Example 131 illustrates how the removal of joint and several liability for an exiting company is removed with the Commissioner's agreement.

Example 131: Joint and several liability

A GST group was formed in 2012 with Companies A, B, C, and D. On 31 May 2022, Company A is sold and the group gets approval from the Commissioner under section 55(1AP) to remove joint and several liability from Company A.

Company A's GST joint and several liability is removed for any assessment of the GST group made after Company A exits the group that increases the GST liability of the group for any taxable period from 2012 until Company A is sold out of the group.

However, Company A's joint and several liability remains for a GST assessment made before Company A exits the group.

Commencement of membership of a GST group

The amendments clarify the start date for a member company that is newly incorporated and joins a GST group.

Section 55(4AA) provides that where a company that is incorporated less than 12 months joins a group, the representative member may choose that the start date of membership is either:

- the date of the company's incorporation, or
- the start of the taxable period following the date of incorporation.

Non-statutory boards

Section 6(3)(c)(iii) of the Goods and Services Tax Act 1985

This amendment ensures that services provided by members of non-statutory boards are not subject to GST. This brings the law into line with the existing treatment of services provided by members of statutory boards.

Background

The GST issues paper, released in February 2020, identified different GST treatments between services supplied by members of statutory bodies, such as a local authority, and services supplied by members of non-statutory bodies, such as community boards.

Under the previous law, the engagement, occupation or employment as a chairman or member of any statutory board was excluded from being a taxable activity for GST purposes, and therefore not subject to GST. Services supplied by members of non-statutory boards were treated differently and were potentially subject to GST. This was inconsistent with the policy intent.

Key features

Under the amendment, the exclusion for members of statutory boards from the definition of taxable activity has been widened to also apply to members of non-statutory boards. This has been achieved by removing the word "statutory" from section 6(3)(c)(iii).

This means that when a natural person, who is a registered person, provides services to local authorities, boards, committees, or any other council, the services are not subject to GST. The GST treatment no longer differs based on whether the services are provided to statutory or non-statutory boards.

Application date

The amendment came into effect on 30 March 2022.

More flexibility for changing end date for taxable periods

Sections 15, 15B, 15C, 15D, 15E, and 15EB of the Goods and Services Tax Act 1985

The Commissioner may approve an end date for the taxable period of a registered person that is not the last day of the month if

the Commissioner is satisfied there are good commercial reasons for the registered person's chosen date. The Commissioner may also approve a day of the week as the last day for the taxable period of a registered person if the Commissioner is satisfied that the use of the day would improve the alignment of the registered person's taxable periods with their accounting systems.

Background

For GST return purposes, the last day of the month is the normal end date for a taxable period. Although an exception to this requirement exists, this exception is limited to an approved end date that is within seven days of the end of the month. This limitation can result in a relatively high level of compliance and administration costs if, for example, GST taxable periods are not consistent with accounting cycles. The amendments address these compliance cost concerns.

Key features

A registered person may apply to Inland Revenue for approval to change the end date of a taxable period to a date other than the last day of the month to give a better alignment with their accounting systems and commercial practices. It is no longer necessary for the end date to be within seven days of the end of a calendar month.

The approved end date may be either a day of the week (for example, the fourth Thursday of the month) or a particular calendar date in the month (for example, the 20th of the month). An approved end date is treated for GST purposes as corresponding to:

- the end of the preceding month, if the approved end date is on or before the 15th of the month, or
- the end of the current month, if the approved end date is after the 15th of the month.

The new end date rules:

- are similar to the way in which late and early balance dates correspond to a tax year for income tax purposes, and
- provide consistency with provisional tax methods and due dates for satisfying GST obligations.

Application date

The amendments apply for taxable periods starting on or after 30 March 2022.

Detailed analysis

Approved date

New section 15E(2) provides that a registered person may apply under section 15C for approval under section 15EB to have a taxable period that is an approved date or day of the month.

New section 15EB(1) provides that the Commissioner may approve an end date for a taxable period that is not the last day of the month if the Commissioner is satisfied there are good commercial reasons for the registered person's chosen date. Under new section 15EB(2), the Commissioner may approve a day of the week as the last day for a taxable period if the Commissioner is satisfied that the alternative end date would improve alignment with the registered person's accounting cycle and, if that date is not within seven days of the end of the month, the person's accounting systems do not allow the use of a last day within seven days of the end of the month.

New section 15EB(3) ensures that where a registered person gets approval for a new taxable period different from their old one, the person's last old period must end at least the length of a new period before the first day or date approved for the new period, and the new period will begin after the end of the old period. For example, if a registered person has a monthly old period that ends on the last day of the month and a new period is approved for an end date of the 15th of the month, to commence with 15 July, the last old period for which the person makes a return must end on 31 May. The new period will begin on 1 June, and this ensures there is at least the length of the new monthly period (in this case six weeks) before the first approved end date of 15 July.

Under amended section 15E, the approved day or date for the end date of a taxable period can be:

- a specific day of the week (for example, the third Wednesday of each month)[74] or
- a fixed calendar date (for example, the 25th of each month).[75]

[74] For periods equivalent to a 1-month period, the specific day must be in the fourth week of the taxable period. For 2-month periods, it must be in the eighth week, and for 6-month periods it must be not more than 7 days before or after the last day of the sixth month in the taxable period.

[75] For 2-month periods, the specific date must be in the second month of the taxable period. For 6-month periods it must not be more than 7 days before or after the last day of the sixth month in the taxable period.

New section 15D(2B) provides that a change in an end date for a taxable period under section 15E(2) will take effect from either:

- the end of the taxable period in which the person applies, or
- the end of a later taxable period nominated by the registered person.

Approval to change an end date for a taxable period can be for a 1-month, 2-month or 6-month taxable period.

Alignment of approved taxable period with end of the month

Under section 15E(2B), an approved end date of the registered person's taxable period is treated for GST purposes as corresponding to:

- the last day of the month if the approved end date is on or after the 16th of the month. For example, a taxable period with an approved end date of 16th March is treated as a taxable period ending on the following 31 March (late end date).
- the last day of the previous month if the approved end date is on or before the 15th of the month. For example, a taxable period with an approved end date of 13 April is treated as a taxable period ending on the previous 31 March.

For an approved end date that ends on a particular weekday, it is possible for the calendar date of the end of successive taxable periods to vary. This could result in the end dates of the taxable periods corresponding to the same calendar month. For example, if the approved end date of a registered person's taxable period is the third Friday of the month, this could be 17 April for one taxable period, which would be treated as corresponding to 30 April, and 15 May for the next taxable period, which would also be treated as corresponding to 30 April. In these circumstances, section 15E(2C) provides that the GST information from those two taxable periods is aggregated and returned as one taxable period.

An application for any change to filing requirements, including a change to the end date of a taxable period, is to be made in writing. An application to change the end date of a taxable period can be made in the registered person's MyIR account.

Challenge rights – assessing time-barred GST returns

Section 138E of the Tax Administration Act 1994

The amendment ensures that a decision by the Commissioner to reopen an assessment for a time-barred GST return is a disputable decision.

Key features

Under the previous law, an assessment made by the Commissioner for a time-barred GST return could only be challenged under a judicial review process.

Section 138E of the Tax Administration Act 1994 (TAA) has been amended to ensure that challenge rights are not conferred in respect of section 108A of the TAA, which is the provision containing the time bar for amending a GST assessment. The reference to section 108A in section 138E(1)(iv) has been removed. This ensures that an assessment made by the Commissioner for a time-barred GST return is treated as a disputable decision.

This aligns the treatment of Commissioner assessments for time-barred periods for both income tax and GST.

Application date

The amendment came into force for taxable periods starting on or after 30 March 2022.

Zero-rated supplies of going concerns

Section 20(3J) of the Goods and Service Tax Act 1985

The scope of section 20(3J) has been expanded so that it now also applies to goods that were zero-rated as a going concern under section 11(1)(m) at the time they were acquired by the registered person.

Background

Under section 11(1)(m) of the Goods and Services Tax Act 1985, the sale of a going concern between registered persons may be zero-rated if the supplier and recipient agree.

Section 20(3J) requires a registered person to determine if they have any non-taxable use of goods (such as private use or use of

the goods to make exempt supplies) and return output tax in respect of 15% of the consideration they paid to acquire the goods multiplied by their percentage of non-taxable use.

Section 20(3J) previously applied only to land that was zero-rated under section 11(1)(mb) at the time it was acquired. The scope of the section has now been extended to apply to goods zero-rated under section 11(1)(m) as well.

Application date

The amendment applies from 30 March 2022.

Switching off adjustment provisions after a wash-up calculation is performed

Section 21(2) of the Goods and Services Tax Act 1985

The amendment ensures a registered person is not required to continue to perform annual adjustments for goods and services that have had a complete change of use and have been subject to a wash-up calculation under section 21FB of the Goods and Services Tax Act 1985 (GST Act).

Background

Section 21FB requires a wash-up calculation be performed if there has been a change to 100% taxable or 100% non-taxable use of an asset for two consecutive adjustment periods (balance dates).

Key features

New section 21(2)(ac) of the GST Act prevents a registered person from being required to make further annual adjustments if they have previously performed a "wash up" calculation for the good or service under section 21FB of the GST Act and there has been no subsequent change in use since they performed the wash-up.

If there has been a subsequent change in use, then section 21(2)(ac) will no longer apply, and adjustments will continue to be required under section 21.

Example 132: Van with changing business and private use

Kyle is a GST-registered delivery driver who acquires a van in February 2022.

In his first adjustment period since acquiring the van, Kyle uses the van 70% for business purposes and 30% for private use.

In March 2022, Kyle purchases a car for his private use and changes the use of the van so that it is exclusively used in his delivery business (100% taxable use) for the next two consecutive adjustment periods between 1 April 2022 and 31 March 2024. At the end of these two adjustment periods, Kyle performs a wash-up calculation under section 21FB to claim an additional input tax deduction in his next GST return to reflect his 100% taxable use of the van.

Section 21(2)(ac) applies, so Kyle does not make any annual adjustments for his use of the van during the next two adjustment periods between 1 April 2024 and 31 March 2026, as the van remains having 100% taxable use for these periods.

Kyle sells his car in April 2026 and changes his use of the van to 75% business and 25% for private use. Section 21(2)(ac) no longer applies, and Kyle is required to make an adjustment at the end of his next adjustment period to pay output tax in his GST return to reflect his 25% private use of the van.

Application date

The amendment applies from 30 March 2022.

INCOME TAX REMEDIALS

Hybrid and branch mismatches – imported mismatch rule

Sections FH 11, FH 15 and YA 1 of the Income Tax Act 2007

The amendments address issues identified with the imported mismatch rule in section FH 11 of the Income Tax Act 2007.

Background

The New Zealand hybrid and branch mismatch rules were enacted in 2018 in response to the OECD reports *Neutralising the Effects of Hybrid Mismatch Arrangements – Action 2: 2015 Final Report* (the **Hybrid Mismatch Report**)[76] and *Neutralising the Effects of Branch Mismatch Arrangements – Action 2: Inclusive Framework on BEPS* (the **Branch Mismatch Report**). Issues have been identified in the imported hybrid and branch mismatch rules. In general, these issues arise where New Zealand's rules do not align with the Hybrid Mismatch Report and the Branch Mismatch Report.

New Zealand's hybrid and branch mismatch rules seek to remove the tax benefit from various hybrid and branch mismatch arrangements. Hybrid and branch mismatch arrangements are cross-border arrangements that exploit differences in the tax treatment of an instrument, entity or branch under the laws of two or more countries to eliminate, defer or reduce income tax.

All the remedial amendments concern the imported mismatch rule in section FH 11. The imported mismatch rule generally denies deductions for payments made by New Zealand taxpayers where the payments fund a "hybrid mismatch" located offshore. The imported mismatch rule therefore prevents the benefit of the hybrid or branch mismatch being imported to New Zealand. It is the most complex of the hybrid rules, and for that reason, it only became fully effective for tax years beginning on or after 1 January 2020.

Key features

The amendments:

- clarify that a deduction for a charge to a deducting branch in New Zealand is denied where the charge imports the benefit of an offshore mismatch into New Zealand
- ensure a deduction for a payment is not denied (either wholly or partly) where a jurisdiction(s) in a chain of payments funding a mismatch has hybrid mismatch legislation
- ensure a deduction is not denied where there is sufficient dual inclusion income for the payer of the funded payment
- deny a deduction for payments that can be traced to a hybrid mismatch through loss grouping, group contributions of income, or consolidation
- ensure a deduction is not denied for a payment that funds a mismatch where the mismatch is not due to hybridity, and
- introduce two cross references into section YA 1 for terms defined in section FH 15(1) ("hybrid entity" and "hybrid mismatch").

Application date

With the exception of new section FH 11(4), the amendments generally apply for income years beginning on or after 1 July 2018 (when the hybrid and branch mismatch rules generally applied from). However, if a person takes a tax position for an income year beginning before 30 March 2022 in relation to the amended provisions in reliance on the unamended law, the changes do not apply in relation to that position.

New section FH 11(4) applies for payments made in income years beginning on or after 1 January 2020.

Detailed analysis

Denying deductions for charges that import the benefit of a hybrid mismatch into New Zealand

The amendments clarify that deductions generated by charges to branches[77] in New Zealand can be denied under the imported mismatch rule where the charge shifts the benefit of a hybrid mismatch into New Zealand.

[76] OECD. (2015). *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 – 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris at [234].

[77] Typically, charges to branches are for cost of goods sold or interest on a notional loan.

New section FH 11(1) replaces the opening text of the current section, which describes the payment or charge for which a deduction can be denied under the imported mismatch rule. The subsection excludes payments to, or charges made by, a person in a country that has hybrid mismatch legislation.

Paragraphs (a) and (d)–(g) of section FH 11(1B) replace current paragraphs (a)–(e) of section FH 11(1). Table X provides details about each paragraph.

Table 2: Commentary on proposed paragraphs (a)–(g)

Paragraph(s)	Comment	Equivalent former paragraph
(a)	Paragraph (a) requires that the original payment or charge provides funds for a payment (the funded payment). Whether a payment or charge "provides funds" for a funded payment is determined consistently with the approaches described in chapter 8 of the Hybrid Mismatch Report and chapter 5 of the Branch Mismatch Report (see section FH 11(5)).	(a)
(b) and (c)	These are new paragraphs and are described under "Chains of payments through jurisdictions with hybrid mismatch legislation" below.	None
(d) and (e)	Paragraphs (d) and (e) implement minor amendments to former paragraphs (b) and (c) to ensure they apply correctly to charges.	(b) and (c)
(f)	Paragraph (f) relies on the new definition of "hybrid mismatch". This new definition is described further under the heading "Limiting the rule to mismatches arising from hybridity" below.	(d)
(g)	Paragraph (g) replicates former paragraph (e) but removes reference to the payer jurisdiction. With the new definition of "hybrid mismatch", that reference is now unnecessary. (For more details see "Limiting the rule to mismatches arising from hybridity" below.)	(e)

Chains of payments through jurisdictions with hybrid mismatch legislation

The imported mismatch rule can apply through a chain of any number of payments, any number of jurisdictions and in any direction (that is, up or down a corporate chain, or sideways). The imported mismatch rule has never applied to a payment where any of the following persons are in a jurisdiction that has hybrid mismatch legislation:

- the recipient of the payment from the New Zealand funder
- the person who makes the payment that constitutes the hybrid mismatch (located offshore), or
- except in the case of a double deduction mismatch, the person who receives the payment that constitutes the hybrid mismatch (located offshore).

Under the amendments to clarify the application of the imported mismatch rule to charges, the rule now also does not apply where a non-resident who makes a charge is located in a jurisdiction with hybrid mismatch legislation.

In all these cases, any denial of a deduction in New Zealand would result in over-taxation. This is because the other jurisdiction with hybrid mismatch legislation has priority to either deny deductions or recognise income to counteract the benefit of the mismatch. Further denial of deductions in New Zealand would result in the denial of two sets of deductions in respect of one mismatch and result in over-taxation.

To prevent this over-taxation, the amendment ensures the imported mismatch rule only denies deductions in New Zealand for a payment that provides funds to the funded payment where:

- First, the funds are provided to the payer either directly or indirectly through a series of further transactions (the **intermediate transaction chain**) that are each governed by the tax laws of countries or territories outside New Zealand (section FH 11(1B)(b)). An intermediate transaction chain only comprises transactions further to (that is, other than) the original payment or charge and the funded payment. An intermediate transaction chain could comprise simply one transaction.

- Second, for each transaction in an intermediate transaction chain, each country or territory with tax laws that govern the transaction does not have hybrid mismatch legislation having an intended effect corresponding to section FH 11 (section FH 11(1B)(c)).

In effect, where there is only one intermediate transaction chain and a country governing a transaction along that chain is subject to hybrid mismatch legislation, then the imported mismatch rule would not apply to deny deductions. However, where an original payment or charge provides funds through multiple intermediate transaction chains to the funded payment, the deduction for the original payment or charge could be denied provided that **at least one chain** of transactions satisfies sections FH 11(1)(b) and (c).

New Zealand providing funds to funded payment through a single intermediate transaction chain

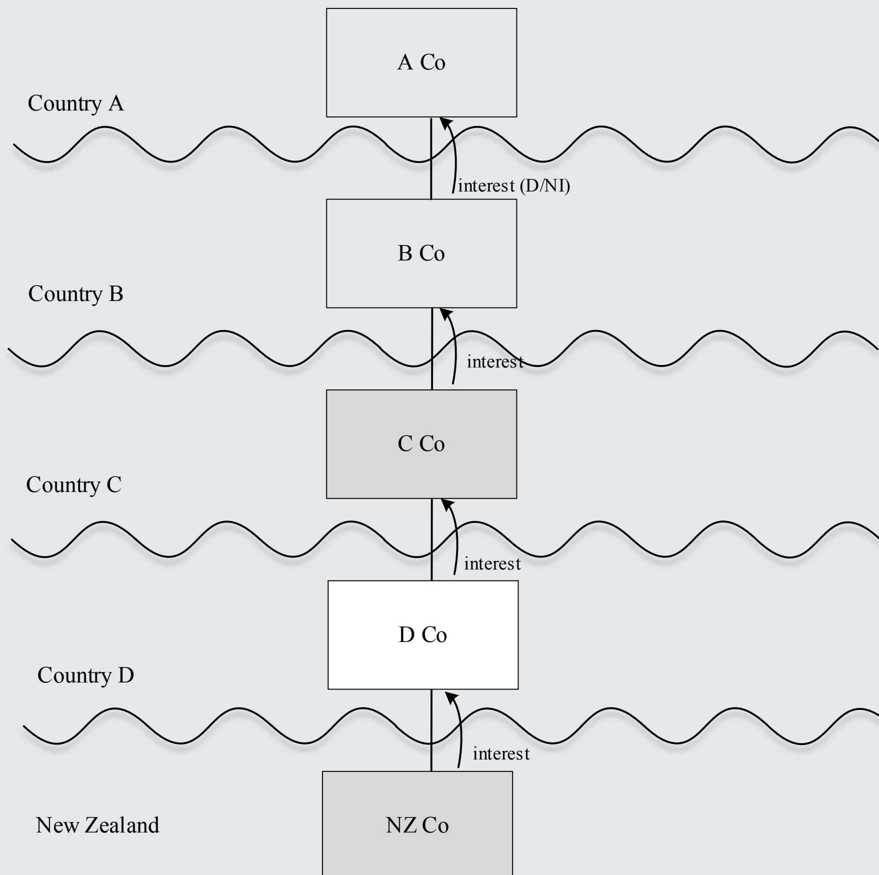
Under section FH 11(1B), where the original payment or charge provide funds for the funded payment through a **single** intermediate transaction chain, and **at least one of those transactions** in the intermediate transaction chain is governed by a country or territory with an imported mismatch rule, then the deduction for the original payment or charge would not be denied in New Zealand. This is demonstrated in example 133.

Example 133

Facts

- A Co, B Co, C Co, D Co, and NZ Co are members of a control group. There is a D/NI outcome (hybrid mismatch) between A Co and B Co – there is a deduction created in Country B, without corresponding income in Country A.
- NZ Co makes a payment to D Co, which provides funds indirectly through transactions (the intermediate transaction chain) from D Co to C Co and from C Co to B Co, to the funded payment (hybrid mismatch) between B Co and A Co.
- C Co is located in Country C, which has hybrid mismatch legislation having an intended effect corresponding to New Zealand's imported mismatch rule (hence it is shaded). Countries A, B and D do not have hybrid mismatch legislation.

Figure 1



Analysis

- Section FH 11(1B)(a) is satisfied as the payment from NZ Co provides funds for the funded payment (for the interest payment from B Co to A Co).
- Section FH 11(1B)(b) is satisfied as the funds are provided to B Co indirectly through a series of further transactions (the intermediate transaction chain) that are each governed by the tax laws of countries or territories outside New Zealand. Those transactions are the interest payments from D Co to C Co and from C Co to B Co.
- However, section FH 11(1B)(c) is not satisfied as at least one transaction in the intermediate transaction chain is governed by a country (Country C) that has an imported mismatch rule.
- The deduction for the payment from NZ Co is therefore not denied under the amendments to section FH 11.

New Zealand providing funds to funded payment through multiple intermediate transaction chains

Where the original payment or charge can be said to provide funds indirectly to the funded payment through **multiple intermediate transaction chains**, and **one** of those chains contains a transaction that is governed by a country or territory with an imported mismatch rule, then the deduction for the original payment or charge could (to some extent) still be denied on the basis that the original payment or charge provides funds indirectly through other **intermediate transaction chains to the payer** for the funded payment.

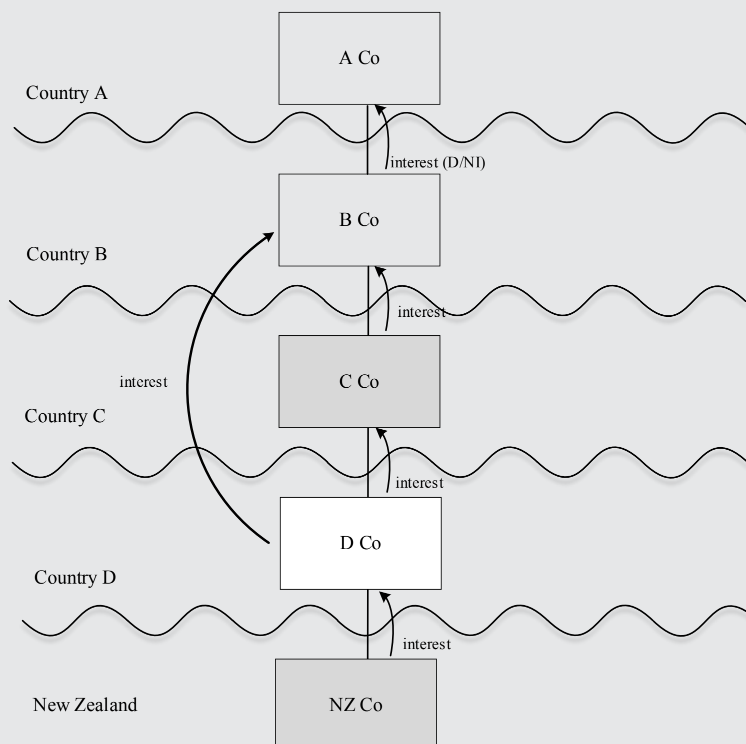
However, the extent to which such a deduction is denied would depend on sections FH 11(4) and (5). This includes first considering whether there is dual inclusion income in the payer jurisdiction,[78] and then second considering the tracing and priority rules provided in the Hybrid Mismatch Report and the Branch Mismatch Report (as is done under current legislation). The extent of the denial under New Zealand's imported mismatch rule may depend on, for example, whether priority to deny a deduction is given to another country's imported mismatch rule (for example, where another country is more proximate to the hybrid mismatch and triggers the direct imported mismatch rule) and therefore deductions in New Zealand should be partly or wholly allowed. This is demonstrated in example 134

Example 134

Facts

The facts are the same as in example 133 except that D Co also makes a direct interest payment to B Co.

Figure 2



[78] See the heading "Imported mismatches and dual inclusion income", describing an amendment to provide that deductions should not be denied under New Zealand's imported mismatch rule to the extent a 'hybrid payment' (in New Zealand, a 'funded payment') is set off against dual inclusion income in the payer jurisdiction.

Analysis

- Section FH 11(1B)(a) is satisfied as the payment from NZ Co provides funds for the funded payment (from B Co to A Co).
- Section FH 11(1B)(b) is satisfied as the funds are provided to B Co indirectly through a series of further transactions (the intermediate transaction chain) that are each governed by the tax laws of countries or territories outside New Zealand. Here, NZ Co provides funds indirectly through **two** intermediate transaction chains:
  - **Chain 1**: From D Co to C Co and from C Co to B Co (to the hybrid mismatch between B Co and A Co).
  - **Chain 2**: From D Co to B Co (to the hybrid mismatch between B Co and A Co).
- Section FH 11(1B)(c) is satisfied where **for each** transaction in **at least one** of the intermediate transaction chains described above, **each** country or territory with tax laws that govern the transaction does not have **an imported mismatch rule**.
  - **Chain 1**: Country C governs both of the transactions that comprise Chain 1. Country C has an imported mismatch rule, so paragraph (c) is not satisfied in respect of Chain 1.
  - **Chain 2**: Countries B and D govern the single transaction that comprises Chain 2. Neither of Countries B or D have an imported mismatch rule, so paragraph (c) is satisfied.
- Provided all other requirements in section FH 11(1B) are met, then section FH 11(2) will deny a deduction in New Zealand for an amount (which could be zero).
- The amount of those denied deductions (if any) is determined according to sections FH 11(3)-(5) as appropriate. This includes using the tracing and priority rules as provided in the Hybrid Mismatch Report and Branch Mismatch Report.
  - In this example, the direct imported mismatch rule provided in the Hybrid Mismatch Report would require that Country C first deny the deductions.

If the direct imported mismatch rule as applied by Country C does not fully neutralise the effect of the mismatch, then deductions for the original payment or charge would be denied in New Zealand sufficient to neutralise the effect of the mismatch.

Tracing through loss grouping, group contributions of income, and consolidation

Section FH 11(5) allows tracing through tax grouping regimes. The subsection provides that whether a payment or charge by a funder "provides funds" for a funded payment under section FH 11(1B)(a) is determined consistently with the approaches described in chapter 8 of the Hybrid Mismatch Report and chapter 5 of the Branch Mismatch Report. This would include determining whether there is a chain of payments (that is, an intermediate transaction chain) that establishes the original payment or charge provides funds indirectly to the funded payment.

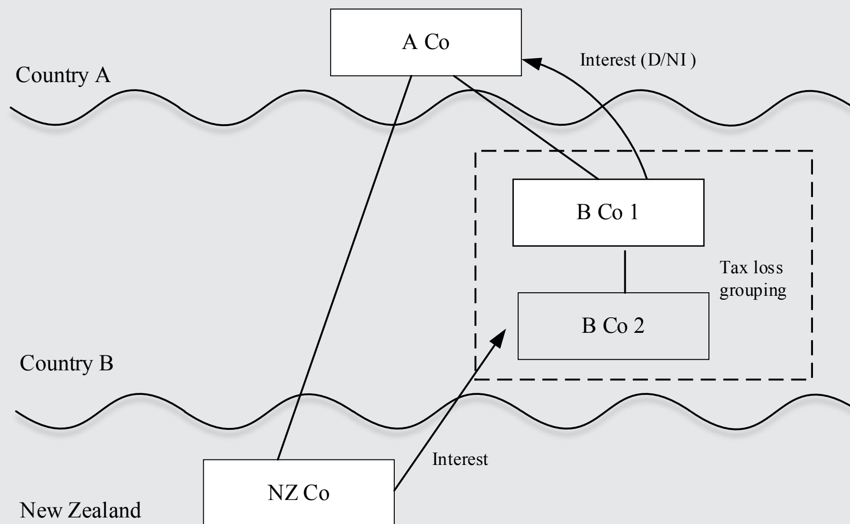
Those report chapters provide various methods for determining the payments that can be traced out from the hybrid mismatch and subsequently denied under an imported mismatch rule; such payments being called "hybrid deductions". This essentially provides a method for tracing chains of payments from a hybrid mismatch out to, for example, New Zealand. A "hybrid deduction" is described in the Hybrid Mismatch Report (at [243]) as including hybrid deductions that are "surrendered to a group member under a tax grouping regime". Further, examples 8.10 and 8.14 in the Hybrid Mismatch Report provide examples of the effect of such loss surrendering and the required tracing method.

Section FH 11(5) includes any type of tax grouping regimes, including loss grouping, income grouping (under regimes providing for group contributions of income), and consolidation regimes. The amount by which the New Zealand original payment or charge funds the funded payment is to be determined consistently with the Hybrid Mismatch Report.

The application of section FH 11(5) is demonstrated in example 135.

Example 135

Figure 3



Tax loss grouping in Country B allows the benefit of the D/NI outcome to erode the New Zealand tax base:

- There is a D/NI outcome between A Co and B Co 1 – a deduction created in Country B, without corresponding income in Country A.
- The tax loss grouping available in Country B allows B Co 1's loss (generated from the deduction from the D/NI outcome) to be offset against B Co 2's income (generated from the payment from NZ Co). The payment from NZ Co to B Co 2 generates a deduction in New Zealand.
- Overall, deductions are generated in New Zealand with no income elsewhere in the world. No income is generated in Country A, the income and deductions in Country B offset each other, and a deduction is generated in New Zealand.

Similar analysis applies where B Co 1 and B Co 2 are subject to a consolidation regime or where a group contribution of income from B Co 2 to B Co 1 is allowed.

Imported mismatches and dual inclusion income

The Hybrid Mismatch Report indicates that deductions should not be denied under the imported mismatch rule to the extent a "hybrid payment" (in New Zealand, a "funded payment") is set off against dual inclusion income (similar to surplus assessable income in section FH 12). New Zealand's imported mismatch rule has always implemented this for structured arrangements through section FH 11(3)(b).

The amount of a denied deduction under section FH 11(3)(b) is equal to the amount of the funded payment that, if hybrid mismatch legislation were applied by the payer jurisdiction, would be disallowed as a deduction against income or equivalent tax relief. In other words, if the payer jurisdiction applied a dual inclusion income rule and some or all of the deductions in the payer jurisdiction would not be denied in such a situation, then some or all of the deductions in New Zealand under the imported mismatch rule would also not be denied.

However, section FH 11(3)(b) only applies for structured arrangements (being arrangements priced assuming the existence of a hybrid or intended to rely on, or produce, a hybrid). No similar rule exists for unstructured arrangements.

Section FH 11(5) provides a test for unstructured arrangements similar to that provided in section FH 11(3)(b).

Section FH 11(6) allows a carry forward of denied deductions to a later year when there is excess dual inclusion income. It provides that a deduction denied under the imported mismatch rule is allowed in a later income year to the extent that:

- the payer jurisdiction would allow a deduction for the funded payment in the later income year if hybrid mismatch legislation were applied by the payer jurisdiction
- the funded payment is funded by the denied deduction, and
- the denied deduction meets the requirements of section FH 12(8) to be carried forward to the later income year as a mismatch amount.

The amount allowed in New Zealand is proportional to the amount of deduction that is allowed in the payer jurisdiction. For example, assume the funded payment (hybrid mismatch) was $100, of which New Zealand funded $50 (that is, 50%). If $80 of dual inclusion income arose in a later year, the payer jurisdiction would allow a deduction in that year of $80. Given that the extent of New Zealand's funding of the funded payment (hybrid mismatch) was 50%, then a $40 deduction is allowed in New Zealand.

($50 × $80/$100 = $40)

Limiting the rule to mismatches arising from hybridity

The current definition of "hybrid mismatch" could deny deductions for New Zealand payments that fund offshore payments that receive different tax treatments in different jurisdictions for reasons other than hybridity. For example, the jurisdiction receiving the hybrid payment may have no corporate income tax regime or have a territorial tax regime. Denying deductions in these situations is inconsistent with the intention of the Hybrid Mismatch Report, which was to only address mismatches that arise due to the different tax characterisations of instruments or entities.

The new definition of "hybrid mismatch" mitigates these concerns by using New Zealand's hybrid and branch mismatch rules to determine whether a payment from a jurisdiction (the payer jurisdiction) is a hybrid mismatch. If an amount of a deduction for a payment would be denied by the payer jurisdiction if that jurisdiction had legislation having an effect corresponding to New Zealand's hybrid and branch mismatch rules, then a hybrid mismatch arises. Practically, this requires consideration of whether the deduction would be denied under New Zealand's hybrid and branch mismatch rules if the payer was in New Zealand.

If the payer jurisdiction does, in fact, have hybrid mismatch legislation that counteracts the relevant mismatch in that jurisdiction, then no deduction exists in the payer jurisdiction, and therefore no "hybrid mismatch" will arise for the purposes of New Zealand's imported mismatch rule. As a result of this approach, references to counteraction by the payer jurisdiction in former section FH 11(1)(e) have been removed from the new equivalent section FH 11(1B)(g).

Early payment discount rate change

Section RC 38 of the Income Tax Act 2007

The rate of the early payment discount (EPD) has been changed from 6.7% to match the use of money interest (UOMI) credit rate plus 200 basis points.

Background

The EPD is intended to encourage early payment of provisional tax to relieve the financial strain associated with having to pay both terminal tax and provisional tax in the second year of business.

The rate was set at 6.7% when it was introduced in 2005 and has not been updated since. Consequently, the discount now provides an excess benefit for qualifying taxpayers. The amendment aligns the EPD rate with the UOMI credit rate plus 200 basis points. The EPD will therefore retain its purpose of incentivising the early payment of provisional tax without representing an excess benefit for taxpayers who receive it.

Application date

The amendment applies to the 2022–23 and later income years.

Restricted transfer pricing remedials

Sections CD 38 and GC 18 of the Income Tax Act 2007

The two remedial amendments to the restricted transfer pricing rules ensure:

- the deemed dividend arising when interest is disallowed under the restricted transfer pricing rules is calculated based on the amount disallowed under those rules rather than on the arm's length amount, and
- the second method of a third-party test for loans with terms of more than five years applies only when there is significant third-party borrowing with terms of more than five years.

Key features

Deemed dividend

When interest is denied under the transfer pricing rules, the additional amount above the arm's length amount is treated as a deemed dividend. However, in some circumstances, the amount of interest deductible under the restricted transfer pricing rules may be less than the arm's length amount of interest. As the legislation previously did not contemplate this, the difference between the arm's length interest and the allowable interest under the restricted transfer pricing rules retained its status as interest (albeit non-deductible to the borrower).

The remedial amendment ensures the rules calculate the amount of a deemed dividend by comparing the actual amount of interest paid with the lower of the amount determined under ordinary transfer pricing rules and the amount determined under the restricted transfer pricing rules.

Third-party test for loans of more than five years

The third-party test to allow terms of more than five years when there is significant third-party borrowing with terms of more than five years previously compared the relevant individual cross-border related borrowing with borrowing from third parties. This test has been amended so it compares the amount of all cross-border related borrowing with borrowing from third parties.

Application date

The deemed dividend amendment applies for income years starting on or after 1 April 2022. The five-year term amendment applies retrospectively from 1 July 2018.

Detailed analysis

Deemed dividend

The general transfer pricing rules in sections GC 6 to GC 14 deny deductions for interest payments for cross-border related-party loans where the interest rate is above the rate for arm's length conditions that would be agreed to by a third party in a comparable transaction.

The restricted transfer pricing rules in sections GC 15 to GC 19 also apply to certain related-party loans between non-resident lenders and New Zealand resident borrowers. The rules alter the terms and conditions of a borrower and/or a loan that are considered when applying the general transfer pricing rules to price the interest and calculate any deductions.

When interest is denied under the transfer pricing rules, the additional amount above the arm's length amount is treated as a deemed dividend by subpart CD.

In some circumstances, such as where there are uncommercial terms or conditions are being ignored, application of the restricted transfer pricing rules may deny a deduction for a portion of the amount calculated as arm's length under the ordinary transfer pricing rules. However, as subpart CD did not contemplate this, the difference between the allowable interest under the ordinary transfer pricing rules and the allowable interest under the restricted transfer pricing rules retained its status as interest (albeit as non-deductible to the borrower). Therefore, the amount of denied interest and the deemed dividend did not match.

Section CD 38(2) has been amended so that the amount of a deemed dividend is determined by comparing the actual amount of interest paid with the lower of the amount determined under the ordinary transfer pricing rules and the amount determined under the restricted transfer pricing rules.

Note, in the Officials' report to the Finance and Expenditure Committee on submissions on the Taxation (Annual Rates for 2021–22, GST, and Remedial Matters) Bill, officials agreed with submitters that clear guidance should be provided as to the interaction of the deemed dividend rules and the non-resident withholding tax rules. This guidance has not been provided in this edition of the Tax Information Bulletin. This is because there is a legal matter pending which might affect the accuracy of any guidance issued now. Officials will provide clear guidance on the interaction between these rules when this matter is settled.

Third party test for loans of more than five years

The Taxation (Annual Rates for 2020–21, Feasibility Expenditure, and Remedial Matters) Act 2021 amended section GC 18(4) to introduce a second method to allow a cross-border related borrowing to have a term of more than five years. This is provided the term of cross-border related borrowing is less than the weighted average term of third-party borrowing. As with other parts of the restricted transfer pricing rules, this is only available when there is significant third-party debt. The reason for this is to prevent a borrower having a small amount of expensive third-party debt and using that to justify a large amount of expensive related-party debt.

As enacted, the amendments to section GC 18(4) allowed terms of more than five years when the amount of the cross-border related borrowing is less than four times the amount of third-party borrowing. However, this test applied to each cross-border related borrowing at the time the interest rate was being determined. This made it possible for a borrower to have multiple cross-border related borrowings that were each individually below the four-times threshold but, when viewed collectively, were above the threshold. This was not intended.

The amendment has changed section GC 18(4)(b)(ii) so that the relevant test is applied to the total value of all cross-border related borrowing rather than only the specific cross-border related borrowing for which the terms and interest rate are being determined.

Example 136: How the second method operates

The worldwide group that includes NZ Sub Co has third-party borrowing of NZ$1m and a weighted average term of 8 years. The foreign parent, Non-resident Co, has provided NZ Sub Co with a loan of NZ$3m with a term of 6 years. Although the term is greater than 5 years, no adjustment is required under section GC 18 as the loan to NZ Sub Co is less than the average term of third-party borrowing and the amount is less than four times the amount of third-party borrowing.

Non-resident Co provides a second loan of $2m to NZ Sub Co with a term of 6 years. Before the current amendment, no adjustment would have been required under section GC 18 as the term is less than the average term of third-party borrowing and the amount is less than four times the amount of third-party borrowing.

However, when considered together, the two loans have a total amount of $5m and an average term of 6 years. Under the current amendments, as the total of $5m is more than four times the third-party borrowing of $1m, NZ Sub Co will not be able to rely on this method to prevent an adjustment to the term of the second loan. It can consider whether the original method would allow it to retain the 6-year term.[79]

Depreciation cost base integrity measure

Section EE 40 of the Income Tax Act 2007

The amendments ensure that the depreciation cost base integrity measure in section EE 40 of the Income Tax Act 2007 applies to non-residential buildings that were transferred to an associate when depreciation on non-residential buildings was 0%.

Background

The cost base that may be used for depreciation purposes where a purchaser has acquired depreciable property from an associated vendor is restricted to the cost of the property to the associate under section EE 40(7). This is an integrity measure to prevent the purchaser from claiming more depreciation than was available to the associated vendor.

The restriction applies where the associated vendor was allowed a deduction for an amount of depreciation loss for the item either in the year it was transferred to the purchaser or in the previous income year (sections EE 40(2) and (3)).

Non-residential buildings were depreciable at a rate of 0% from the 2011–12 income year until the start of the 2020–21 income year.

Prior to the current amendments, it was arguable that the cost base restriction did not apply to a non-residential building sold to an associate during the years where non-residential buildings were depreciable at 0%, as the associated vendor was not allowed a deduction for an amount of depreciation loss for the building. It was not intended that the cost base restriction would not apply because the depreciation rate was set at 0%. The amendments address this issue.

Key features

Sections EE 40(2) and (3) have been amended to ensure that the depreciation cost base restriction in section EE 40(7) applies where an associated vendor would have been allowed a deduction for an amount of deprecation loss for a non-residential building if the depreciation rate had not been 0%.

Application date

The amendments apply for the 2011–12 and later income years.

[79] Refer to page 24 of the BEPS Interest Limitation Special Report for detail on how the first method operates.

Foreign currency loans that finance residential rental property in a foreign jurisdiction

Section EL 3 of the Income Tax Act 2007

The definition of "residential income" has been amended to include income that a person derives from a foreign currency loan to the extent the loan finances their residential portfolio.

Background

Deductions relating to a foreign currency loan that finances a residential rental property, including foreign exchange losses, are ring-fenced by section EL 4. However, foreign exchange gains on the same loan in a subsequent period could not previously be offset against the ring-fenced deductions because this income was not included in the definition of "residential income" in section EL 3. The amendment to the definition addresses this issue.

Key feature

Income that a person derives from a foreign currency loan under section CC 3 is residential income for section EL 3 to the extent the loan finances the person's residential portfolio.

Application date

The amendment applies for the 2022–23 and later income years.

Fringe benefit tax – unclassified benefits paid by associates

Section RD 45 of the Income Tax Act 2007

Unclassified benefits paid by an employer's associate to that associate's employees are excluded from the calculation of the de minimis concession for fringe benefit tax (FBT) when the employer and their associate are not part of the same commonly owned group (as defined in section IC 3 of the Income Tax Act 2007 (ITA)).

Background

Section RD 45 of the ITA provides that if the amount of unclassified benefits provided by an employer falls below a de minimis concession, then FBT does not apply. An employer is only liable to pay FBT on unclassified benefits if they exceed $300 per individual employee per quarter or $22,500 of total benefits in four consecutive quarters.

Section RD 45(6) expanded the meaning of "employer" to include persons 'associated' with the employer within the relevant period. This was intended to prevent benefits being provided by an associated employer or to employees of an associate, rather than directly, to effectively increase the amount of unclassified benefits being paid while remaining under the de minimis concession.

However, benefits paid by an employer's associate to that associate's employees, even where the employer had no connection with or oversight of the benefit, had to be taken into account when determining whether the de minimis in section RD 45 applied to the employer. The amendment addresses this issue.

Key features

The amendment excludes unclassified benefits paid by an employer's associate to that associate's own employees from the calculation of the de minimis concession when the employer and the associate are not part of the same commonly owned group (as defined in section IC 3).

Application date

The amendments apply for the 2022-23 and later income years.

Detailed analysis

New section RD 45 clarifies the categories of unclassified benefits that an employer must take into account when determining if they are liable to pay FBT. The pre-existing categories that have been included in new subsection (4) are:

- unclassified benefits provided by an employer to their employee
- unclassified benefits provided by persons associated, at any time in the relevant period, with the employer to employees of the employer, and

- unclassified benefits provided by the employer to employees of persons associated, at any time in the relevant period, with the employer.

The new category included in subsection (4) is:

- if the employer is a company, unclassified benefits provided by other companies that are part of the same group of companies as the employer, at any time in the relevant period, to employees of those other companies.

This category removes the need for an employer to consider unclassified benefits provided by an associate to the associate's own employees.

Election day worker tax code

Section YA 1 of the Income Tax Act 2007

The definition of "election day worker" has been amended to extend access to the election day worker tax code to advance voting workers.

Background

Election day workers are taxed through the PAYE system at a flat rate of 17.50 cents in the dollar (plus ACC earners' levy). The rationale for this flat rate of PAYE was to simplify withholding for the Electoral Commission in dealing with a temporary workforce.

The previous definition of election day worker applied to "work done or services rendered immediately before, on, or immediately after the day on which the election or poll is held." However, this definition has been outpaced by both the growth in advance voting and the fact that many election workers work throughout the voting period.

Key features

Paragraph (c) of the definition of "election day worker" in section YA 1 of the Income Tax Act 2007 has been amended to apply to a person who works on any days on which voting is held in New Zealand for an election or poll. This replaces the previous definition that only applied to a person who works on election day.

In addition, the terms "Deputy Returning Officer" and "poll clerk" in paragraph (a) of the definition have been replaced with "electoral official" in line with the Electoral Commission's current practice.

Application date

The amendments apply from 1 April 2022.

Detailed analysis

The issue with the previous definition was that the work done, or services rendered, had to be immediately before, on, or immediately after election or polling day. Advance voting can take place several weeks before election or polling day and so most of the work associated with advance voting did not meet this definition.

The amendment decouples the definition from the election day or polling day and links it to days on which voting is held instead. This captures those workers who work immediately before, on, or immediately after days when voting, including advance voting, takes place.

The amendment also specifies that the work must be in relation to voting held in New Zealand. This is to clarify that workers hired to facilitate overseas voting are not intended to be covered.

Approved issuer levy and security trusts

Section RF 12(1)(a)(iv) of the Income Tax Act 2007

The amendment ensures that approved issuer levy (AIL) can still be paid if the approved issuer and the lender are associated only through a security trust.

Background

Under section RF 12, a borrower can pay approved issuer levy (AIL) at the rate of 2% on interest payments to non-residents under registered securities. This is instead of withholding non-resident withholding tax (NRWT) at the rate of 15%. However, payment of AIL is only available if (amongst other things) the borrower and the lender are not associated. Association for this purpose is determined under the general associated person rules. Section RF 12(1)(a)(ii) provides that AIL is still available if the parties are associated only because the lender is a beneficiary of a trust established for the main purpose of protecting and enforcing the beneficiary's rights under the registered security (referred to as a security trust).

However, amendments in 2017 inserted section RF 12(1)(a)(iv). This new section extended AIL unavailability to "related party debts", as defined in section RF 12H. For the purposes of the definition of "related party debt", this included loans between those associated through a security trust. This effectively overrode the exclusion from association for security trusts in section RF 12(1)(a)(ii), making that exclusion ineffective. This was not intended.

Key features

Section RF 12(1)(a)(iv) has been amended to restore the effectiveness of the exclusion in section RF 12(1)(a)(ii) by providing that AIL may still be paid if the debt is only related party debt because the parties are associated through the lender being the beneficiary of a security trust. The amendment does not provide the ability to pay AIL if the registered security is a related party debt for other reasons. So, AIL will not be payable if the registered security is an indirect associated funding arrangement (section RF 12H(1)(a)(ii)), or the lender is a member of a non-resident owning body that is associated with the borrower (section RF 12H(1)(a)(iii)), or the borrower and lender are associated for other reasons.

Application date

The amendment applies retrospectively from 30 March 2017 (being the date section RF 12(1)(a)(iv) came into effect).

Electing into the securitisation regime

Section HR 9BA(1) of the Income Tax Act 2007

Taxpayers can elect into the securitisation regime from the date their securitisation vehicle is formed, rather than waiting until they file a return.

Background

Under the securitisation regime in sections HR 9 – HR 10 and HZ 9 – HZ 10, the originator of debt assets is treated as still owning those assets for tax purposes following their transfer to a special purpose vehicle (SPV). This allows the SPV to be tax neutral (that is, have no net tax obligations). The securitisation regime requires the originator, rather than the SPV, to satisfy all the tax obligations relating to the transferred debts. This means the originator must withhold and pay any non-resident withholding tax (NRWT) or approved issuer levy (AIL) on the interest payments by the SPV.

Currently, an originator elects into the securitisation regime when it files its tax return for the year in which it transferred the relevant assets to the SPV and the election has effect for that year and future years. For NRWT and AIL (which are usually payable monthly), the election effectively applies retrospectively to the start of the income year. This was intended to avoid the need for a separate election process and reduce compliance costs. However, relying on the originator to elect into the securitisation regime in its tax return for the year exposes the SPV to the risk of unpaid tax, plus interest and penalties, if the election is not made.

Key features

The amendment introduces the option for the originator to elect into the regime before they file their first return. This election can be made at any time after the formation of the SPV, but before the return is filed for the year in which the originator transferred the relevant assets to the SPV.

There is no prescribed form or method for the election, but it must be made in writing (including by way of an email or an entry in MyIR) rather than verbally.

Application date

The amendment came into force on 30 March 2022.

Tax pooling and early payment discount settings

Sections RC 40, RP 17 and RP 19 of the Income Tax Act 2007

Four remedial amendments have been made to tax pooling and early payment discount (EPD) settings. These amendments:

- allow the use of tax pooling to mitigate use of money interest (UOMI) in the first year as a provisional taxpayer
- allow purchased tax pooling funds to qualify for the EPD
- restore the link between sections RP 19(2) and RP 19(3) of the Income Tax Act 2007 (ITA), and
- extend the definition of "small-business person" to include the shareholder of a look-through company.

Background

Mitigating UOMI

Under previous settings, non-safe harbour taxpayers (those with residual income tax of more than $60,000) could not use purchased tax pooling funds to mitigate UOMI in their first year as a provisional taxpayer. This was contrary to the policy intention.

The availability of tax pooling was intended to reduce exposure to UOMI if there is uncertainty over the correct tax liability at the due date. As tax pooling is limited to satisfying taxpayer 'obligations' (section RP 17) and initial provisional taxpayers are not "obliged" to pay provisional tax (section RC 3(3)) then they could not use purchased tax pooling funds to reduce exposure to UOMI.

Section RP 19(3)(a) has been amended to allow for a date to be nominated that is no earlier than the first day of the relevant income year. This allows non-safe harbour taxpayers to purchase tax pooling in their first year as a provisional taxpayer

Use of tax pooling to get the EPD

In 2009, tax pooling was extended beyond provisional tax to include terminal tax. Consequently, a taxpayer who has no obligation to pay provisional tax (and therefore may qualify for an EPD) will still have an obligation to pay terminal tax, and tax pooling can be used to "meet an obligation" to pay that terminal tax (section RP 17).

Such taxpayers qualify for the EPD if their income tax is paid before balance date and they use their own deposited tax pooling funds to qualify for the discount. This is on the basis that tax pooling can be used to meet an obligation to pay terminal tax, and for own-deposited funds the credit date under section RP 19(3) is the date the funds were deposited.

However, the earliest credit date for purchased funds is the terminal tax date, so purchased funds would not qualify for the EPD.

Previously, non-safe harbour taxpayers were generally able to use tax pooling and were credited with an EPD. However, following Inland Revenue's Business Transformation, a transfer with a backdated effective date was no longer recognised for the purposes of the EPD if the date the transfer was processed was after the taxpayer's balance date.

The amendment to section RP 19 reinstates the previous position, which is considered the right policy outcome.

Aligning disjointed provisions

In 2011, section RP 19(3) was updated to prevent an unintended ability to use tax pooling funds to eliminate imputation credit account debit closing balances. However, section RP 19(2) was not updated at the same time, and this resulted in the sections not making sense when read together.

The link between the sections has now been restored by amending section RP19(3) to make it clear that purchased tax pooling funds can be transferred with an effective date that is on or after the first day of the relevant income year.

Including look-through companies in the definition of "small-business person"

Section RC 40 of the ITA contains some definitions for the EPD, including that it applies to a person who is self-employed or a partner in a partnership. The section was not updated to include look-through companies (LTCs) following their introduction.

As the revenue in an LTC flows through to the owners as if it was their own income, much like in a partnership, it follows that an LTC should also be included in the definition.

Application date

The amendments apply to the 2019-20 and later income years.

Custodial institutions: definition of end investor

Section RE 10C(7) of the Income Tax Act 2007; section 25MB(8) of the Tax Administration Act 1994

The definition of an "end investor" has been amended to ensure that custodial institutions that operate a New Zealand branch are able to access the relaxed reporting and withholding obligations for custodial institutions.

Background

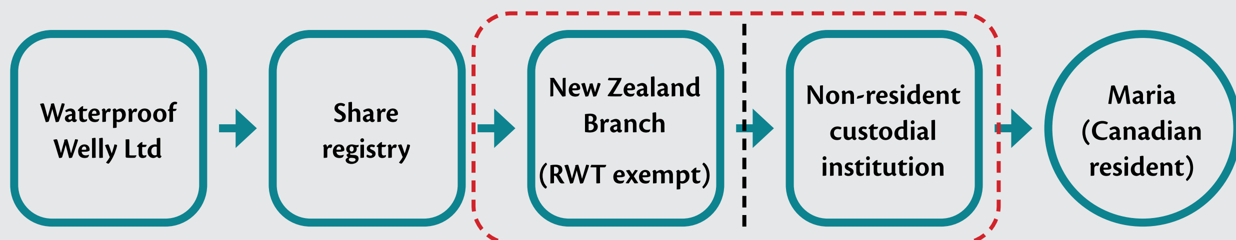
Custodial institutions act as a conduit between the payer of investment income and the ultimate owner of that income. New rules to clarify the investment income withholding and reporting obligations imposed on custodial institutions were introduced by the Taxation (KiwiSaver and Student Loans) Act 2020 with effect from 1 April 2020. The rules provide for some relaxations of the strict requirements of the general withholding and reporting rules.[80]

The general rules place the obligation for withholding tax and reporting to Inland Revenue on the custodial institution that pays or transfers investment income to an end investor. An end investor can be resident or non-resident and may be a person or an entity. Where the income passes to a non-resident custodial institution, these reporting and withholding obligations are relaxed.

Some custodial institutions operate their New Zealand business by way of a fixed establishment in New Zealand. It is intended that, in all cases, the New Zealand business should withhold tax and report to Inland Revenue when it pays or transfers investment income to an end investor. However, the New Zealand fixed establishment is not a separate legal person from the overseas parent. As fixed establishments are currently excluded from the definition of an end investor, those custodial institutions that use this business model are unable to access the relaxations of the rules available to others. The amendments align the rules with the policy intent.

Example 137: New Zealand branch of a non-resident custodial institution

Maria, a Canadian tax resident, has invested in a managed fund, which is not resident in New Zealand. The fund makes investments in New Zealand via its New Zealand branch. One of the investments in Maria's portfolio is in Waterproof Welly Ltd, a New Zealand manufacturer of hardy urban footwear.



Under the previous rules, the withholding and reporting obligation would strictly fall on the share registry, as the branch is a non-resident of New Zealand. The amendment clarifies that notwithstanding the branch's residence status, the branch is required to withhold and report. The branch is also able to access the relaxed withholding and reporting requirements when making the payment offshore.

Application date

The amendments apply for the 2020–21 and later income years.

Corporate spin-outs and shareholding continuity

Section YC 13 of the Income Tax Act 2007

Amendments have been made to prevent a spun-out company from breaching shareholder continuity requirements due to a corporate spin-out when there has been no change in ultimate ownership.

[80] See *Tax Information Bulletin*, Vol 32, No 4, May 2020, pp 95-101

Background

For the purposes of section YC 13, a spin-out involves the shareholders in a parent company (the original parent) acquiring the shares in a subsidiary of the original parent (the spun-out company). Prior to the amendments, section YC 13 only addressed shareholding continuity problems for subsidiaries of a spun-out company that were caused by a spin-out. However, tax losses and credits of the spun-out company itself could still be lost because of a spin-out even though, from an economic viewpoint, no change in ownership occurred (because the company retained the same ultimate shareholders). The amendments address this issue.

Key features

New section YC 13(1B) treats the notional single person that holds an interest in a spun-out company after a spin-out as holding the original parent's interest in the spun-out company before the spin-out.

Application date

The amendments apply from 30 March 2022.

Detailed analysis

Clarification of form of spin-out

Section YC 13 applies to a form of spin-out described in section YC 13(1). New section YC 13(1)(db) clarifies that, in this form of spin-out, a notional single person will be treated as holding a voting interest or market value interest in the spun-out company after the spin-out under section YC 10.

Rule for ownership of a spun-out company

New section YC 13(1B) addresses shareholding continuity problems for a spun-out company in a similar way to how section YC 13(2) currently addresses these problems for a subsidiary of a spun-out company.

Under the new provision, the notional single person that holds an interest in the spun-out company after a spin-out is treated as holding the original parent's interest in the spun-out company before the spin-out. However, this treatment only applies to the extent a group of persons exists who hold common interests in the original parent and the spun-out company immediately after the spin-out, calculated on the assumption that the only interests in those companies are those treated as held by a notional single person under section YC 10.

Share-for-share exchanges and available capital distribution amount

Section CD 44(7B) of the Income Tax Act 2007

The calculation of the available capital distribution amount (ACDA) arising when a company (Acquirer) disposes of shares in another company (Target) acquired in a share-for-share exchange to a non-associated party has been amended. The ACDA is increased by the amount that was excluded from Acquirer's available subscribed capital (ASC) by section CD 43(10) when those shares were acquired. This allows a distribution of the same amount to not be treated as a taxable dividend upon the liquidation of Acquirer.

Background

A share-for-share exchange is when the shareholders of a company (Target) transfer ownership of Target to another company (Acquirer) in exchange for shares in Acquirer. Two common applications of a share-for-share exchange are: internal restructuring to insert a holding company; and mergers/acquisitions where Acquirer purchases Target from a third party and issues its own shares to Target's former shareholders, rather than paying cash.

Generally, when property is contributed to Acquirer in exchange for shares, Acquirer's ASC is increased by the value of the property at the time of the contribution. This amount can be distributed tax free on a share repurchase or liquidation of the company.

However, if the property is shares in another company (Target), this is undesirable. For example, suppose Target is worth $500, and it has ASC of $100 and retained earnings of $400. If, by simply contributing Target to Acquirer, the contribution of Target's shares to Acquirer increased Acquirer's ASC by $500, the $400 of retained earnings would be able to be distributed tax free (first as an exempt intercorporate dividend from Target to Acquirer, then as a liquidating distribution of ASC or share repurchase by Acquirer to its shareholders).

To prevent this outcome, sections CD 43(9) and (10) limit the ASC of the shares issued by Acquirer to the ASC of the contributed shares in Target ($100 in the above example 137). This is known as the share-for-share ASC limitation.

However, this response created a flow-on problem if Acquirer sold Target and was later liquidated. This problem is easiest explained as a sequence of transactions:

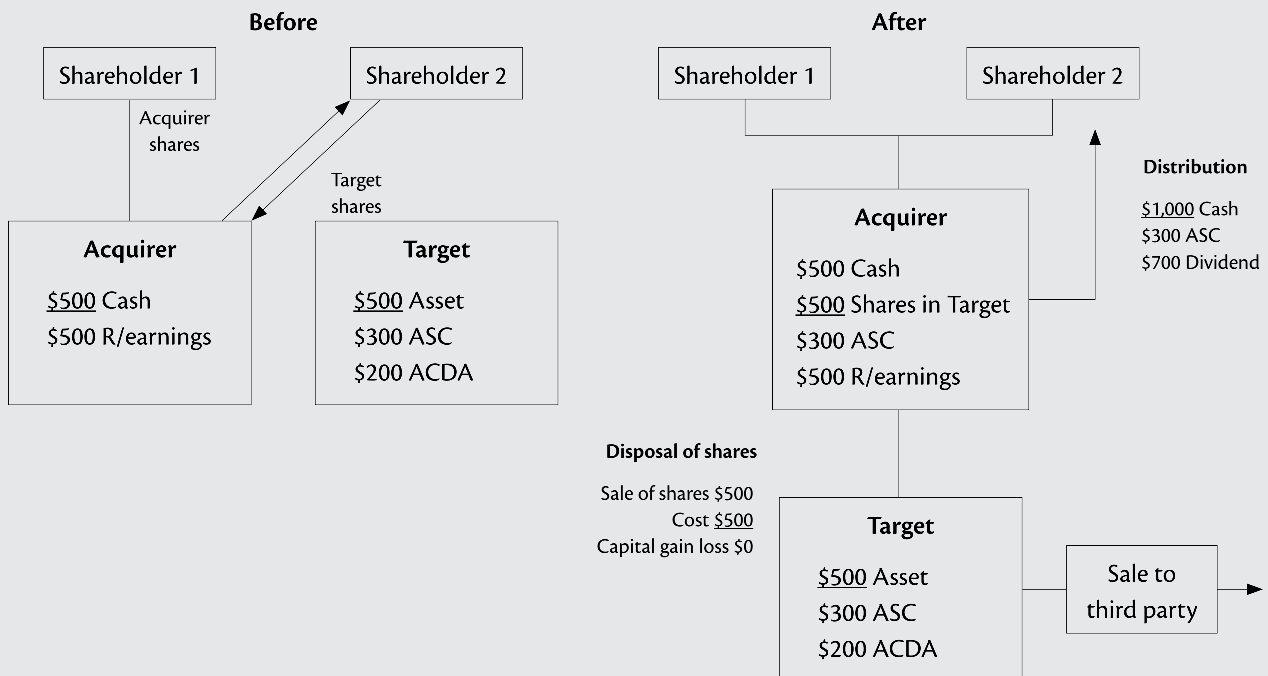
- The first transaction was a share-for-share exchange, where Acquirer acquires shares in Target from the Target shareholders in exchange for the issue of shares in Acquirer to the Target shareholders. The ASC of the issued shares is limited to the ASC of the Target shares under sections CD 43(9) and (10). The problem arose only if the ASC of the Target shares was less than their value (which it usually is).
- The second transaction was the sale of Target by Acquirer. The gain or loss from this sale was measured by comparing the sale price with the value of the Target shares when they were acquired by Acquirer in the share-for-share exchange.
- The third transaction is the liquidation of Acquirer. This was the point at which the problem arose. Because of the ASC limitation referred to in the first transaction above, the Acquirer shareholders were taxed on the liquidating distribution to the extent that it was funded out of the sale of Target and the sale proceeds recovered the cost of the Target shares in excess of Target's ASC. This meant the Acquirer shareholders were taxed more heavily on the liquidating distribution than if the share-for-share exchange in the first transaction had not occurred, in which case the Target shareholders would have either liquidated or sold Target directly.

This is explained further in the following example.

Example 138: Problem under previous law

Acquirer has $500 retained earnings and $500 cash. Target has $300 ASC and $200 capital gain. If Acquirer was liquidated, Shareholder 1 would receive a $500 taxable dividend. If Target was liquidated, the $500 distributed to Shareholder 2 would be $300 ASC and $200 ACDA, so there would not be a taxable dividend.

Instead, Target is acquired in a share-for-share exchange with Shareholder 2 on capital account. Target is subsequently sold to a third party for $500. Acquirer is liquidated immediately thereafter.



Acquirer's ACDA is $0. The $1,000 distributed would be $300 ASC and $700 taxable dividend. Taxable dividends are $200 higher than if the share-for-share exchange had not occurred.

This problem is addressed by new section CD 44(7B).

Key features

A component of the ACDA calculation is capital gains. Capital gains arise under section CD 44(7) and include the disposition of capital property for more than the cost of the property to the company (subsection (a)) and a capital gain distributed by a subsidiary upon its liquidation (subsection (c)).

New section CD 44(7B) provides for an additional capital gain amount equal to the amount that was excluded from Acquirer's ASC under current section CD 43(10). This amount arises when Acquirer sells some or all of its shares in Target to a third party.

Application date

The amendment came into force on 30 March 2022. It therefore applies to distributions upon the liquidation of an Acquirer on or after that date, which may include distributions arising from the proceeds of the sale of shares in Target before that date.

Detailed analysis

When a shareholder is paid an amount in relation to a share on liquidation of a company, section CD 26 provides that the amount paid is a taxable dividend only to the extent to which it is more than the ASC per share calculated under the ordering rule and the ACDA per share.

The ACDA per share is calculated by applying the formula in section CD 44(1):

(receipt − ASC per share) × (capital gains + (capital property distributed − cost) − capital losses) ÷ (total receipts − total ASC)

For the purposes of this formula, sections CD 44(7)(a) and CD 44(9) provide that "capital gains" and "capital losses" include a gain or loss on disposal of capital property.

Although the ASC limitation in sections CD 43(9) and (10) reduces the additional ASC to Acquirer from the share-for-share exchange, it does not impact the cost of the Target shares, which will be equal to their market value. This means if Acquirer sells Target, its capital gain will only be equal to the increase in share value since the share-for-share exchange. This effectively means Acquirer's shareholders will be taxed when the proceeds from the sale of Target shares are distributed, even though this would partially be a recovery of the cost.

While removing the ASC limitation would have allowed these amounts to be distributed tax free to Acquirer's shareholders, it would also have allowed these amounts to be distributed tax free without selling Target or liquidating Acquirer. This would have placed Acquirer's shareholders in a better position than if the share-for-share exchange had not occurred.

Instead, the amendment creates an additional capital gain that flows through to the ACDA formula shown above. This allows any gains that could have been derived by Target's former shareholders by selling their shares in Target to be distributed tax free as ACDA to Acquirer's shareholders instead. This capital gain arises only when all the following requirements are met:

- Target has been acquired by Acquirer in a share-for-share exchange that meets the requirements of section CD 43(9)
- Acquirer's ASC uplift has been limited by section CD 43(10), and
- Acquirer has subsequently sold shares in Target to a third party.

Debt remission within an economic group

Sections CD 5, CD 43, CD 44, DV 18B, EW 46C, FO 21 and YA 1 of the Income Tax Act 2007

Remedial amendments have clarified the related party debt remission rule in section EW 46C of the Income Tax Act 2007 and other associated provisions.

Background

Generally, when debt is remitted, the debtor derives taxable income to reflect that they are better off by the amount of debt they no longer have to pay. An exception to this is the related party debt remission rule. This rule provides that, in some circumstances, debt forgiven within an economic group is not income for the person who owes the debt (the debtor). This leads to the correct result, as bad debts are not deductible to an associated party creditor. There is therefore no income for the debtor and no deduction for the creditor, which reflects that net worth is unchanged from the remission when considered on a group basis.

Three remedial amendments have been made to ensure that the related party debt remission rule operates as intended.

Key features

The amendments clarify the rules for debt remission within economic groups by:

- clarifying that the related party debt remission rule applies to any type of remission, not only forgiveness
- providing an available subscribed capital (ASC) increase to a resident company within a wholly-owned group of companies where a shareholder remits a debt owed by the company (without requiring the company to capitalise the debt), and
- applying the related party debt remission rule to the remission of debt owed by a New Zealand branch of a non-resident company to a member of the same wholly-owned group.

Application date

The first amendment (relating to terminology) applies for a person from 1 April 2008. The exception is section EW 46C, where the amendment applies from the 2008–09 and later income years except for an income year before the 2015–16 income year for which the person takes a tax position in a return of income that is inconsistent with the amendments. This is consistent with the existing application provision for section EW 46C.

The other two amendments apply from 30 March 2022.

Detailed analysis

Use of terminology

The language in the debt remission rule was previously centred around the word "forgiveness". However, the rule has been commonly understood to apply to all types of debt remission (for example, when debt is not forgiven but is remitted by a court order or due to the passing of time). To align with current practice, amendments to section EW 46C have replaced references to "forgiveness" (and its derivatives) with "remission" (and its derivatives).

Available subscribed capital

Where a shareholder of a company remits a debt owed by the company, an increase in ASC is permitted to recognise that the remission of a loan is in substance a capital contribution to the company. Previously, a resident company must have capitalised the debt, but a non-resident was not required to do so in the same circumstances. Section CD 43(6B) has been amended to allow the resident company to obtain an ASC increase where debt is remitted even when no shares are issued.

Remission of debt owed by New Zealand branches of non-residents

The related party debt remission rule has only applied in limited circumstances to debt owed by branches of non-resident companies. Branches located in New Zealand are treated very similarly to New Zealand resident subsidiaries for debts owing. Where a New Zealand branch owes money to an associate that is a New Zealand resident or a non-resident with a New Zealand branch, an asymmetrical outcome arose because no deduction was provided to the creditor, but debt remission income was recognised for the New Zealand branch.

Section EW 46C(1)(a) has been amended to extend the debt remission rule to a New Zealand "fixed establishment", provided it meets the other requirements in the debt remission rule that apply to New Zealand residents. However, this is limited to apply only where the creditor does not receive a deduction on the remission of the debt (in New Zealand or offshore).

Employer superannuation contribution tax on contributions for past employees

Section RD 67 of the Income Tax Act 2007

The employer superannuation contribution tax (ESCT) rate on contributions for past employees has been reduced from 39% to 33%.

Background

In general, ESCT rates are designed to match an individual's marginal income tax rate. However, exceptions exist where it is not practical to do so. While it is not common, some employers continue to make contributions after an individual leaves their employment. In these circumstances, a flat rate applies because an employer will not have up-to-date information for past employees to enable them to match an individual's rate.

When the 39% personal income tax rate was introduced, with effect from 1 April 2021, the rate of tax on employer superannuation contributions made for past employees was increased from 33% to 39%. However, the 39% rate results in over-taxation in nearly all past employee cases. Reverting to a 33% rate is more accurate and poses minimal integrity risk.

Key features

The ESCT rate on contributions for past employees has been reduced from 39% to 33%.

Some employers who make contributions to defined benefit schemes elect to pay a flat rate of ESCT because they wish to avoid the administrative costs of allocating the contributions to specific employees. Employers continue to be able to elect a flat rate of 39% when contributions are to a defined benefit scheme. This rate remains 39% because use of the rate is not mandatory. Employers retain the ability to attribute contributions to defined benefit schemes to specific individuals using the range of ESCT rates.

Application date

This amendment applies from 1 April 2021.

Definition of decommissioning in the petroleum mining regime

Sections LT 1 and YA 1 of the Income Tax Act 2007

The definition of "decommissioning", as used in the petroleum mining rules, has been narrowed by removing the paragraph that referred to exploratory wells. This has been replaced by new provisions for tax credits for petroleum miners.

Background

Since 2018, petroleum miners have been allowed a refundable credit for qualifying expenditure on decommissioning petroleum assets. The purpose of the petroleum refundable credit is to recognise that decommissioning a well is an unavoidable expense from petroleum production, but that cost must be incurred after production has ceased. The refundable credit, therefore, allows that expense to effectively be offset against tax paid in previous years, rather than being carried forward where it may be of limited or no value.

Part of the definition of "decommissioning" in the Income Tax Act 2007 (ITA) referred to plugging and abandoning certain types of wells, including production wells and other wells used in the commercial production of petroleum.

Paragraph (b)(ii) in the definition of "decommissioning" in section YA 1 of the ITA previously extended the scope to exploratory wells that were plugged and abandoned in a permit area together with a commercial well geologically contiguous with the exploratory well. This was intended to cover a situation where a petroleum miner delayed plugging and abandoning an exploratory well in case it was used in the future for water or gas injection (to extend the life of a geologically contiguous production well). The petroleum miner may have been allowed a refundable credit if they decommissioned the exploratory well and the production well together as part of an arrangement.

Exploratory wells are drilled to determine whether petroleum can be extracted in commercial quantities. The cost of plugging and abandoning an exploratory well has a nexus with income and is deductible when incurred. However, there are commercial reasons why a miner may delay permanently abandoning an exploratory well; this can include the potential to use it for another purpose (such as water or gas injection to extend production from a nearby well) or because it is cheaper to abandon it at a later date when a production well is being decommissioned.

An unintended consequence of including exploratory wells in the decommissioning definition was that it was possible for expenditure on plugging and abandoning an exploratory well to be eligible for a refundable credit even if there was never an intention that the well might be used in the production process. This was exacerbated by the fact that the phrase "geologically contiguous" was likely to be a broader term than what was contemplated at the time the definition was introduced.

However, without including certain exploratory wells in the refundable credit, a petroleum miner that delays abandoning an exploratory well may not get the benefit of the deduction for that abandonment expenditure. This is because the miner could have insufficient taxable income after the abandonment expenditure was incurred, and that expenditure may result in a loss carried forward rather than reduce tax payable. This would create a tax incentive for the miner to plug and abandon the exploratory well earlier than would otherwise be economically efficient.

The purpose of the amendments to section LT 1 is to allow the petroleum miner to access a refundable credit for a loss incurred due to plugging and abandoning an exploratory well. This is restricted to exploratory wells that are drilled sufficiently early in the field's lifespan that, had the miner plugged and abandoned the exploratory well as soon as they had finished drilling it, the expenditure would have been offset against taxable income that the miner would otherwise have paid income tax on. Another way of presenting this is the refundable credit is available to the extent income tax has been paid by the miner in income years after the exploratory well was drilled.

Key features

- Paragraph (b)(ii) of the definition of "decommissioning" in section YA 1, which referred to exploratory wells, has been repealed.
- A consequential amendment to paragraph (d)(i) of the "decommissioning" definition removes the term "exploratory well", so that expenditure on monitoring an exploratory well will no longer qualify as decommissioning expenditure.
- Section LT 1 has been amended to increase the tax credit for petroleum miners by an amount relating to qualifying expenditure on an exploratory well.

Application date

The amendments came into force on 30 March 2022.

Detailed analysis

Changes to the definition of "decommissioning"

Paragraph (b)(ii) of the definition of "decommissioning" has been repealed, and there is a consequential removal of the term "exploratory well" from paragraph (d)(i). This means that all expenditure on plugging, abandoning or monitoring the abandonment of an exploratory well will no longer qualify for a deduction under section DT 16 as decommissioning expenditure. This has the following two consequences:

- the expenditure will no longer qualify for a refundable credit under section LT 1(1)(a)(ii), and
- the expenditure will no longer be deductible as decommissioning expenditure under section DT 16.

However, this is not intended to change the amount or timing of deductions available to the miner, as this expenditure will continue to meet the section YA 1 definition of "exploratory well expenditure" that, in paragraph (a), includes "expenditure incurred by a petroleum miner in… abandoning an exploratory well". Exploratory well expenditure is included in the section YA 1 definition of "petroleum exploration expenditure", which remains deductible under section DT 1.

Structure of the refundable credit provision

Changes have been made to the structure of section LT 1 to insert a refundable credit for expenditure on abandoning an exploratory well. These changes are not intended to affect the size or timing of a refundable credit for a miner that has not incurred expenditure on abandoning an exploratory well. They are also not intended to reduce the size of the credit for a miner that has incurred expenditure on both decommissioning a commercial well and an exploratory well when compared with an equivalent miner who has only decommissioned the commercial well.

New section LT 1(1)(a)(iii) has been inserted to cover deductible expenditure incurred during the year on plugging and abandoning an exploratory well. This will include deductible expenditure on an exploratory well that is not intended to qualify for the refundable credit, as this non-qualifying expenditure is covered within the exploration abandonment excess term discussed below. This means that:

- For a miner that had deductible expenditure on abandoning exploratory wells that would have all been included within the previous definition of "decommissioning", the total of amounts under the amended section LT 1(1)(a) will be identical to the amounts under the previous decommissioning definition and the previous section LT 1(1)(a).
- For a miner that had deductible expenditure on abandoning exploratory wells that would not have met the previous definition of "decommissioning", the total of amounts under the amended LT 1(1)(a) will be larger than under the previous decommissioning definition and the previous section LT 1(1)(a).

Section LT 1(2) has been amended to replace "for an amount" with "less than or equal to the amount (the current loss credit)". As well as introducing the term "current loss credit", which simplifies the presentation of section LT 1, this change in wording clarifies that this section has never given the amount of the tax credit, rather it only provides the maximum available credit if the other criteria are satisfied.

The term "post-abandonment tax" has been introduced in section LT 1(4D)(b). This term covers tax paid by the miner, and any consolidated group they are a member of, in income years after drilling for the purposes of exploration ceased in an exploratory well. This calculation is based on the existing calculation of tax paid in previous section LT 1(4)(b) and amended section LT 1(4B), except that those calculations cover all periods, whereas the post-abandonment tax only covers income years since drilling ceased.

The term "exploration abandonment excess" has been introduced in section LT 1(4D). This term reduces the refundable credit when expenditure has been incurred on abandoning an exploratory well where that well was drilled sufficiently late in the field's life that insufficient tax has been paid to cover the deduction for the abandonment expenditure. Exploration abandonment excess cannot be less than zero as it is designed to limit, if necessary, the amount of the refundable credit, not to increase it. Paragraphs (a) to (c) cover three distinct situations as follows:

(a) The miner's net loss is less than or equal to the total of the deductions satisfying section LT 1(1)(a)(i) and (ii). In this case, the limiting factor for the refundable credit is the miner's loss for the year. The miner may not have incurred deductible expenditure on abandoning an exploratory well, or they may have derived some income for the year so that their loss was less than their expenditure that qualifies for section LT 1(1)(a). The existence (or not) of expenditure on abandoning an exploratory well does not increase the refundable credit available in this situation, so exploration abandonment excess will be zero.

(b) The miner's net loss is greater than or equal to the total of the deductions satisfying section LT 1(1)(a)(i) to (iii). In this case, the limiting factor for the refundable credit is the amount of deductions that could qualify for the refundable credit. Therefore, all deductible expenditure on abandoning an exploratory well will, subject to sufficient tax having been paid in prior years, contribute to the refundable credit and an increase (or decrease) in that expenditure would directly correspond to an increase (or decrease) in that refundable credit. The full refundable credit should be available if sufficient post-abandonment tax has been paid, in which case the exploration abandonment excess will be zero. If insufficient post-abandonment tax has been paid the refundable credit will be reduced by:

    expenditure on abandoning exploratory wells x 28% – post-abandonment tax

(c) Neither paragraph (a) nor (b) applies. This will occur when the existence of deductible expenditure on abandoning an exploratory well is contributing to the amount of the refundable credit, but the full amount is not available as the miner's net loss is less than the total of section LT 1(1)(a)(i) to (iii). In this case, an ordering rule is necessary to ensure the exploration abandonment excess applies, when necessary, but that it does not reduce the refundable credit below the amount available if no deductible expenditure on abandoning exploratory wells had been incurred. The exploration abandonment excess is calculated in this situation as:

    (net loss – decommissioning deductions) × tax rate – post-abandonment tax

This is essentially the same formula as paragraph (b) other than it subtracts "decommissioning deductions" (being the amounts described in section LT 1(1)(a)(i) and (ii)) from net loss to leave the portion of loss relating to abandonment expenditure on exploratory wells that contributes to the refundable credit, rather than the entire abandonment expenditure.

Example 139: Single year

A petroleum miner has paid $1,000 in tax with $500 of post-abandonment tax. They have $100 of decommissioning expenditure under section LT 1(1)(a)(ii) and $100 of exploratory well abandonment expenditure under section LT 1(1)(a)(iii), with a net loss for the year of $200. The miner has a current loss credit of $56, equal to their net loss of $200 multiplied by their tax rate of 28%.

The petroleum miner's exploration abandonment excess under section LT 1(4D) is zero. The relevant calculation is under paragraph (b) because the miner's net loss is greater than or equal to the total of the deductions taken under section LT 1(1)(a) and the exploratory well abandonment expenditure is greater than zero. The expenditure on abandoning exploratory wells ($100) multiplied by the tax rate (28%) gives an amount of $28 but subtracting the post-abandonment tax of $500 results in a negative amount (-$472). Section LT 1(4D) stipulates that the exploration abandonment excess cannot be negative, so it is zero in this case.

Without any exploration abandonment excess, the petroleum miner's tax credit is equal to their current loss credit of $56.

Example 140: Multi years

A petroleum miner has paid $1,000 in tax with $14 of post-abandonment tax. In both years 1 and 2, the miner has $50 of decommissioning expenditure under section LT 1(1)(a)(ii) and $50 of exploratory well abandonment expenditure under section LT 1(1)(a)(iii), with a net loss for each year of $100. The miner has a current loss credit of $28 in both years, equal to their net loss each year of $100 multiplied by their tax rate of 28%.

For the purposes of calculating the petroleum miner's tax credit in year 1, their exploration abandonment excess is zero. The relevant calculation is under paragraph (b) because the miner's net loss is greater than or equal to the total of the deductions taken under section LT 1(1)(a) and the exploratory well abandonment expenditure is greater than zero. The expenditure on abandoning exploratory wells ($50) multiplied by the tax rate (28%) gives an amount of $14, but subtracting the post-abandonment tax of $14 results in an overall exploration abandonment excess for year 1 of zero. This means the miner's tax credit for year 1 is equal to their current loss credit of $28.

With identical expenditures in year 2, the relevant calculation for exploration abandonment excess in that year is also under paragraph (b). Again, multiplying expenditure on abandoning exploratory wells for the year by the tax rate gives an amount of $14. However, the initial post-abandonment tax of $14 was used to wipe out the exploration abandonment excess in year 1, and there is no post-abandonment tax available for year 2. This means that the petroleum miner has an exploration abandonment excess of $14 in year 2 and subtracting this from the year 2 current loss credit of $28 gives an overall tax credit for the year of $14.

Example 141: Different exploration abandonment excess calculations

A petroleum miner has paid $1,000 in tax with $14 of post-abandonment tax. In year 1, the miner has $50 of decommissioning expenditure under section LT 1(1)(a)(ii) and no exploratory well abandonment expenditure under section LT 1(1)(a)(iii), with a net loss for the year of $50. The miner has a current loss credit of $14 in year 1, equal to their net loss of $50 multiplied by their tax rate of 28%.

For the purposes of calculating the petroleum miner's tax credit in year 1, their exploration abandonment excess is zero. The relevant calculation is under paragraph (a) because the miner's net loss is less than or equal to the total of the deductions taken under section LT 1(1)(a)(i) and (ii). This means the miner's tax credit for year 1 is equal to their current loss credit of $14.

In year 2, the miner has no decommissioning expenditure under section LT 1(1)(a)(ii) and has exploratory well abandonment expenditure of $100 under section LT 1(1)(a)(iii), with a net loss for the year of $50. The miner has a current loss credit of $14 in year 2, equal to their net loss of $50 multiplied by their tax rate of 28%.

For the purposes of calculating the petroleum miner's tax credit in year 2, their exploration abandonment excess is $14. The relevant calculation is under paragraph (c) because the miner's net loss is not less than or equal to the total of the deductions taken under section LT 1(1)(a)(i) and (ii) (required for paragraph (a)), and it is not greater than or equal to the total of the deductions taken under section LT 1(1)(a) (required for paragraph (b)). The net loss of $50 (minus the decommissioning deductions in section LT 1(1)(a)(i) and (ii) of zero) is multiplied by the tax rate (28%), giving an amount of $14. Subtracting the post-abandonment tax of $14 results in an exploration abandonment excess of zero. This means the miner's tax credit for year 2 is equal to their current loss credit of $14.

Plugging and abandoning

Various provisions within the petroleum mining regime refer to either "plugging and abandoning" or just "abandoning". For example, in section YA 1, the definition of "exploratory well expenditure" refers to "abandoning" but the definition of "decommissioning" refers to "plugging and abandoning". New section LT 1(1)(a)(iii) uses the words "plugging and abandoning an exploratory well", which aligns with the previous wording in the decommissioning definition. No difference in meaning of the process of plugging and abandoning is intended between these phrases.

Ability to refund ancillary taxes

Sections RM 2 and RM 4 of the Income Tax Act 2007

The filing of an ancillary tax return is deemed to be an assessment for sections RM 2 and RM 4 of the Income Tax Act 2007. This ensures that amounts of overpaid ancillary tax can be refunded.

Background

Under previous law, the filing of an ancillary tax return was not considered an assessment. The refund rules require there to be an assessment before an amount of overpaid tax can be refunded. This meant that, in most cases, there was no legislative ability to refund ancillary taxes. This was contrary to the policy intent of the refund rules.

Key Features

New section RM 2(1BA) provides that, for the purposes of that section, the provision by a person of a return for an amount of an ancillary tax for a period is treated as the making of an assessment of the amount of the ancillary tax by the person.

New section RM 4 (1B) contains a similar provision in respect of amounts of overpaid ancillary tax arising on amended assessments.

Taken together, the sections ensure that amounts of overpaid ancillary tax can be refunded.

Application date

These amendments apply in relation to a return for an amount of an ancillary tax for a period regardless of whether the return was or is provided before, on or after 30 March 2022.

Amending memorandum accounts when making transfer from previous years

Sections OB 4, OB 32, OK 2, OK 3, OK 11 and OK 12 and tables O1, O2, O17 and O18 of the Income Tax Act 2007

The amendments permit imputation credit account (ICA) and Māori Authority credit account (MACA) entries that result from a transfer of tax from a previous period to be made on the date the taxpayer requests the transfer, rather than the effective date chosen by the taxpayer, provided certain conditions are met.

Transfers made before the end of an income year will continue to be made in the current year.

Background

An issue was raised that the practice of taxpayers and Inland Revenue accounting for ICA/MACA entries was not in line with the relevant legislation when making transfers between tax types or taxpayers. Under that interpretation of the legislation, taxpayers who transferred tax between tax types or taxpayers had to request the Commissioner make amendments to ICA/MACA returns that had already been filed with Inland Revenue where those tax transfers occurred at a date outside the tax year in which the transfer was requested.

However, in practice this interpretation was not adopted and entries reflecting the transfer were included in the ICA of the year of transfer.

Key features

The amendments permit ICA and MACA entries resulting from a transfer of tax from a previous period to be made on the date the taxpayer requests the transfer, rather than the effective date chosen by the taxpayer.

This is provided that, on 31 March of the imputation year in which the effective date arises:

- the ICA of the transferee is in credit, and
- the ICA of the transferor was in credit by at least the amount of the transfer and any other transfers made during that imputation year.

Transfers made before the end of an income year will continue to be made in the current year (that is, in unfiled ICA/MACA returns).

Section OB 4(4) of the Income Tax Act 2007 (ITA) sets out the credit dates for different types of debits and credits to a company's ICA. Paragraph (c) has been inserted into this section for amounts transferred in a tax year from another period under sections 173L and 173M of the Tax Administration Act 1994 (TAA) and section RC 32(5)(b) of the ITA.

Section OB 4(4)(c)(i) states that the credit date of these amounts is the day on which the taxpayer requests the transfer, provided the credit in the ICA equals or exceeds the amount of all transfers from that account requested in the tax year, and that the ICA to which the transfer is made is also in credit.

If these requirements are not met, subparagraph (ii) clarifies that the credit date is instead the date of transfer as defined in sections 173L and 173M of the TAA or section RC 32(5)(b) of the ITA.

Table O1 is amended to reflect the additions to section OB 4(4).

Corresponding amendments for section OB 32 and table O2 pertain to the debit side of the ICA transfer.

These changes have also been made for debits and credits in MACAs (sections OK 2, OK 3, OK 11, OK 12 and tables O17 and O18).

Transfers made under sections 173L and 173M of the TAA or section RC 32(5)(b) of the ITA during an income year will continue to use the dates prescribed by those sections.

These amendments do not alter the timing of the effective date of the underlying tax credit, just the entry in the ICA/MACA.

Application date

The amendments came into force on 30 March 2022.

Business continuity test

Sections IA 5, IB 3, IB 5, ID 5, IP 1, IP 3B, IP 4–IP 6 of the Income Tax Act 2007

The following amendments have been made to the BCT:

- It has been clarified that losses incurred prior to the 2020–21 income year can be carried forward to the 2020–21 income year under the business continuity test (BCT).
- Clarification of the application of the part-year loss rules ensures that companies that have a major change in the nature of their business activities and fail the BCT during an income year can use losses up to the day of the breach. This is the same treatment as under the normal part-year loss rules for a breach in ownership continuity.
- Section IB 5 has been amended to ensure that only New Zealand resident companies are included in a group of companies and treated as a single company for the purposes of the BCT.
- It has been clarified that a company can still carry forward losses subject to the BCT if those losses were incurred before the 2020–21 income year after a subsequent ownership change. This amendment aligns the treatment for losses incurred before the 2020–21 income year with that for losses incurred in the 2020–21 and subsequent income years.
- The application of the permitted major changes in the BCT has been clarified to ensure they relate to business activities performed before the ownership change in the company.

Background

The BCT was introduced by the Taxation (Annual Rates for 2020–21, Feasibility Expenditure, and Remedial Matters) Act 2021. It allows companies to carry forward tax losses to future years when they have an ownership continuity breach, provided there is no major change in the nature of the business activities of the company.

Losses carried forward after an ownership breach

It was intended that tax losses incurred after an ownership continuity breach in an income year before the 2020–21 income year could be carried forward under the BCT. However, the drafting in section IB 3(3) technically did not allow this in all the intended circumstances. Amendments to section IB 3(3) have addressed this issue.

Part-year losses

The previous BCT did not work well with the part-year loss rules. Where a company had a major change in its business, and therefore failed the BCT during an income year, the previous rules were unclear about how part-year losses should be treated.

From a policy viewpoint, losses incurred up to the date of the BCT breach should be available for use or offset (if possible). Tax loss components incurred after the breach should be able to be carried forward (subject to any future ownership continuity breach). This is in line with the normal part-year loss rules on an ownership continuity breach.

Example 142: Business continuity test and part-year losses

Wilma Widgets Limited (WWL) had a breach in ownership continuity on 1 April 2022. However, WWL maintained a similar business before and after the ownership continuity breach, and therefore, the company carried forward its tax losses under the BCT.

On 1 October 2023, however, the company made a major change in the nature of its business activities and therefore breached the BCT. This resulted in WWL being unable to carry forward its losses. As this change happened during the year, WWL should be able to offset any losses incurred up to 30 September 2023 (the day before the breach) against any net income for the same period (or to offset the losses against income of other group companies, if permitted).

WWL should also be able to carry forward any losses incurred from 1 October 2023 (the day of the breach), subject to meeting the other requirements of the part-year loss rules (such as providing part-year accounts).

Amendments to sections IP 1, IP 3B, IP 4, IP 5 and IP 6 have addressed this issue.

Clarify the definition of "group of companies" for BCT purposes

The BCT rules provide that companies purchased as a group are treated as a single company for the purposes of the BCT. The current definition of "group of companies" can include non-resident companies that are not in the New Zealand tax base. The definition was intended to be restricted to New Zealand tax resident members of a group for the purposes of the BCT. The amendment to section IB 5 addresses this issue.

Subsequent shareholding changes

When a company has an ownership breach, the BCT will apply. For most companies, provided they do not have a major change (unless it is a permitted major change), they will be able to continue to carry forward losses. For most companies, they must not have a major change for five years after they apply the BCT.

The intention was that if a company had a breach in shareholding before the 2020–21 income year, losses incurred before that breach could not be carried forward and those after the breach could be carried forward under the BCT on a further shareholding breach. This was achieved for losses incurred in the 2020–21 and subsequent income years, but the rule does not work as intended for losses incurred before the 2020–21 income year.

Amendments to section IB 3(3) address this issue.

Exclusion of mining companies

Mining companies are excluded from the BCT on the basis that they have their own similar business test that allows them to carry forward losses for a particular mining permit despite a change in shareholding continuity. However, those losses cannot be used against other income unless shareholder continuity is maintained.

Technically a mining company that changes its business before a change in ownership will no longer be a "mining company" at the time of the change in ownership. This may allow that company to use the BCT. Given that the quantum of mining losses could be material, it could be beneficial for a company to change from being a "mining company" before a change in ownership and to maintain the alternate business for five years to utilise tax losses.

This was not intended and the exclusion from the BCT should relate to any mining losses incurred when a company was also a mining company. The insertion of new section IB 3(5B) addresses this issue.

Clarification of the application of the permitted major changes

The BCT allows companies to carry forward tax losses to future years if it has a change in ownership, provided there is no major change in the nature of the business activities of the company. However, even if there is a major change, provided that major change fits within the permitted major changes in section IB 3(5), the company will still be able to carry forward its tax losses.

There was a concern, however, that several of the permitted major changes did not specifically refer to a business activity of the company that was undertaken before a shareholding breach, although this was the policy intent. The permitted major changes were to allow for growth and innovation within companies. It was not intended that they would also allow for new business activities (other than a pivoting scenario, which is dealt with separately in the legislation).

The amendments to section IB 3(5) address this concern.

Application date

The amendments to sections IA 5, IB 3 and IB 5 apply in relation to a breach of the requirements for continuity of ownership of section IA 5 if the breach occurs during the 2020-21 income year or a later income year.

The amendments to sections ID 5, IP 1, IP 3B, IP 4–IP 6 apply for the 2020–21 and later income years.

FBT – pooled alternate rate option

Sections RD 50(5), (6), RD 60(3)(b), RD 61(3)(b) and RD 63(3)

Amendments enacted in the Taxation (Annual Rates for 2021–22, GST, and Remedial Matters) Act 2022 provide employers with a new option for calculating fringe benefit tax (FBT).

Background

An employer who provides a fringe benefit to an employee is liable to pay FBT. Most fringe benefits are required to be attributed to individual employees to calculate the employer's FBT liability. The following benefits must be attributed:

- making available a motor vehicle for an employee's private use
- employment-related loans
- providing certain benefits, such as subsidised transport and contributions to superannuation schemes, where each category of benefit has a taxable value of $1,000 or more per year per employee, and
- any unclassified benefit provided with a taxable value of $2,000 or more per year per employee.

Generally, all other fringe benefits (non-attributed benefits) must be pooled. FBT is calculated on the annual taxable value of these pooled benefits at the rate of 63.93% (for benefits provided to employees who are major shareholders or to persons associated with an employee who is a major shareholder) or 49.25% (for benefits provided to all other employees).

Before 1 April 2021, employers may have used any of the following three options to calculate their FBT liability on attributed benefits:

- the single rate option
- the full alternate rate option, and
- the short form alternate rate option.

The lowest compliance cost option, both then and now, is the single rate option. Under the single rate option, an employer pays tax at the highest FBT rate (currently 63.93%) on all fringe benefits provided (including non-attributed benefits) without having to carry out a compliance cost intensive calculation for each employee who receives a fringe benefit. Applying tax at the highest FBT rate is a deliberate policy setting that is intended to avoid the possibility of under-taxation.

The rate of FBT for the single rate option was increased from 49.25% to 63.93% when the new top personal tax rate of 39% for income over $180,000 was introduced. However, under this tax setting, the single rate option may have resulted in many employers generally having a significantly higher FBT liability for employees earning below $180,000 in gross salary or wages than if the employer attributed benefits directly to the individual employees. This may be an issue when employers have no, or few, employees earning income over $180,000.

The full alternate rate option is a more accurate alternative available to employers, but it requires calculations of the employer's FBT liability for each individual employee to be carried out, which may increase compliance costs. Under the full alternate rate option, attributed benefits provided in the first three quarters are initially taxed either at the second highest FBT rate of 49.25% or at the highest FBT rate of 63.93%. A "wash-up" calculation is then performed after the end of the fourth quarter to tax every dollar of attributed benefits provided to an employee during the year at the applicable FBT rate, which is based on the employee's "all-inclusive pay".

The short form alternate rate option is an easier option for employers, but like the single rate option, it may also result in over-taxation given the top FBT rate of 63.93%. Instead of carrying out calculations of the employer's FBT liability for each employee, under the short form alternate rate option attributed benefits are taxed at a flat rate of 63.93%. Non-attributed benefits are taxed at the 49.25% rate (except where they are provided to employees who are major shareholders or to their associates).

The new "pooled alternate rate" option aims to strike a better balance between accuracy and simplicity for many employers than the pre-existing FBT payment options. This option may appeal to employers who predominantly provide attributed benefits to employees who earn less than $180,000 in gross cash pay, especially if all or most of those employees earn within the "safe harbour" thresholds (that is, up to $160,000 in gross cash pay and up to $13,400 each in attributed benefits for the year).

Key features

Many fringe benefits are required to be attributed to those employees receiving the benefits. This can make the calculation of an employer's FBT liability a complex exercise. Employers can choose different calculation options. They may choose to pay FBT at the flat maximum rate of 63.93% (49.25% before 1 April 2021) or to calculate their FBT liability for each individual employee using the applicable FBT rate for each dollar of "all-inclusive pay" received by the employee.

Under the new pooled alternate rate option, employers pay FBT on attributed benefits at the flat rate of 63.93% only for those employees that earn more than $160,000 in gross cash pay or receive more than $13,400 in attributed benefits over the year. FBT is payable at the flat rate of 49.25% on benefits attributed to all other employees. Employers may also choose to pay FBT at the 49.25% rate on benefits attributed to employees who receive less than $129,681 in all-inclusive pay, even if the employee receives more than $160,000 in cash pay or more than $13,400 in attributed benefits.

The new pooled alternate rate option does not change the treatment of non-attributed benefits. Non-attributed benefits provided to employees who are not major shareholders are still required to be pooled and taxed at the 49.25% rate, while non-attributed benefits provided to employees who **are** major shareholders or to their associates are required to be pooled and taxed at the 63.93% rate (the same treatment as currently applies under both the full alternate rate and short form alternate rate options).

Employers previously using any of the single rate, full alternate rate or short form alternate rate options may switch to the new pooled alternate rate option. This means that employers who used another option for the first three quarters of the 2021–22 tax year can switch to the new option for the fourth quarter of the 2021–22 tax year.

Amendments have also been made to the provisions setting out the close company and small business options. The amendments allow employers using those options to pay FBT at the rate of 49.25% on benefits attributed to employees receiving remuneration within the "safe harbour" thresholds (up to $160,000 in gross cash pay and up to $13,400 in attributed benefits). Consistent with the approach under the new pooled alternate rate option, FBT is payable at the rate of 63.93% only for benefits attributed to employees that earn more than $160,000 in gross cash pay or receive more than $13,400 in attributed benefits over the year. Employers using these options may also choose to pay FBT at the 49.25% rate on benefits attributed to employees who receive less than $129,681 in all-inclusive pay.

A similar amendment has also been made to the existing provision setting out employers' options for paying FBT when they have stopped employing staff.

Application date

The amendments apply on and after 1 April 2021, except for the amendments to sections RD 50(5), (6) and RD 60(3), which apply for the 2021–22 and later income years.

Detailed analysis

Alternate rate options (section RD 59)

Existing section RD 59 sets out how the alternate rate options work. Most relevantly, subsection (2) provides that an employer may pay FBT for any, or all, of the first three quarters of a tax year at 49.25% of the taxable value of a fringe benefit.

Subsection (4) sets out the wash-up calculation for the final quarter of the tax year under the alternate rate options. Under subsection (4), the employer must calculate the total FBT payable for each employee for the tax year and subtract the amount of FBT payable for the previous three quarters of the tax year. The difference is the amount payable for the final quarter.

Pooled alternate rate option (section RD 50(5) and (6))

Section RD 50(5) provides that an employer may choose to pay FBT at a flat rate of 63.93% on the taxable value of attributed benefits (rather than calculating the difference between tax on all-inclusive pay and tax on cash pay under section RD 50(2)).

New section RD 50(6) provides employers with a further option. Under the new pooled alternate rate option, an employer pays FBT at the rate of 49.25% on the total taxable value of benefits attributed to an employee whose remuneration is within the following "safe harbour" thresholds:

- Attributed benefits of up to $13,400 (paragraph (a)(ii)).
- Cash pay of up to $160,000 (paragraph (a)(iii)).

"Cash pay" is defined in section RD 51(3)(a) (for employees who are major shareholders) and section RD 51(4)(a) (for employees who are not major shareholders). If an employee is a major shareholder, "cash pay" is the employee's gross cash pay for the income year in which the fringe benefit is attributed that is paid to the employee by the employer or a related employer, and includes dividends and interest derived by the employee from the employer or a related employer. For all other employees, "cash pay" is the employee's gross cash pay for the tax year in which the fringe benefit is attributed that is paid to the employee by the employer or a related employer.

New section RD 50(6)(b)(i) provides that an employer opting to use the new pooled alternate rate option pays FBT at the rate of 63.93% on the taxable value of attributed benefits provided to employees earning above the safe harbour thresholds. This essentially requires two separate pools for attributed benefits, with one pool (for employees within the safe harbours) being taxed at a flat rate of 49.25% and the other (for all other employees) being taxed at a flat rate of 63.93%.

Example 143: Pooled alternate rate option

Company A employs full-time and part-time staff in a range of roles requiring different skill sets, qualifications, and levels of experience. Salaries range from $30,000 to $170,000. However, only Employee X earns $170,000 before tax, with the next highest-paid employee earning $120,000 before tax.

In the 2021–22 tax year, Company A provides fringe benefits totalling $100,000 to all its staff members in the form of subsidised transport and some low interest, employment-related loans. No individual staff member received more than $6,000 in attributed benefits, so none of Company A's staff received anywhere near $13,400 in attributed benefits. Employee X received attributed benefits to the value of $5,000.

Company A has calculated its FBT liability for attributed benefits for the first three quarters of the 2021–22 tax year under section RD 59(2). This means it paid FBT at the rate of 49.25% of the taxable value of attributed benefits for those first three quarters. As fringe benefits totalling $75,000 were provided in the first three quarters, Company A has paid FBT of $36,937.50 for that period. Company A decides to use the pooled alternate rate option to calculate its FBT liability for the final quarter of 2021–22.

When preparing the FBT return for the final quarter, Company A identifies that only one employee earned above the safe harbour limit of $160,000 in cash pay for the 2021–22 tax year, being Employee X. Company A accordingly pays FBT on the taxable value of fringe benefits attributed to Employee X at the top rate of 63.93%.

FBT for Employee X

Company A's FBT liability for Employee X for the 2021–22 year is $3,196.50 ($5,000 × 63.93%).

FBT for other employees

The total FBT payable for all other employees for the 2021–22 year is calculated by subtracting the taxable value of benefits attributed to Employee X from the taxable value of attributed benefits Company A provided to all its staff during 2021–22 and then applying the 49.25% rate to this amount.

The taxable value of attributed benefits Company A provided to all its staff during 2021–22 is $100,000. Employee X received $5,000 of these benefits. This means that the total FBT payable for Company A's employees (excluding Employee X) for the 2021–22 tax year is $46,787.50 (($100,000 - $5,000) × 49.25%).

Total FBT liability

Therefore, Company A's total FBT liability for all employees (including Employee X) for the 2021–22 tax year is $49,984 ($46,787.50 + $3,196.50).

As Company A has already paid $36,937.50 in FBT for the first three quarters of the 2021–22 tax year, the FBT payable for the final quarter is $13,046.50 ($49,984 - $36,937.50).

Option to pay FBT at 49.25% rate for employees receiving all-inclusive pay below $129,681

New section RD 50(6)(b)(ii) provides an exception to the rule outlined above. Under subparagraph (ii), an employer may choose to pay FBT at the 49.25% rate on the total taxable value of benefits attributed to an employee whose all-inclusive pay is less than $129,681. Provided the requirement around the level of the employee's all-inclusive pay is met, this choice is available to an employer even if the employee earns above either of the safe harbour thresholds outlined above.

This ensures that employers with employees earning between $160,000 and $180,000 in cash pay but with only relatively modest fringe benefits (such that the employees each receive less than $129,681 in all-inclusive pay) can (if they wish to) include benefits attributed to such employees in the pool of attributed benefits taxed at the 49.25% rate.

The calculation of an employee's all-inclusive pay is set out in existing section RD 51(2). This amount is calculated as cash pay less tax on cash pay, plus the taxable value of all fringe benefits attributed to the employee (or a person associated with the employee) in the tax year.

The all-inclusive pay threshold of $129,681 in section RD 50(6)(b)(ii) is based on the level of an employee's all-inclusive pay at which the top FBT rate of 63.93% would apply if the person's employer opted to use the full alternate rate option to calculate its FBT liability. This in turn is determined by reference to the personal income tax rates and the income brackets at which these rates apply. All-inclusive pay above $129,681 often equates to cash pay of more than $180,000, but in some cases the employee's cash pay may be less than that amount, depending on the value of fringe benefits provided to the employee.

FBT rates are based on the concept of all-inclusive pay, rather than monetary remuneration, because it is important to include the value of fringe benefits received when determining an employee's FBT rate – otherwise employers may be incentivised to provide fringe benefits instead of cash remuneration to employees earning near the personal income tax brackets. Limiting employers' ability to pay tax at the lower 49.25% rate on benefits attributed to employees earning outside the safe harbour thresholds to just those employees receiving less than $129,681 in all-inclusive pay ensures that fringe benefits provided to employees earning near or above $180,000 are not under-taxed.

Example 144: Employer opts to include employee receiving less than $129,681 in all-inclusive pay in 49.25% pool

Instead of paying FBT at the 63.93% rate on benefits attributed to Employee X, Company A from Example 143 decides to include the benefits attributed to Employee X in the pool of fringe benefits taxed at the 49.25% rate. Company A can do this because it knows Employee X has $127,980 in all-inclusive pay, which is less than the all-inclusive pay threshold of $129,681 in section RD 50(6)(b)(ii).

Calculation of Employee X's all-inclusive pay

The calculation of the total tax on Employee X's cash pay is set out below.

Income tax thresholds	Applicable marginal tax rate	Income of Employee X taxed at marginal rate	Tax on cash pay
$0 to $14,000	10.5%	$14,000	$1,470
$14,001 to $48,000	17.5%	$34,000	$5,950
$48,001 to $70,000	30%	$22,000	$6,600
$70,001 to $180,000	33%	$100,000	$33,000
> $180,000	39%	$0	$0
	Total	**$170,000**	**$47,020**

The total tax on Employee X's cash pay is $47,020. As Employee X received $5,000 in attributed benefits, Employee X's all-inclusive pay is $127,980 ($170,000 - $47,020 + $5,000 = $127,980).

Total FBT liability

The total FBT payable for all employees for the 2021–22 year is calculated by multiplying the taxable value of attributed benefits Company A provided to all its staff during 2021–22 and then applying the 49.25% rate to this amount.

The taxable value of attributed benefits Company A provided to all its staff during 2021–22 is $100,000. This means that the total FBT payable for Company A's employees for the 2021–22 tax year is $49,250 ($100,000 × 49.25%).

As Company A has already paid $36,937.50 in FBT for the first three quarters of the 2021–22 tax year, the FBT payable for the final quarter is $12,312.50 ($49,250 - $36,937.50).

Treatment of non-attributed benefits under the pooled alternate rate option (section RD53)

The amendments do not change the treatment of non-attributed benefits – non-attributed benefits are still treated in the same way under the pooled alternate rate option as they are under the pre-existing alternate rate options. This means non-attributed benefits provided to employees who are not major shareholders are still required to be pooled and taxed at the 49.25% rate, and non-attributed benefits provided to employees who **are** major shareholders or to their associates are required to be pooled and taxed at the 63.93% rate.

Changing from a pre-existing option to the pooled alternate rate option

Employers who used any of the three pre-existing FBT payment options for the first three quarters of the 2021–22 year may switch to the new pooled alternate rate option. An employer switching from one of the existing options to the pooled alternate rate option may be asked to provide the information necessary for calculating its FBT payable for the final quarter.

Example 145: Employer switches from single rate option to pooled alternate rate option

Company B did not employ any staff that earned above the safe harbour thresholds in the 2021–22 tax year. Company B used the single rate option to pay its FBT liability for the first three quarters of that year and wishes to switch to the pooled alternate rate option for calculating its FBT payable for the final quarter.

Company B provided $50,000 in attributed benefits to its employees during the 2021–22 tax year and no non-attributed benefits. The taxable value of the benefits that were provided in the first three quarters was $37,500. Therefore, Company B has already paid $23,973.75 in FBT for the 2021–22 tax year using the single rate option ($37,500 × 63.93%).

Since none of its employees received remuneration above the safe harbour thresholds, Company B calculates its FBT payable for the final quarter by simply applying the 49.25% rate to the taxable value of benefits provided to its employees during the year ($50,000 × 49.25% = $24,625) and subtracting from the resulting figure the amount of FBT it has already paid for the first three quarters of the year. This gives an amount of FBT payable for the final quarter of $651.25 ($24,625 – $23,973.75).

Amendments to close company and small business options (sections RD 60 and RD 61)

Existing sections RD 60 and RD 61 set out the close company and small business options for paying FBT.

Section RD 60 applies to close companies providing fringe benefits to shareholder-employees in an income year if, in the preceding income year:

- the gross amounts of tax for both PAYE income payments and employer's superannuation cash contributions withheld were no more than $1 million
- the only benefit provided was making one or two motor vehicles available to shareholder-employees for their private use, or
- the company did not employ anyone.

The small business option in section RD 61 applies to employers providing fringe benefits to employees who are not shareholder-employees in a tax year if in the preceding tax year, the gross amounts of tax for both PAYE income payments and employer's superannuation cash contributions withheld were no more than $1 million, or the employer did not employ any employees.

Instead of paying FBT quarterly, employers using the small business option pay their FBT liability on an annual (tax year) basis, while employers using the close company option pay on an income year basis. Under both these options, an employer must either calculate its FBT liability for each individual employee under section RD 50 (and calculate the amount of FBT on non-attributed benefits under section RD 53) or pay FBT on the taxable value of all fringe benefits at 63.93%.

New sections RD 60(3)(b) and RD 61(3)(b) ensure that an employer using the close company option or the small business option can choose to pay FBT at a flat rate of 63.93% only on benefits attributed to those employees receiving remuneration above the safe harbour thresholds (that is, more than $160,000 in cash pay or more than $13,400 in attributed benefits), with benefits provided to all other employees taxed at 49.25%. Employers may also choose to pay FBT at the 49.25% rate on benefits attributed to employees who receive less than $129,681 in all-inclusive pay, even if the employee earns above the safe harbour thresholds.

The words "the total pay of each employee" in each of the sections have been replaced with "their FBT liability". This clarifies that calculating the amount of FBT for each individual employee (which involves calculating each employee's all-inclusive pay) is not required as a practical matter if the employer opts to pay FBT at the flat rates of 63.93% on attributed benefits provided to employees receiving remuneration above the safe harbour thresholds and 49.25% on attributed benefits provided to all other employees (as provided for in new section RD 50(6)).

When an employer stops employing staff (section RD 63)

Existing section RD 63 applies to an employer who stops employing staff and does not intend to replace them.[81] Subsection (2) provides that the employer must pay FBT using section RD 59 (the full alternate rate option), treating the quarter of the tax year in which the employment ended as if it were the final quarter. Essentially this means the final quarter wash-up calculation to tax all attributed benefits at the appropriate rates must be performed in the quarter in which the employment ended. However, as an alternative to *full attribution*, subsection (3) provides that the employer may choose to pay FBT under the single rate option.

An amendment has been made to the cross-references in section RD 63 to clarify that the full alternate rate and single rate options are not the only options available to employers that have stopped employing staff. The short form alternate rate and pooled alternate rate options are also available, with the quarter of the tax year in which the employment ended being treated as the final quarter under these options too.

Racing entities income tax exemption

Section CW 47 of the Income Tax Act 2007

Racing New Zealand and the Racing Integrity Board have been added to the list of racing organisations in section CW 47 of the Income Tax Act 2007 that are exempt from income tax.

Background

With effect from 1 August 2020, the Racing Industry Act 2020 created two new organisations, "the Racing Integrity Board" and "Racing New Zealand". However, the income tax treatment of these entities was inadvertently overlooked. Consistent with TAB NZ and the three racing codes, the Racing Integrity Board and Racing New Zealand should be exempt from income tax.

Key features

Income derived by Racing New Zealand and the Racing Integrity Board is exempt from income tax under section CW 47 of the Income Tax Act 2007.

Application date

The amendments apply from 1 August 2020.

Depreciation treatment of grandparented structures

Sections EE 47, EE 48, EZ 23B, EZ 23BB, EZ 23BC, EZ 23BD and EZ 73 of the Income Tax Act 2007

Taxpayers may claim a deduction for the loss on disposal of a grandparented structure.

Background

Inland Revenue's interpretation statement IS 10/02: "Meaning of 'building' in the depreciation provisions", which applies from 30 July 2009, brought within the definition of "building" certain items that were previously "structures", such as barns, carpark buildings and site huts. This changed the way these were treated for tax depreciation purposes.

Buildings were subject to a 0% depreciation rate from 2010. However, the structures affected by IS 10/02 were grandparented to preserve their depreciation treatment. To facilitate this grandparenting, the definition of "building" did not include these affected structures.

The definitions of "building" and "grandparented structure" were repealed by the COVID-19 Response (Taxation and Social Assistance Urgent Measures) Act 2020 as part of the reinstatement of depreciation on non-residential buildings. This meant that grandparented structures were now buildings for the purposes of the Income Tax Act 2007 and were no longer eligible for depreciation deductions for loss on disposal. This was not intended.

Key features

New section EZ 23BD introduces a definition of "grandparented structure" and provides that section EE 48(2), which allows a deduction for loss on disposal, applies to grandparented structures.

Consequential amendments have also been made to sections EE 47, EE 48, EZ 23B, EZ 23BB, EZ 23BC and EZ 73 to remove redundant references to "grandparented structures".

[81] However, the section does not apply if the employer continues to provide a fringe benefit to a former employee.

Application date

The amendments apply for the 2020–21 and later income years.

Alignment of ICA provisions relating to tax pooling

Section OP 31 of the Income Tax Act 2007

The wording in the imputation rules between individual companies and consolidated imputation groups for the transfer of tax pooling funds has been aligned to make them consistent.

Background

The imputation rules for individual companies are replicated almost identically for consolidated imputation groups. In 2009, however, a remedial amendment was made to the imputation rules for individual companies to correct a rewrite issue relating to tax pooling. This amendment was not replicated in the consolidated imputation group rules. The current amendment corrects this and realigns the rules.

Application date

The amendment applies for the 2008–09 and later income years, unless a person has taken a tax position ignoring the amendment before the start of the 2020–21 income year.

Income equalisation reserve and environmental restoration fund accounts

Sections EH 2 and EK 1 of the Income Tax Act 2007

The requirement for the Commissioner to maintain separate bank accounts for Income Equalisation Reserves and Environmental Restoration Funds has been removed.

Background

The requirement to keep separate bank accounts for these funds is redundant. With the removal of cheques, it is now much simpler and easier for taxpayers to deposit funds directly with Inland Revenue through internet banking into Inland Revenue's general account. This also provides better information for taxpayers, as they have visibility on the amounts that sit within their income equalisation account and environmental restoration fund through MyIR.

There is no change in security of the funds as both those accounts are backed by the government.

Application date

The amendments come into force on 30 March 2022.

Income tax treatment of voluntarily cancelled emissions units

Sections CB 36(8D), GC 3B(2)(c)(iii) and GC 3B(2)(d) of the Income Tax Act 2007

The income tax treatment of emissions units that are voluntarily cancelled through the New Zealand Emissions Trading Scheme (ETS) has been amended so that the taxpayer is not deemed to derive income when they cancel an emissions unit.

Background

The voluntary cancellation of emissions units under the ETS has become more common in recent years as businesses seek to demonstrate their environmental responsibility. The previous tax treatment of a voluntarily cancelled emissions unit was unclear and counter-intuitive, the provisions having been developed at a time when voluntarily cancellations had not been envisaged.

Specifically, income equivalent to the market value of the unit was deemed to be derived by the taxpayer when they cancelled an emissions unit, although no consideration was received for the unit. There is no anti-avoidance concern that would require this deemed income to arise, given that the cancellation of an emissions unit places it in a Crown account, effectively removing it from circulation in the ETS market.

We understand that the previous lack of clarity about the law in this area had led to inadvertent widespread non-compliance.

Key features

The amendments remove this deemed income, recognising that the purchase and cancellation of an emissions unit is a cost incurred by the business for which they should receive a net deduction equivalent to the cost of the unit.

The amendments apply retrospectively to preserve past positions taken by taxpayers who have previously cancelled emissions units.

Application date

The amendments apply for a person and an income year beginning on or after 1 January 2009, except for an income year for which the person chooses to rely on a tax position taken before 30 March 2022.

OTHER REMEDIALS

Extending use of money interest relief during COVID-19

Sections 183ABAB and 183ABAC of the Tax Administration Act 1994

Amendments have been made to the provisions that allow for an extension of use of money interest (UOMI) relief on tax debt for taxpayers affected by COVID-19. The changes allow the relief to be extended retrospectively and for a specific group of taxpayers described in an Order in Council. The changes also include a time limit of 36 months for extensions that can be set by Order in Council.

To complement a recent Order in Council that was made to generally extend the relief for a further two years until 8 April 2024, an extension to the 2021–22 tax year has also been made to the UOMI relief provisions for provisional taxpayers in certain situations.

Background

The Government's response to the economic impacts of COVID-19 included a wide range of measures, including tax measures that are administered by Inland Revenue. One of these was to provide relief on tax debt by allowing taxpayers to apply for relief of UOMI on tax due from 14 February 2020 onward.

Under section 183ABAB of the Tax Administration Act 1994 (TAA), relief is available for taxpayers whose ability to make a payment required by a tax law on or before the due date for the payment is significantly adversely affected by COVID-19. To be eligible for UOMI remission, the taxpayer must have asked for relief as soon as practicable and made the payment of tax as soon as practicable. The Commissioner will then remit UOMI charged for failing to make a tax payment once the payment has been made. However, if the tax has not yet been paid, a taxpayer can still seek relief by entering into an instalment arrangement with Inland Revenue to pay off the tax. In this case, UOMI will be supressed (not charged) during the arrangement so long as the taxpayer is meeting the arrangement's terms. Once the arrangement is completed and the tax has been paid, the UOMI can then be remitted.

The original expiry date of the ability of the Commissioner to remit interest under section 183ABAB was 24 March 2022. However, an Order in Council was recently made to extend this date until 8 April 2024 for all taxpayers. The current amendments to section 183ABAB were necessary in case a more targeted extension was proceeded with.

Further COVID-19 UOMI remission provisions were introduced in August 2020. Section 183ABAC is intended to assist provisional taxpayers that struggle to forecast their residual income tax and are consequently charged with UOMI. The amendments extend the application of this provision.

Key features

Section 183ABAB has been amended:

- to allow an Order in Council to retrospectively extend the Commissioner's ability to remit UOMI
- to enable an Order in Council made to extend UOMI relief to also describe a specific group of taxpayers that it applies to, and
- to limit the length of extension that can be made to 36 months.

Section 183ABAC has been amended to extend relief for provisional taxpayers to the 2021–22 tax year. Some references to terminal tax have also been changed to residual income tax to clarify the scope of the section.

Application date

The amendments to section 183ABAB came into force on 25 March 2022. The extension of section 183ABAC applies for the 2021–22 tax year.

Detailed analysis

Extension of use of money interest relief during COVID-19: General rules

Section 183ABAB allows for the remission of UOMI by the Commissioner for taxpayers affected by COVID-19, subject to meeting the criteria outlined in that section. Section 183ABAB(4) and (5) allow for an extension of the Commissioner's ability to remit UOMI by Order in Council, made on the recommendation of the Minister of Revenue.

The insertion of section 183ABAB(4)(c) enables such an Order in Council to also specify a group of taxpayers it applies to. This enables UOMI relief to be extended for a specific group of taxpayers (rather than a general extension for all taxpayers) if that is preferred. The amendment mirrors the equivalent provisions in section 183ABA that allow UOMI remission for a specific group of taxpayers for emergency events.

A timing difference between the original expiry date of the Commissioner's ability to remit UOMI (24 March 2022) and the enactment date of the current amending Act (30 March 2022) meant the amendment to allow targeted extensions was not itself sufficient to allow for a continuous extension of the ability to remit UOMI. A further amendment was therefore made to section 183ABAB(4)(b) to allow an Order in Council to be made retrospectively provided it was made within six months of the expiry date. This ensured that the other changes would be effective for the recent Order in Council that has been made in case a targeted extension was desired.

A 36-month time limit on the length of extension that can be set by Order in Council has also been introduced. This does not limit the ability for such an Order in Council to be renewed.

Relief for provisional taxpayers

The general rules in section 183ABAB do not provide UOMI relief for provisional taxpayers in certain situations. This may be the case where a taxpayer chooses to revise their estimate of their residual income tax downward due to anticipating that COVID-19 will obstruct their trading, thus allowing them to pay less provisional tax during the year. If the taxpayer makes an inaccurate forecast and revises their estimate down too far, they will be charged with UOMI because of underpaying amounts at provisional tax dates relative to what their ultimate residual income tax liability is.

Section 183ABAC was therefore inserted into the TAA with effect from 7 August 2020 to allow remission of UOMI charged in this situation. The section originally applied only for the 2020–21 tax year. However, amendments to section 183ABAC have extended its application to the 2021–22 tax year as well, with no other substantive changes.

Some references to "terminal tax" have been changed to "residual income tax", including in the section 183ABAC heading. These changes are intended to clarify the scope of the section and are not intended to change its operation.

Use of money interest relief during emergency events

Section 183ABA of the Tax Administration Act 1994

The use of money interest (UOMI) provisions relating to emergency events have been amended to bring them in line with the equivalent provisions enacted for COVID-19. This includes widening the eligibility test from the previous requirement that an emergency event "physically prevents" a taxpayer from making a payment of tax on time. Specific relief for provisional taxpayers has also been introduced.

Background

Eligibility test for remission

UOMI remission during emergency events (such as floods and earthquakes) is permitted if a taxpayer has not made a payment required by a tax law on or before the due date for the payment. Section 183ABA of the Tax Administration Act 1994 allows remission in this case if an emergency event has been declared by Order in Council pursuant to satisfying definitions set out in the Civil Defence Emergency Management Act 2002.

Previously, for a taxpayer to be eligible, the declared emergency event had to "physically prevent" the taxpayer from making a payment required by a tax law on or before the due date for the payment. The Commissioner could then remit UOMI if the Commissioner considered that doing so was equitable, and if the taxpayer asked for the relief and made the payment of tax as soon as practicable.

When UOMI remission rules were developed in response to the economic impact of COVID-19, a new eligibility test was introduced. Under that test, UOMI remission is allowed if the taxpayer is "significantly adversely affected" by COVID-19 in their ability to make a payment of tax on time. This wider test allows remission for a broader range of reasons, including being physically prevented from being able to pay tax or being financially affected by COVID-19.

It was considered this wider test should also be applied to the emergency events rules. The current amendments address this.

Relief for provisional taxpayers

Specific UOMI remission relief for provisional taxpayers was introduced in August 2020 for COVID-19. This covers situations where a taxpayer has underpaid their provisional tax instalments at due dates because they revised their estimate of their residual income tax liability down too far, as it was recognised that taxpayers may face difficulties in accurately revising their estimate during COVID-19. Section 183ABAC was enacted to ensure UOMI charged in this situation could also be remitted. (See also "Extending use of money interest relief during COVID-19" above.)

Previously, no equivalent provision existed for emergency events. It was considered UOMI remission should also be allowed when an emergency event significantly adversely affects a provisional taxpayer's ability to forecast their residual income tax reasonably accurately. The current amendments address this.

Key features

New section 183ABA(1)(ab) now provides that the failure to make a required payment by the due date must be a consequence of an emergency event that "significantly adversely affects" the taxpayer's ability to:

- make a reasonably accurate forecast, on one or more provisional tax instalment dates, of the taxpayer's residual income tax for the year (subparagraph (i)), or
- make the required payment on or before the due date (subparagraph (ii)).

Use of the phrase "significantly adversely affects" brings the test for UOMI remission during emergency events in line with that used for COVID-19.

New section 183ABA(1)(ab)(i) has been inserted to allow UOMI remission when an emergency event significantly adversely affects a provisional taxpayer's ability to forecast their residual income tax reasonably accurately. However, it differs from the equivalent COVID-19 provisions in that it is not limited to specific tax years and is available in any tax year after enactment. It is also available for taxpayers with any amount of residual income tax, whereas the equivalent COVID-19 provision in section 183ABAC(1)(b) limits this type of relief to taxpayers with residual income tax of less than $1 million.

Application date

The amendments came into force on 30 March 2022.

Aligning filing and payment dates for six-monthly payers of investment income information

Section 25NB of the Tax Administration Act 1994

The six-monthly filing option for resident withholding tax (RWT), non-resident withholding tax (NRWT) and the approved issuer levy (AIL) has been reinstated.

Background

Before 1 April 2020, the relevant legislation provided a de minimis option to allow taxpayers to file and pay RWT, NRWT and AIL on a six-monthly basis when the payer met certain statutory criteria.

New investment income reporting rules have applied since 1 April 2020. Under these rules, such payers still have the payment options but were not provided with a de minimis option of filing six-monthly. A variation was granted for the 2020–21 and 2021–22 income years to allow a six-monthly filing option consistent with the rules that applied before 1 April 2020.

The amendment reinstates the six-monthly filing option in the legislation, consistent with the rules that applied before 1 April 2020.

Application Date

The amendment applies for the 2022–23 and later income years.

Non-active estates return filing

Section 43B of the Tax Administration Act 1994

The non-filing provision in section 43B of the Tax Administration Act 1994 (TAA) has been extended to include non-active estates. Executors and administrators of non-active estates can now apply for an exemption from filing a tax return where the non-active estate meets the requirements in section 43B(2).

Background

Executors and administrators of estates have an obligation to file income tax returns under section 43(1) of the TAA. Although an exclusion from this return filing obligation previously existed for trustees of non-active trusts under section 43B of the TAA, the section did not include non-active estates.

Executors and administrators of non-active estates have generally been unable able to apply under the non-filing provision because the section is limited to 'trusts', and an estate is not a 'trust' in the ordinary meaning of the word. Differing advice on, and interpretations of, the section have caused confusion for executors and administrators. Estates could not apply under section 43B. However, testamentary trusts could generally utilise section 43B, as could executors and administrators that had reached the point of distribution where the property was to be held on trust for beneficiaries.[82]

This meant estates that did not derive income (non-active estates) were still required to file income tax returns. This caused issues for executors and administrators of estates who may have been obligated to file income tax returns for many years despite deriving little to no income.

Application date

The amendment applies from 1 April 2022.

Repeal of the information-sharing clause for the Registrar of Companies by Order in Council

Schedule 7 of the Tax Administration Act 1994

The amendment will repeal clause 36 of schedule 7 of the Tax Administration Act 1994 (TAA), which enables information sharing with the Registrar of Companies, on a date set by Order in Council, provided this occurs before 1 April 2025.

Background

Inland Revenue is currently developing an Approved Information Sharing Agreement (AISA) with the Ministry of Business, Innovation, and Employment (MBIE). This AISA will replace the existing information-sharing provision in the TAA that enables the Commissioner to share information with the Registrar of Companies.

The Privacy Act 2020 prevents two provisions for sharing the same information from being in place at the same time. This means that the relevant information-sharing provision of the TAA needs to be repealed when the AISA comes into force.

As officials cannot determine exactly when the new AISA will take effect, the amendment repeals the relevant information-sharing provision of the TAA on a date set by an Order in Council.

If the AISA is not in place by 1 April 2025, the ability to repeal clause 36 of schedule 7 by way of an Order in Council will cease on that date.

Application date

The amendment comes into force on a date to be set by Order in Council. If this has not occurred by 1 April 2025, the amendment is repealed.

Commissioner's remedial powers – disputable decisions

Section 138E(1)(e)(iv) of the Tax Administration Act 1994

The amendment clarifies that the disputes and challenge procedures of the Tax Administration Act 1994 (TAA) do not apply for the purposes of resolving disagreements with the Commissioner about the application of the discretionary remedial powers in that Act.

Background

Sections 6C to 6G were inserted into the TAA in 2019. These sections contain remedial powers, including discretionary regulation-making powers, that can be exercised in limited circumstances. These powers enable Orders in Council to modify

[82] ED0231: Excusing Estates from filing income tax returns **taxtechnical.ird.govt.nz/consultations/draft-items/ed0231**

the application of tax laws to be made on the recommendation of the Minister of Revenue. They also allow the Commissioner to grant exemptions from provisions of the Inland Revenue Acts where those provisions contain minor errors or are otherwise unable to be interpreted as giving effect to the intended purpose. Generally, a six-week period of public consultation is required on any proposed Order in Council or exemption before it comes into force. This can be shortened or dispensed with if the Commissioner considers a case of urgency exists.

Key features

References to sections 6E and 6F have been included in section 138E(1)(e)(iv) to clarify that a person cannot initiate the disputes and challenge procedures of the TAA for decisions made by the Commissioner under those provisions, for example, to grant (or not grant) an exemption, or to shorten or dispense with the period of public consultation for proposed exemptions if the Commissioner considers a case of urgency exists. This recognises that more appropriate mechanisms are in place for resolving issues about regulation-making powers, such as judicial review and the Regulations Review Committee.

Application date

The amendments apply from 30 March 2022.

Challenge notices – whether required after amended assessment issued

Section 89P of the Tax Administration Act 1994

The Commissioner is not required to issue a challenge notice, to the extent to which a taxpayer-initiated dispute has ended, when an assessment is issued that reflects some but not all the adjustments proposed by the taxpayer.

Background

In taxpayer-initiated disputes, the Commissioner is required to issue a challenge notice to mark the end of the disputes process under the Tax Administration Act 1994 (TAA). The challenge notice then forms the basis for the taxpayer to commence proceedings with either the High Court or the Taxation Review Authority.

However, it was unclear whether the Commissioner had to issue a challenge notice in circumstances where, at the end of the disputes process, the Commissioner issued an amended assessment that reflected some, but not all, of the taxpayer's proposed adjustments.

In such circumstances, if the Commissioner did issue a challenge notice, there seemed to be two bases on which a taxpayer could commence challenge proceedings:

- under section 138B(2) because an amended assessment had been issued, and
- under section 138B(3) because a challenge notice had been issued.

Two separate bases were not intended to exist for a taxpayer to commence challenge proceedings with a hearing authority. Further, the Commissioner should not have been required to issue a challenge notice to mark the end of the disputes process where an amended assessment was issued. This is because the amended assessment should form the basis of any challenge proceedings.

Key features

The amendment clarifies that the Commissioner is not required to issue a challenge notice to the extent a taxpayer-initiated dispute has ended when:

- the Commissioner issues an amended assessment that reflects some, but not all, of the adjustments proposed by the taxpayer, and
- the taxpayer can initiate challenge proceedings on the basis of the amended assessment.

Application date

The amendments apply from 30 March 2022.

Removing fax as a mode of communication

Sections 14, 14F and 14G of the Tax Administration Act 1994; section YA 4 of the Income Tax Act 2007; section 75B of the Goods and Services Act 1985; sections 211 and 212 of the Student Loan Scheme Act 2011

Faxes have been removed as a method of communication between a person and the Commissioner in the Inland Revenue Acts.

Background

Faxes were previously an approved method of communication (along with personal delivery, post and electronic means) between a person and the Commissioner in the Inland Revenue Acts. However, as faxes have not been supported since 31 August 2021, the legislation has been amended to reflect this.

Key features

These amendments remove faxes as a mode of communication between a person and the Commissioner in sections 14, 14F and 14G of the *Tax Administration Act 1994*, section YA 4 of the *Income Tax Act 2007*, section 75B of the *Goods and Services Act 1985*, and sections 211 and 212 of the *Student Loan Scheme Act 2011*.

Application date

This amendment applies from 30 March 2022, except for GST purposes, where the amendment applies for taxable periods starting on or after 1 April 2023.

R&D tax incentive – extension of due dates

Sections 33F and 68CF of the Tax Administration Act 1994

Certain due dates for the research and development tax incentive (RDTI) have been extended for specific years, including the dates for supplementary returns for the 2019–20 income year and applications for pre-approval for the 2020–21 income year, and an ongoing extension to the general approval application due date has also been introduced in certain situations.

Background

For any given income year, the RDTI generally requires a general approval (GA) application to be submitted by the seventh day of the second month after the end of the income year. For an application for criteria and methodologies (CAM) approval (for significant performers of R&D), the due date is generally the last day of the sixth month before the end of the income year. These requirements for GA and CAM approval are set out in sections 68CB and 68CC of the Tax Administration Act 1994 respectively.

An R&D activity can be covered under a GA or a CAM approval, and if a significant performer of R&D is unable to receive CAM approval, then they can still seek approval for specific activities through a GA application. However, significant performers may be notified that their CAM application has been declined too late in the income year to have enough time to prepare a GA application. To mitigate this risk, some businesses are filing both CAM and GA applications for the same activities, which creates unnecessary compliance and administrative costs.

A business then needs to file an R&D supplementary return generally within 30 days of their income tax return due date to receive their R&D tax credit.

Key features

- New section 33F extends the due date for filing a supplementary return for the 2019–20 income year to 31 August 2021.
- New section 68CF(1) extends the due date for making a GA or CAM approval application for the 2020–21 income year to 31 August 2021.
- New section 68CF(2) extends the due date for making a GA application to the date that is three months after the date that a significant performer has been notified of the outcome of their application for CAM approval for an income year.

Application date

Section 33F came into force on 1 April 2019. Section 68CF applies for the 2020–21 and later income years.

Detailed analysis

The extensions for the 2019–20 and 2020–21 income years have been enacted after the amended due date of 31 August 2021 passed. However, affected businesses were communicated with prior to that date to ensure that they were aware of the proposed extended deadlines so they could make use of them. If a taxpayer has a late balance date that resulted in their due date already being later than 31 August 2021, then this later due date remained.

For the 2020–21 and later income years, section 68CF(2) extends the due date for submitting a GA application if the applicant has submitted a CAM application for the income year but has not (before the GA application due date) been notified by the Commissioner of its outcome.

The extension under section 68CF(2) means a business will always have at least three months (from the time an application for CAM approval is declined) to prepare a GA application that covers activities for which the business initially applied for CAM approval. If the due date that would otherwise apply under section 68CB falls later than the due date that would apply under section 68CF(2), then the later due date will apply.

R&D tax incentive – tax year cut-off for claiming supporting activities

Section LY 5 of the Income Tax Act 2007; sections 68CB and 68CC of the Tax Administration Act 1994

Within the research and development tax incentive (RDTI), expenditure on supporting activities that arises one year before or after the relevant core activity is now eligible research and development (R&D) expenditure.

Background

Subpart LY of the Income Tax Act 2007 (ITA) sets out the provisions for R&D tax credits under the RDTI. Under section LY 3, the RDTI is only available in an income year if a core R&D activity is performed and if that activity is approved under sections 68CB or 68CC of the Tax Administration Act 1994 (TAA). Before the current amendments, approval could only be given for R&D activities in the current and future income years, but not for activities in a prior year.

Supporting R&D activities are those that have the only or main purpose of, and are required for, and integral to, conducting a person's core R&D activity. Expenditure on supporting activities was only intended to be eligible for the RDTI if a corresponding core activity has commenced (as this means there is R&D activity).

However, the concept of income years unintentionally resulted in some arbitrary exclusions from eligibility where the expenditure was incurred outside the income year in which the core activity occurred. For example, expenditure incurred on a pre-commencement supporting activity in March 2021 was ineligible if the core activity did not start until a month later in April 2021. However, if the supporting activity took place in April 2021, then all expenditure would be claimable. A similar concern arose for expenditure on a supporting activity relating to the end of a core activity if that expenditure was incurred in the year after that core activity concluded.

Key features

- New section LY 5(1)(ab) of the ITA includes in the definition of "eligible research and development expenditure" expenditure on supporting activities that occur up to one year before and after a relevant core activity.
- New sections 68CB(7B) and (7C) of the TAA allow for the variation of a general approval to give businesses time to seek approval for supporting activities occurring the year before or after the core activity.
- Amended sections 68CB(2) and 68CC(3) of the TAA ensure that, in addition to expenditure in the year of the core activity and up to two income years immediately after, supporting activity expenditure in the year before a core activity can now also be approved.

Application date

The amendments to section LY 5 of the ITA apply for the 2020–21 and later income years. They permit supporting activity expenditure incurred from the 2019–20 and later income years to be claimed.

The amendments to sections 68CB and 68CC of the TAA came into force on 1 April 2020.

Detailed analysis

Supporting activities outside the year the core activity is performed

Section LY 5 of the ITA sets out what constitutes eligible R&D expenditure. Subsection (1)(ab) has been inserted to make supporting activity claimable if it occurs in the year before (subparagraph (i)) or in the year after (subparagraph (ii)) the corresponding core activity commences or ceases, for the purposes of calculating a person's tax credit in section LY 4.

Pre- and post-core supporting activity expenditure or loss is therefore claimable in the year of the core activity. For example, pre-core supporting activity expenditure that arises in the 2019–20 income year can be claimed in the 2020–21 supplementary return if there was a core activity in that year. If the core activity ceased in that year, then post-core supporting activity in the 2021–22 income year could also be claimed in the 2020–21 supplementary return. This might require re-opening the assessment for that year.

As the supporting activity is claimed in the income year in which the core activity occurs, it counts toward the various caps for that year, such as the $120 million total cap on expenditure under section LY 4(3)(a).

Consequential amendments have been made to sections 68CB(2) and 68CC(3) of the TAA relating to the income years covered by a general approval (GA) and a criteria and methodologies (CAM) approval respectively. Before the amendments, the Commissioner was permitted to approve a person's R&D activities for an income year and up to two income years immediately after. For the avoidance of doubt, the income year prior to the relevant income year has now also been included if the approval is for pre-core supporting activity expenditure described in section LY 5(1)(ab)(i).

Variation powers

Both core and supporting activities are only eligible for the RDTI if they are pre-approved through the GA process or CAM approval process under sections 68CB and 68CC of the TAA.

A GA application must be submitted by the seventh day of the second month after the end of the relevant income year. For example, for a standard balance date taxpayer, the GA application due date for the 2021–22 income year is 7 May 2022. This creates a timing issue for post-core supporting activities where a business does not anticipate in time that it will have claimable supporting activity in the 2022–23 income year for a core activity performed in the 2021–22 income year.

New section 68CB(7B) gives the Commissioner the power to vary a general approval to include supporting activity that occurs in the year after the relevant core activity so that it can be included in a tax credit calculation under section LY 5. A variation must be applied for on or before the seventh day of the fourteenth month after the end of the relevant income year.

Example 146: Supporting activity in following year

Whizzy Ltd has a standard balance date and started its eligible R&D project in the 2020–21 income year. A general approval was sought for their 2020–21 core and supporting activities. However, toward the end of the 2020–21 income year, Whizzy Ltd's health and safety team put an abrupt end to their R&D work. Whizzy Ltd has some unexpected supporting activity occurring in the 2021–22 income year, but this was not included in its GA application.

Section 68CB(7B) gives Whizzy Ltd until 7 May 2022 to vary its 2020–21 GA application to include the supporting activities in the year after the end of its core R&D activity. If this process occurs after Whizzy Ltd files its supplementary return for the 2020–21 income year (due 30 April 2022), it will also need to request an amendment under section 113 to revise its eligible expenditure amount upward.

A transitional variation power has also been introduced in new section 68CB(7C) for pre-core supporting activity arising in the 2019–20 income year. Businesses have until 31 August 2022 to apply to include any such supporting activities in their general approval for the 2020–21 income year. This short-term variation power was required as the due date for these general approvals will have passed before any legislation could be enacted permitting the activities to be claimed. This issue will not arise for the 2021–22 and later income years as businesses will be able to establish whether they had any eligible pre-core supporting activity in the prior year when they submit their general approval for the particular year.

Example 147: Supporting activity in prior year

Fizzy Ltd has supporting activity expenditure in the 2019–20 income year, but the core activity only starts in the 2020–21 income year. Fizzy Ltd should be able to claim the 2019–20 supporting activity expenditure in its 2020–21 supplementary return, but to do so the activity must have been approved in a general approval for the 2020–21 year.

Fizzy Ltd has up until 31 August 2021 to submit its GA application under section 68CF (an extended due date). Up until 31 August 2021, Fizzy Ltd could request that the Commissioner vary the approvals in the GA application. However, new section 68CB(7C) now gives Fizzy Ltd until 31 August 2022 to vary its 2020–21 GA application to include the supporting activities that occur one year before its core activity.

R&D tax incentive – transition support payment

Sections CX 47, DF 1, and schedule 21B, part B of the Income Tax Act 2007

The transition support payment (TSP) for the research and development tax incentive (RDTI) is taxable with corresponding expenditure deductible. The TSP has also been carved out of the RDTI expenditure exclusions.

Background

The Government has agreed to implement the TSP to provide additional support to former Callaghan Innovation Growth Grant (Growth Grant) businesses transitioning to the RDTI. The Growth Grant, which ended in March 2021, was the main R&D support product for these businesses before the introduction of the RDTI.

The TSP is an adjustment to the RDTI entitlement of a business so that it approximates what the business would have received under the Growth Grant if that scheme had continued. It is available for the 2019–20 to 2021–22 income years. To claim the TSP, businesses must have been a former Growth Grant recipient and must participate in the RDTI for the relevant year.

Key features

- New section CX 47(5) of the Income Tax Act 2007 carves out the TSP from being excluded income and therefore makes it taxable.
- Amended section DF 1(1BA) ensures that expenditure attributable to the TSP is allowed a deduction.
- Schedule 21B, part B, clause 21 has been amended to ensure that receipt of the TSP does not make any expenditure or loss ineligible for the RDTI.

Application date

The amendments apply for the 2019–20 and later income years.

Detailed analysis

Section CX 47 provides for government grants generally being excluded income. New subsection (5) carves out the TSP from this section, which means the TSP is taxable and must be returned as income by the recipient business in the tax return for the income year the payment is received.

Section DF 1 provides for government grants generally being non-deductible. A corresponding amendment to subsection (1BA) also carves out the TSP from this section, which means that expenditure funded by the TSP is subject to the normal deduction rules in part D.

Schedule 21B, part B excludes certain expenditure from being eligible for the RDTI. Clause 21 covers "expenditure or loss that is a precondition to, subject to the terms of, or required by, a grant", meaning R&D spending funded by government grants is ineligible expenditure for the RDTI. However, clause 21 also contains carve-outs to these exclusions. An amendment to this clause ensures that receipt of the TSP does not make any expenditure or loss ineligible for the RDTI.

The tax treatment of the TSP is consistent with an option to treat the Growth Grant as taxable income, provided for under section CX 47(4). This optional treatment recognised that the business may receive the Growth Grant in a different income year to when the corresponding expenditure arose. The same situation could occur for the TSP. As with the Growth Grant, treating the TSP as taxable eliminates significant compliance costs and the need for a business to later amend a previously filed tax return to reverse deductions that were no longer allowed.

Similarly, it is desirable to treat deductible expenditure in a matching way. Instead of expenditure being treated as non-

deductible where the grant is non-taxable, the normal tax treatment applies. This eliminates difficult tracing and measurement or apportionment costs for the business, as well as the need to seek an amended return.

Administrative Amendments to the Child Support Act 1991

Sections 40AA, 40, 44, 81A, 87A, 88, 89H, 152B and 180D, schedule 1 and schedule 3 of the Child Support Act 1991

Background

In October 2021, the child support scheme moved to new systems and processes under Inland Revenue's new START system as part of its multi-year business transformation programme. This move allowed for greater efficiency and simplicity and created opportunity for legislative changes to further improve the administration of the child support scheme.

Such legislative changes were included in the Child Support Amendment Act 2021 (CSAA). However, following enactment of the CSAA, a group of minor and technical remedial changes were identified as necessary to be made to the Child Support Act 1991 (CSA) to give full effect to the policy intent of the CSAA amendments. The current amendments address these changes.

Application

The application dates for the current amendments to the CSA have been aligned to be consistent with the relevant application dates for the CSAA. For more information regarding the specific amendments in the CSAA, please see the *Tax Information Bulletin* Vol 33, No 10 (November 2021).

Key features

Topic	Section	Issue	Amendment
Estimations	Sections 40AA and 40	The CSAA allows newly liable parents to backdate their estimations (provided the estimation is made within 28 days of the notification of the assessment). It was intended that the backdating would cover estimations both previous years and within the current child support year. However, the amendment only allowed estimations over previous years.	The estimation rules have been clarified to allow backdated estimations to occur within the current child support year.
	Section 40	The CSAA allows a person to provide their initial child support estimate within 28 days and then submit a re-estimate within the same time period. Inland Revenue was not able to refuse subsequent backdated estimations made by a newly liable parent.	The estimation rules have been clarified to allow Inland Revenue to decline subsequent backdated estimations when the period has ended and will be squared up.

Continued...

Topic	Section	Issue	Amendment
End-of-year reconciliation	Sections 40AA and 44	The definition of "reconciliation period" under the CSAA does not result in the correct outcome for new backdated estimations. The definition was previously tied to the first day of the month in which notice is given. However, if the estimation was backdated to a period during the child support year, notice would have been given after the start date of the assessment. This means that, because the reconciliation period would begin on the first day of the month in which the notice of election is given, it would start too late to cover the correct period. Additionally, the definition did not work in cases when Inland Revenue received a backdated estimation that spanned multiple child support years.	The definition of "reconciliation period" has been updated to allow backdated estimations within the current child support year. Additionally, consistency has been provided within the definition of "election period" to provide accurate reconciliation of estimations that span multiple child support years.
Change of family circumstances	Section 81A	The CSAA allows Inland Revenue to backdate an assessment to correct for certain living circumstances that did not exist at the time of an initial assessment. However, Inland Revenue was not required to be satisfied that a relevant set of circumstances existed at the time of the assessment. Additionally, there was no requirement that the notification be accompanied by documentation.	The rules relating to a change of living circumstances have been clarified. Inland Revenue is now required to be satisfied that the relevant circumstances existed at the time of the initial assessment, and the notification must be accompanied by relevant documentation.
	Section 81A	The provision referred to circumstances that existed at the time the notification was made, as opposed to when the assessment began. It is possible that family circumstances change between the child support notification being made and when a child support application begins.	The provision relating to a change in family circumstances has been updated to clarify that the relevant circumstances are those that existed when the assessment begins.

Continued...

NEW LEGISLATION

Topic	Section	Issue	Amendment
Time bar	Sections 87A and 88	The CSAA restricts reassessments of a child support year to being made within four years from the end of the relevant child support year. Parents and carers are sent notification of their child support assessment in February each year and that assessment relates to the child support year starting on 1 April. However, the time bar previously started from the notification, rather than the beginning of the relevant child support year.	The four-year time bar provision has been clarified so that it begins from the beginning of the child support year, rather than when notification of the assessment is given. This ensures that it covers the intended four-year period.
	Section 87A	The CSAA provides an exception to the four-year time bar in circumstances where a liable person has a dual liability with an overseas jurisdiction. Previously, the exception referred to the payment of financial support, as opposed to having been assessed to pay financial support. This meant that the liable person must have "paid" financial support before the exception could apply. However, dual liability may exist but neither liability has been paid. This meant Inland Revenue could not apply the exception.	The exception to the four-year time bar has been clarified so that it can apply on assessment of a liability.
	Section 87A	The CSAA introduced an exception to the time bar that allows a person to apply for an administrative review of an assessment that relates to a time-barred period. The application must be received by Inland Revenue within four months of the date of the latest notice of assessment. However, the specified exclusions to the time bar did not allow successful administrative reviews under the provision to then be reflected in the child support assessment.	An additional exception to the time bar has been added to allow for administrative reviews received within the four-month window to be reflected in the child support assessment. This ensures the policy intent can be achieved, that is, to provide a limited period for reassessments.
Temporary exemption	Section 89H	The CSAA introduced a new temporary exemption from paying child support for people who have a long-term illness or injury and who are subsequently unable to engage in paid work. However, the application only required evidence that an individual had a long-term period of illness.	The exemption relating to a long-term period of illness has been clarified. When submitting an application, an individual is now required to provide evidence that they are unable to engage in paid work.
Offsetting	Section 152B	The CSAA allowed Inland Revenue to offset child support amounts between parents without the relevant parent having to apply for an administrative review. However, it did not allow offsetting to occur under a voluntary agreement.	The offsetting provision has been clarified so that it also allows for the offsetting of a voluntary agreement.
Write-off rules	Section 180D	The CSAA allows Inland Revenue to write off debt, including penalties, when a liable person or receiving carer dies. Currently, the relevant provision uses outdated terminology.	The write off provisions have been clarified to update the terminology used. The provision now refers to a penalty or a pre-2021 penalty.

Continued...

Topic	Section	Issue	Amendment
Transitional provisions	Schedule 1, Part 4, clause 14	The CSAA included a transitional provision to establish that the amendments introduced did not affect the 2020–21 and earlier child support years. This was not required and had the capacity to result in some difficulty with the application of certain amendments in the CSA.	The transitional provision has been repealed.
	Schedule 1, Part 4, clause 16A	In removing the transitional provision, Inland Revenue would have been required to use the new reconciliation rules, including when the reconciliation was for a child support year before 1 April 2022. This would have meant Inland Revenue would be required to use rules that may not work for a particular year because of, for example, changes to the child support assessment formula.	A transitional provision has been introduced that allows the old reconciliation rules to be used in earlier child support years in which they apply.
Child expenditure tables	Schedule 3	The CSAA removed the mixed-aged bracket of the expenditure table for calculating a rate of child support. However, the heading still contained the words "or the oldest three".	The child expenditure table has been clarified to correct the heading.

Removal of the power to repeal the Serious Fraud Office information-sharing clause

Sections 2(37), 235 and 239(3) of the Taxation (KiwiSaver, Student Loans, and Remedial Matters) Act 2020

The amendments remove the power to repeal clause 7 of schedule 7 of the Tax Administration Act 1994 (TAA), which relates to the sharing of information with the Director of the Serious Fraud Office, by Order in Council.

Background

The Taxation (KiwiSaver, Student Loans, and Remedial Matters) Act 2020 provided for clause 7 of schedule 7 of the TAA to be repealed on a date to be appointed by Order in Council. This Order has not been made.

This empowering provision was enacted ahead of the implementation of the Serious Crime Approved Information Sharing Agreement (AISA), which was being progressed at that time. The provision was intended to enable the AISA to be implemented correctly and to avoid two authorising provisions (the clause and the AISA) from being in place at the same time.

However, it has since transpired that, due to the information being shared, it is not necessary to repeal the clause. The amendment addresses this by removing the power to repeal the clause by Order in Council.

Application date

The amendment came into force on 30 March 2022.

Clarifying the definitions of "sensitive revenue information" and "revenue information"

Section 16C of the Tax Administration Act 1994

The definitions of "revenue information" and "sensitive revenue information" in sections 16C(2) and (3) of the Tax Administration Act 1994 have been clarified.

Background

It could previously have been argued that a broad interpretation of the definitions of "revenue information" and "sensitive revenue information" meant all information held by the Commissioner (including non-tax-related information) needed to be treated as sensitive revenue information. On that basis, types of information that could be released by any other government agency, such as the number of lightbulbs purchased in a year, would have its release restricted for Inland Revenue. Such a broad interpretation would negatively affect the interpretation and application of the confidentiality rules, which were modernised in

2019 with the aim of enabling more information held by Inland Revenue to be made available than previously.

The confidentiality rules were not intended to impose restrictions on information held by Inland Revenue with no real connection to either the Commissioner or to Inland Revenue's responsibility for tax law and the administration of the tax system. The amendments address this issue.

Key features

The amendments clarify the relevant terms and prevent a broad interpretation by emphasising the need for a connection with a revenue law and a relevant revenue purpose. From a practical perspective, this has no implications for taxpayers or their information.

Application date

The amendments came into effect on 18 March 2019, the date the rules were modernised.

Repeal of transitional co-existence provisions

Sections 139A(10), 139AA(7) and 139B(1B) of the Tax Administration Act 1994

Provisions that relate to the co-existence of Inland Revenue's two software platforms have been repealed.

Background

Inland Revenue has updated its software platform as part of its Business Transformation programme. During the duration of that programme, several transitional provisions were introduced to support co-existence of the old platform, FIRST,[83] and the new START[84] platform.

By October 2021, all tax products had been migrated to the new START platform, with FIRST being decommissioned. The transitional provisions relating to the co-existence of two software platforms were therefore no longer required.

Application date

The amendments apply for penalties imposed after 1 April 2022.

[83] Future Inland Revenue System and Technology

[84] Simplified Tax and Revenue Technology

Amending and later repealing the definition of "START tax type"

Sections 3 and 183C of the Tax Administration Act 1994

Three new tax types (casino duty, lottery duty, and totalisator duty) have been added to the definition of "START tax type" from 1 March 2021. The definition of "START tax type" has then been repealed from 1 April 2022.

Background

Inland Revenue had been progressively adding tax types from its old technology platform, FIRST, to its new START system as part of its Business Transformation programme.

From 1 March 2021, casino duty, lottery duty and totalisator duty were added to the START system. These three tax types also had to be added to the definition of "START tax type" in section 3 of the Tax Administration Act 1994 (TAA) from that date. The definition of "START tax type" was used in section 183C of the TAA, which relates to the cancellation of interest.

In October 2021, Inland Revenue completed shifting all tax types to START. As the definition of "START tax type" then became redundant, the definition has been repealed from 1 April 2022.

Consequential amendments also had to be made to section 183C to replace references to "START tax type" from 1 April 2022.

Preventing circularity of KiwiSaver employer contributions

Section 4 of the KiwiSaver Act 2006

The definition of "employer contribution" in section 4 of the KiwiSaver Act 2006 has been amended to ensure that an employer need not pay an employer KiwiSaver contribution if the employer knows that the employee has opted out.

Background

Under section 93 of the KiwiSaver Act 2006, an employer is required to pay all amounts of employer KiwiSaver contributions to the Commissioner. Where an employee opts out of KiwiSaver, Inland Revenue is required to refund that money to the employer under section 100 of the KiwiSaver Act 2006. However, the interaction of section 93 and section 100 could produce a circularity of cash flow by requiring the employer to pay a KiwiSaver contribution to Inland Revenue that Inland Revenue in turn had to refund to the employer.

The amendment addresses this issue.

Application date

The amendment came into force on 30 March 2022.

ACC and KiwiSaver being made subject to a time bar

Sections 89B, 89L, 108, 108AB, 108B, 125, and 138P of the Tax Administration Act 1994; sections 80, 81, 81B, 91B, 100, 101, 101AA, and 114 of the KiwiSaver Act 2006

The amendments introduce a four-year time bar on increased and decreased assessments of KiwiSaver employer and employee deductions and increased assessments of ACC earners' levy deductions. This treats KiwiSaver employer and employee deductions and ACC earners' levy deductions the same as other PAYE deductions for time bar purposes.

Background

The Tax Administration Act 1994 (TAA) imposes a four-year time bar on the amendment of tax assessments. The time bar means that, once four years have passed, the Commissioner of Inland Revenue may not amend an assessment to increase the amount assessed or decrease the amount of a net loss. There are a limited number of exceptions to this four-year period, most notably that it does not apply in instances of fraud. The Income Tax Act 2007 also imposes a four-year time bar on taxpayers' ability to claim a refund for overpayments of tax. Both time bars are present to provide certainty within the tax system and to taxpayers.

The KiwiSaver Act 2006 (KSA) legislates that employer and employee deductions are subject to the PAYE rules.[85] However, this requirement does not capture increased assessments or refunds of KiwiSaver employer and employee deductions for the purposes of the time bar.

[85] Section 67 of the KiwiSaver Act 2006.

The consequence of this is that, for time bar purposes, KiwiSaver employer and employee deductions and ACC earners' levy deductions are not treated consistently with other PAYE deductions that are subject to the time bar. This increases uncertainty and exposure to ongoing liabilities for taxpayers, KiwiSaver providers and Inland Revenue.

Key features

New section 108AB has been inserted into the TAA. The provision applies to both employer and employee deductions and provides a four-year time bar on amended assessments of KiwiSaver deductions that increase an amount assessed.

However, where the employer information provided by the employer is fraudulent or wilfully misleading, the Commissioner is able to amend an assessment at any time to increase the amount assessed.

Section 108(1C) of the TAA has been amended to provide that the Commissioner may not amend an assessment of ACC earners' levy deductions to increase the amount of an assessment after a period of four years from the date the employer provided the return.

New section 91B has been inserted into the KSA. This section provides that the Commissioner and KiwiSaver providers must not refund employer and employee contributions after the four-year period under section 108AB of the TAA has ended.

There are also several consequential amendments to the TAA and the KSA to give effect to these changes.

Application date

The amendments came into force on 30 March 2022.

Penalty for failure to keep taxpayer information confidential

Section 143D of the Tax Administration Act 1994

The penalty for failure by employees of another agency to keep taxpayer information confidential has been reinstated. These employees were unintentionally omitted when changes were made to the penalty provision in the Tax Administration Act 1994 (TAA) in 2019.

Background

Inland Revenue currently shares taxpayer information with 22 other agencies to assist those agencies in providing public services. Employees of these other agencies are required to keep this information confidential under the TAA. Before March 2019, failure by an employee of another agency to keep taxpayer information confidential was included in an offence provision under the TAA and punishable by a maximum penalty of $15,000 and/or a term of imprisonment of up to six months.

Changes were made to the offence provisions in the TAA by the Taxation (Annual Rates for 2018–19, Modernising Tax Administration, and Remedial Matters) Act 2019. An unintended outcome of these changes was that the references to situations where employees of other agencies receive taxpayer information were omitted.

Key features

Section 143D of the TAA describes the instances where a person, having access to taxpayer information, commits an offence for failing to keep taxpayer information confidential. The amendment inserts a new subparagraph into section 143D(1) to refer to situations where the Commissioner shares taxpayer information with other agencies and their employees.

Application date

The amendment came into force on 30 March 2022.

Back-dated validation of enrolment of certain KiwiSaver members

Sections 59A, 59B, 59C, and 59D, and schedule 1 of the KiwiSaver Act 2006

Amendments have been made to allow back-dated validations of enrolments in KiwiSaver for those persons who were over 65 at the time they joined KiwiSaver and were still a member of KiwiSaver on 1 September 2021.

Background

Before 1 July 2019, a person of New Zealand superannuation qualification age (65 years) or over could not enrol in KiwiSaver. On 1 July 2019, a legislative change was made to allow people aged 65 years or over to opt in to KiwiSaver. However, automatic enrolment into KiwiSaver was still prevented for those people.

Where a person aged 65 years or over opted in to KiwiSaver before 1 July 2019, or they were automatically enrolled at any time, their enrolment was invalid and could not be subsequently validated.

The amendments address this issue.

Application date

The amendments came into force on 1 September 2021.

Small Business Cashflow (Loan) Scheme and COVID-19 Support Payments Scheme

Sections 7AA and 7AAB of the Tax Administration Act 1994

Amendments to the recovery provisions for the Small Business Cashflow (Loan) Scheme (SBCS) and COVID-19 Support Payments (CSP) Scheme allow the Commissioner of Inland Revenue to recover funds in situations where an ineligible applicant receives a loan and/or grant amount, but the funds are received by, or otherwise passed on to, an associated person.

Background

The SBCS was introduced in 2021 to support small to medium businesses and organisations struggling with a loss of actual revenue due to COVID-19. If a person receives a loan under the SBCS and does not meet the required eligibility requirements, the person must repay the total amount to the Commissioner of Inland Revenue immediately.

The Resurgence Support Payments (RSP) Scheme was designed on similar principles to the SBCS and was introduced in January 2021. The RSP Scheme allowed the Governor-General, by Order in Council, to activate an RSP Scheme to provide support to persons that had suffered a decline in revenue due to COVID-19. Similar to the SBCS, if a person received a grant from the Commissioner under the RSP Scheme and did not meet the eligibility requirements, the person had to immediately repay the total grant amount to the Commissioner. The RSP Scheme was adapted into the more flexible CSP Scheme in November 2021. No changes were made to the recovery provisions.

Before the amendments, the recovery provisions for the SBCS and CSP only allowed for the recovery of funds from ineligible applicants. This did not include situations where the loan and/or grant amount was received by the applicant, but the benefit of the funds was received directly or indirectly by an associated person.

For example, a company applied for (and received) a loan under the SBCS and paid the funds to its 100% shareholder/director as a dividend. If the company was ineligible to receive the loan, the Commissioner only had a statutory right of recovery against the applicant (the company) and not the associated person (shareholder/director) who received the funds. No contractual relationship existed with that associated person, and no statutory provision required repayment from that person in this situation. Often in these cases, the company is just a shell or deregistered and the Commissioner cannot recover the funds from the company. However, the Commissioner also had no statutory right to recover the funds from the other party (albeit that the Commissioner could, depending on the circumstances, have a claim against that other party for money they had received).

Key features

The recovery provisions of both the SBCS and CSP have been amended to ensure that the Commissioner of Inland Revenue can recover funds from associated persons who have directly or indirectly received the benefit of the funds from an ineligible application other than as adequate consideration for a supply of goods or services, (that is, it is limited to associated persons of the applicant that have received the benefit of the funds for no or inadequate consideration).

Application date

The amendments came into force on 30 March 2022.

Domestic trust disclosure rules

Section 59BA of the Tax Administration Act 1994

The domestic trust disclosure rules in section 59BA of the Tax Administration Act 1994 (TAA) have been amended to require trustees to disclose the nature of each distribution made, to exclude minor and incidental non-cash distributions from the disclosure requirements, and to exclude all foreign trusts from the rules.

Background

The Taxation (Income Tax Rate and Other Amendments) Act 2020 introduced disclosure requirements for domestic trusts for the 2021–22 and later income years to help evaluate the effectiveness of the new top personal tax of 39% and gain insight into the use of structures and entities by trustees in New Zealand. Several issues with these disclosure rules have been identified.

The disclosure rules do not specifically require trustees to disclose the nature of each distribution. This poses a risk for the quality of the data collected. Requiring trustees to disclose the nature of distributions would help ensure the quality of information collected is sufficient to draw informed conclusions.

Trustees subject to the disclosure rules in section 59BA must disclose details of each settlement that is made on the trust in the income year. The exception to this is if the settlement is the provision to the trustee, at less than market value, of minor services incidental to the operation of the trust. In contrast, however, trustees must disclose details of every distribution made by them in the income year, as there is no equivalent exclusion for minor and incidental distributions. The requirement to disclose minor and incidental, non-cash distributions imposes unnecessary compliance costs on trustees and provides negligible benefit to Inland Revenue.

Foreign trusts required to make a return under section 59D of the TAA are excluded from the domestic trust disclosure requirements, as they already have a disclosure regime. However, not all foreign trusts are captured by section 59D. Subjecting foreign trusts to the domestic trust disclosure requirements raises several practical issues and is likely to impose unnecessary compliance costs for limited benefit. Foreign trusts with no New Zealand resident trustees or settlors but with New Zealand-sourced income are outside the intended scope of the domestic trust disclosure rules.

Key features

The domestic trust disclosure rules have been amended to:

- explicitly state that trustees subject to the rules must disclose the nature of distributions made
- exclude distributions that are non-cash, minor and incidental to the activities of a trust from the disclosure requirements, and
- exclude all foreign trusts from the scope of the rules.

Application date

The amendments apply for the 2021–22 and later income years.

Provisional tax – safe harbour concession

Sections 120KE and 120KF of the Tax Administration Act 1994

Section 120KE has been amended to remove the requirement for eligible provisional taxpayers to have to pay in full and on time to access the safe harbour concession. Section 120KF is also consequentially repealed, as the tolerance provided in that section for underpaying provisional tax instalments by $20 or less is no longer necessary.

Background

The safe harbour concession for provisional tax is available to those provisional taxpayers who meet the requirements in the TAA. Qualifying as a safe harbour taxpayer means that use of money interest (UOMI) is only charged to underpayments after the terminal tax due date.

In 2017 the safe harbour concession was amended to require a person to have paid their provisional tax instalments in full and on time to qualify as a safe harbour taxpayer.

At the time of the change, the number of taxpayers who unintentionally pay one or two days late or by small amounts was underestimated. As a result, a large number of taxpayers have since been caught out by the change and have incurred UOMI, as well as late payment penalties. In these circumstances, the application of UOMI and late payment penalties is not proportionate to the offence committed.

The amendments ensure taxpayers retain the safe harbour concession even if they miss a payment. However, late payment penalties will still apply to any underpayments.

Application date

The amendments apply for the 2022–23 and later income years.

Regular collection of bulk data

Section 17B(4) of the Tax Administration Act 1994

The definition of "person" in section 17B(4) of the Tax Administration Act 1994 (TAA) has been extended to also apply for the purposes of section 17L of the TAA. This clarifies that section 17L, which authorises the making of regulations covering regular and/or ongoing requests for bulk data, applies to the Crown and government departments.

Background

When enacted, section 17L was intended to facilitate the regular collection of information, particularly from other government departments, and to provide an efficient alternative to the one-off data collection requests available under section 17B of the TAA. However, legal advice identified that the section may not have applied to the Crown or government departments. The amendment to section 17B addresses this and makes clear that section 17L applies to the Crown and government departments.

Application date

The amendment applies from 30 March 2022.

Definition of "reportable income"

Section 22D of the Tax Administration Act 1994

The definition of "reportable income" has been extended to include amounts received under the Wage Subsidy, Leave Support and Short-Term Absence schemes.

Background

The Wage Subsidy Scheme (WSS) and Leave Support Scheme (LSS) were introduced in March 2020. The Short-Term Absence Scheme (STAS) was introduced in February 2021.

However, because the definition of "reportable income" in the Tax Administration Act 1994 did not include WSS, LSS and STAS receipts, taxpayers who received payments under these schemes were required to file an IR3 return. Approximately 50,000 of these taxpayers had previously been eligible for an Inland Revenue "auto-calc" income assessment. This resulted in increased compliance costs for taxpayers and raised administrative costs for Inland Revenue.

The amendment addresses this issue.

Application date

The amendment applies for the 2021–22 and later income years.

Government guarantee of pre-2020 KiwiSaver employer contributions

Sections 73, 78 and 85 of the KiwiSaver Act 2006

It has been clarified that KiwiSaver employer contributions outstanding before 1 April 2020 are subject to the government guarantee of those contributions that was introduced on 1 April 2020.

Background

From 1 April 2020 a government guarantee was added for KiwiSaver employer contributions – previously only KiwiSaver employee contributions were guaranteed by the government. This government guarantee was intended to apply to all KiwiSaver employer contributions – with no distinction made between pre- and post-1 April 2020 employer contributions. However, when introduced, the legislation could be read as only those employer contributions on or after 1 April 2020 were subject to a government guarantee.

The amendments clarify that outstanding KiwiSaver employer contributions before 1 April 2020 are covered by the government guarantee. A consequential amendment has also been made to the way in which use of money interest is calculated on those pre-1 April 2020 KiwiSaver employer contributions.

Application date

The amendments come into force on 30 March 2022.

MAINTENANCE ITEMS

Background

The amendments in Table X are minor technical maintenance items, including those arising from both the rewrite of the Income Tax Act and subsequent changes.

The amendments in Table 3 correct any of the following:

- ambiguities
- compilation issues
- cross-references
- drafting consistency, including readers' aids – for example, the defined terms lists
- grammar
- consequential amendments arising from substantive rewrite amendments, and
- inconsistent use of terminology and definitions.

Application date

Application dates for each amendment are stated in Table 3.

Detailed analysis

Table 3: Maintenance amendments

Act	Section	Amendment	Application date
Goods and Services Tax Act 1985	5(6AB)	Correcting terminology	1 July 2017
	5(6E)(b)(ii)	Correcting cross- references	1 April 2010
Income Tax Act 2007	BC 5	Correcting the defined terms list	1 April 2008
	DB 20B	Correcting the defined terms list	1 April 2013

Continued...

Act	Section	Amendment	Application date
Income Tax Act 2007	DB 41	Adding to the defined terms list	1 April 2022
	EE 6	Correcting the defined terms list	1 April 2019
	EE 44(2)(d)	Correcting terminology	4 September 2010
	EJ 10B(6)	Correcting terminology	Income years starting on or after 1 January 2019
	FO 2(b)	Correcting cross- references	1 April 2008
	HF 7	Improving drafting consistency	1 April 2008
	HR 3(6A)(f)	Correcting terminology	30 January 2021
	IP 3	Correcting terminology	1 April 2020
	IZ 8	Correcting terminology	30 March 2022
	LY 9	Correcting terminology	1 April 2019
	LY 10	Correcting terminology	1 April 2019
	MD 9(1)(a)	Correcting terminology	1 April 2021
	MD 9(4), (5), (9)	Improving drafting consistency	1 July 2020
	MX 3(3)	Correcting cross- references	30 March 2017
	OA 9(3)	Correcting cross- references	1 April 2008
	RD 5(1)(c)	Correcting cross- references	30 March 2017
	RM 1	Correcting defined terms list	1 April 2017
	YA 1 "capital contribution"	Clarifying the application of the definition	Amount derived on or after 1 April 2015
	YA 1 "date of acquisition"	Correcting cross- references	27 March 2021
	YA 1 "dwelling"	Correcting cross- references	27 March 2021
	YA 1 "finance lease"	Updating terminology	Income years starting on or after 1 January 2019
	YA 1 "group of persons"	Correcting cross- references	27 March 2021
	YA 1 "group of persons"	Correcting cross- references	30 March 2021
	YA 1 "principal settlor"	Correcting terminology	27 March 2021
	YA 1 "residential land"	Correcting terminology	27 March 2021 for bright-line test purposes and 2020–21 and later income years for other purposes

Continued...

Act	Section	Amendment	Application date
Income Tax Act 2007	YA 1 "settlement"	Correcting cross- references	27 March 2021
	YE 1(6)	Correcting terminology	1 April 2008
Tax Administration Act 1994	3 "proscribed question"	Improving drafting consistency	1 October 2019
	3 "tax shortfall"	Correcting cross- references	1 April 2019
	113(1)	Correcting cross- references	1 April 2019
	157A(1)	Correcting cross- references	30 March 2022
	225, 225AA	Revoking redundant regulations	30 March 2022
	Schedule 8	Correcting cross- references and terminology	1 April 2020
KiwiSaver Act 2006	83(3)(c)	Correcting terminology	30 March 2021
Unclaimed Money Act 1971	8(5)(c)	Correcting cross- references	30 March 2021

BINDING RULINGS

This section of the *TIB* contains binding rulings that the Commissioner of Inland Revenue has issued recently. The Commissioner can issue binding rulings in certain situations. Inland Revenue is bound to follow such a ruling if a taxpayer to whom the ruling applies calculates their tax liability based on it.

For full details of how binding rulings work, see *Binding rulings: How to get certainty on the tax position of your transaction (IR715)*. You can download this publication free from our website at **www.ird.govt.nz**

BR Pub 22/01: Income tax – Australian source income earned by Australian limited partnership and foreign tax credits

This is a public ruling made under s 91D of the Tax Administration Act 1994.

Taxation Laws

All legislative references are to the Income Tax Act 2007 unless otherwise stated.

This ruling is on ss BH 1 and HG 2, subpart LJ and articles 1(2) and 23(3) of the Schedule to the Double Taxation Relief (Australia) Order 2010 (the Australia and New Zealand Double Tax Agreement), as modified by the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting.

Definitions

For this ruling:

- **Limited partnership** means a partnership that does not meet the definition of company under s YA 1 and is defined as a corporate limited partnership and treated as a company for Australian income tax purposes under Division 5A of the Income Tax Assessment Act 1936 (Aust).
- **New Zealand partner** means a partner that is resident in New Zealand under s YD 1 (residence of natural persons) or s YD 2 (residence of companies) and is not treated as non-resident under a double tax agreement.
- **Australian income tax** means income tax paid to the Australian Government at the company tax rate (as set out in s 23(2) of the Income Tax Rates Act 1986 (Aust)).
- **Partnership share** is defined in s YA 1 as meaning for a particular right, obligation, or other property, status or thing, the share that a partner has in the partnership.

The Arrangement to which this Ruling applies

The Arrangement is as follows:

- Australian source income is earned by an Australian limited partnership that is income to the New Zealand partners under ss HG 2, CB 1 and CB 35.
- The Australian source income of the Australian limited partnership is attributable to a permanent establishment in Australia.
- Australian income tax is paid on that income.

To avoid doubt, the Arrangement does not include arrangements where:

- subpart BG applies to void the arrangement; or
- an election has been made under s FH 14.

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

- New Zealand partners in the limited partnership are allowed a foreign tax credit for the Australian income tax paid, calculated in accordance with subpart LJ. The foreign tax credit arises under articles 1(2) and 23(3) of the Australia and New Zealand Double Tax Agreement, and ss BH 1 and LJ 1. Under s HG 2 the tax credit claimed by the New Zealand partners must be in proportion to their partnership share of the income earned by the partnership.

The period or income year for which this Ruling applies

This ruling will apply from the first day of the 2022/23 income year to the last day of the 2026/27 income year.

This Ruling is signed by me on 29 April 2022.

Susan Price
Group Leader, Public Advice and Guidance
Tax Counsel Office

BR Pub 22/02: Income tax – distributions made by Australian limited partnership and foreign tax credits

This is a public ruling made under s 91D of the Tax Administration Act 1994.

Taxation Laws

All legislative references are to the Income Tax Act 2007 unless otherwise stated.

This ruling is on ss BH 1 and HG 2, subpart LJ and articles 1(2) and 23(3) of the Schedule to the Double Taxation Relief (Australia) Order 2010 (the Australia and New Zealand Double Tax Agreement), as modified by the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting.

Definitions

For this ruling:

- **Limited partnership** means a partnership that does not meet the definition of company under s YA 1 and is defined as a corporate limited partnership and treated as a company for Australian income tax purposes under Division 5A of the Income Tax Assessment Act 1936 (Aust).
- **New Zealand partner** means a partner that is resident in New Zealand under s YD 1 (residence of natural persons) or s YD 2 (residence of companies) and is not treated as non-resident under a double tax agreement.
- **Australian income tax** means income tax paid to the Australian Government at the company tax rate (as set out in s 23(2) of the Income Tax Rates Act 1986 (Aust)).
- **Dividend withholding tax** means the amount withheld from a dividend to discharge the liability to pay tax on dividends under s 128B of the Income Tax Assessment Act 1936 (Aust).
- **Partnership share** is defined in s YA 1 as meaning for a particular right, obligation, or other property, status or thing, the share that a partner has in the partnership.

The Arrangement to which this Ruling applies

The Arrangement is as follows:

- An Australian limited partnership makes a distribution to its partners and the New Zealand partners are not liable for New Zealand income tax on their partnership share of that distribution.

- Australian income tax in the form of dividend withholding tax is deducted from the payments made to the New Zealand partners.

To avoid doubt, the Arrangement does not include arrangements where:

- subpart BG applies to void the arrangement; or
- an election has been made under s FH 14.

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

- New Zealand partners in the limited partnership are not allowed a foreign tax credit for the Australian dividend withholding tax withheld on the distribution made by the partnership.

The period or income year for which this Ruling applies

This ruling will apply from the first day of the 2022/23 income year to the last day of the 2026/27 income year.

This Ruling is signed by me on 29 April 2022.

Susan Price
Group Leader, Public Advice and Guidance
Tax Counsel Office

BR Pub 22/03: Income tax – distributions made by Australian unit trust to Australian limited partnership and foreign tax credits

This is a public ruling made under s 91D of the Tax Administration Act 1994.

Taxation Laws

All legislative references are to the Income Tax Act 2007 unless otherwise stated.

This ruling is on ss BH 1 and HG 2, subpart LJ and articles 1(2) and 23(3) of the Schedule to the Double Taxation Relief (Australia) Order 2010 (the Australia and New Zealand Double Tax Agreement), as modified by the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting.

Definitions

For this ruling:

- **Australian unit trust** means a unit trust that is tax resident in Australia and derives Australian source income.
- **Limited partnership** means a partnership that does not meet the definition of company under s YA 1 and is defined as a corporate limited partnership and treated as a company for Australian income tax purposes under Division 5A of the Income Tax Assessment Act 1936 (Aust).
- **New Zealand partner** means a partner that is resident in New Zealand under s YD 1 (residence of natural persons) and is not treated as non-resident under a double tax agreement.
- **Australian income tax** means income tax paid to the Australian Government at the company tax rate (as set out in s 23(2) of the Income Tax Rates Act 1986 (Aust)).
- **Partnership share** is defined in s YA 1 as meaning for a particular right, obligation, or other property, status or thing, the share that a partner has in the partnership.

The Arrangement to which this Ruling applies

The Arrangement is as follows:

- A distribution is made by an Australian unit trust to an Australian limited partnership that is a dividend under s CD 1 and income to the New Zealand partners under ss HG 2 and CB 35.
- Australian source income of the Australian limited partnership is attributable to a permanent establishment in Australia.
- The limited partnership pays Australian income tax on that distribution.

To avoid doubt, the Arrangement does not include arrangements where:

- subpart BG applies to void the arrangement; or
- an election has been made under s FH 14.

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

- New Zealand partners in the limited partnership are allowed a foreign tax credit for the Australian income tax paid, calculated in accordance with subpart LJ. The foreign tax credit arises under articles 1(2) and 23(3) of the Australia and New Zealand Double Tax Agreement, and ss BH 1 and LJ 1. Under s HG 2 the tax credit claimed by the New Zealand partners must be in proportion to their partnership share of the income earned by the partnership.

The period or income year for which this Ruling applies

This ruling will apply from the first day of the 2022/23 income year to the last day of the 2026/27 income year.

This Ruling is signed by me on 29 April 2022.

Susan Price
Group Leader, Public Advice and Guidance
Tax Counsel Office

BR Pub 22/04: Income tax – franked dividend received by Australian limited partnership and foreign tax credits

This is a public ruling made under s 91D of the Tax Administration Act 1994.

Taxation Laws

All legislative references are to the Income Tax Act 2007 unless otherwise stated.

This ruling is on ss BH 1 and HG 2, subpart LJ and articles 1(2) and 23(3) of the Schedule to the Double Taxation Relief (Australia) Order 2010 (the Australia and New Zealand Double Tax Agreement), as modified by the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting.

Definitions

For this ruling:

- **Limited partnership** means a partnership that does not meet the definition of company under s YA 1 and is defined as a corporate limited partnership and treated as a company for Australian income tax purposes under Division 5A of the Income Tax Assessment Act 1936 (Aust).
- **New Zealand partner** means a partner that is resident in New Zealand under s YD 1 (residence of natural persons) and is not treated as non-resident under a double tax agreement.

- **Australian income tax** means income tax paid to the Australian Government at the company tax rate (as set out in s 23(2) of the Income Tax Rates Act 1986 (Aust)).
- **Franking credit** for Australian tax purposes is defined in s 205-15 of the Income Tax Assessment Act 1997 (Aust).
- **Partnership share** is defined in s YA 1 as meaning for a particular right, obligation, or other property, status or thing, the share that a partner has in the partnership.

The Arrangement to which this Ruling applies

The Arrangement is as follows:

- An Australian limited partnership receives a dividend that has a franking credit attached.
- The New Zealand partners are liable to tax on their partnership share of the dividend received by the limited partnership under ss HG 2, CD 1 and CB 35. The dividend income derived by the New Zealand partners excludes the amount of franking credits used to reduce the amount of Australian income tax payable.

To avoid doubt, the Arrangement does not include arrangements where:

- subpart BG applies to void the arrangement; or
- an election has been made under s FH 14.

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

- New Zealand partners in the limited partnership are not allowed a foreign tax credit for the franking credit attached to the dividend received by the limited partnership.

The period or income year for which this Ruling applies

This ruling will apply from the first day of the 2022/23 income year to the last day of the 2026/27 income year.

This Ruling is signed by me on 29 April 2022.

Susan Price
Group Leader, Public Advice and Guidance
Tax Counsel Office

BR Pub 22/05: Income tax – tax paid by an Australian limited partnership as a "head company" and foreign tax credits

This is a public ruling made under s 91D of the Tax Administration Act 1994.

Taxation Laws

All legislative references are to the Income Tax Act 2007 unless otherwise stated.

This ruling is on ss BH 1 and HG 2, subpart LJ and articles 1(2) and 23(3) of the Schedule to the Double Taxation Relief (Australia) Order 2010 (the Australia and New Zealand Double Tax Agreement), as modified by the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting.

Definitions

For this ruling:

- **Limited partnership** means a partnership that does not meet the definition of company under s YA 1 and is defined as a corporate limited partnership and treated as a company for Australian income tax purposes under Division 5A of the Income Tax Assessment Act 1936 (Aust).
- **New Zealand partner** means a partner that is resident in New Zealand under s YD 1 (residence of natural persons) or s YD 2 (residence of companies) and is not treated as non-resident under a double tax agreement.
- **Australian income tax** means income tax paid to the Australian Government at the company tax rate (as set out in s 23(2) of the Income Tax Rates Act 1986 (Aust)).
- **Partnership share** is defined in s YA 1 as meaning for a particular right, obligation, or other property, status or thing, the share that a partner has in the partnership.

The Arrangement to which this Ruling applies

The Arrangement is as follows:

- Australian source income is earned by an Australian limited partnership that is income to the New Zealand partners under ss HG 2, CB 1 and CB 35.
- The Australian source income of the Australian limited partnership is attributable to a permanent establishment in Australia.
- The Australian limited partnership is a head company under s 703-15(2) of the Income Tax Assessment Act 1997 (Aust).
- The limited partnership pays income tax in Australia on all the taxable income of the consolidated group.
- The taxable income of the consolidated group in Australia includes income, such as business income earned by Australian subsidiary companies that does not form part of the New Zealand partners' partnership share of the partnership income under ss HG 2 and CB 35.

The Arrangement excludes situations where one or more of the group entities are in a loss position.

To avoid doubt, the Arrangement does not include arrangements where:

- subpart BG applies to void the arrangement; or
- an election has been made under s FH 14.

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

- New Zealand partners in the limited partnership are allowed a foreign tax credit for the Australian income tax paid on the income the limited partnership earns directly (and not through the subsidiary companies), calculated in accordance with subpart LJ. The foreign tax credit arises under articles 1(2) and 23(3) of the Australia and New Zealand Double Tax Agreement, and ss BH 1 and LJ 1. Under s HG 2 the tax credit claimed by the New Zealand partners must be in proportion to their partnership share of the income the partnership earns directly.

The period or income year for which this Ruling applies

This ruling will apply from the first day of the 2022/23 income year to the last day of the 2026/27 income year.

This Ruling is signed by me on 29 April 2022.

Susan Price
Group Leader, Public Advice and Guidance
Tax Counsel Office

BINDING RULINGS

Commentary on Public Rulings BR Pub 22/01 – 22/05

This commentary is not a legally binding statement. The commentary is intended to help readers understand and apply the conclusions reached in Public Rulings BR Pub 22/01 – 22/05 ("the Rulings").

Summary

1. Foreign tax credits for Australian tax paid by Australian limited partnerships are available to New Zealand resident partners, in proportion to their partnership share, when all the following are met:

- the Australian limited partnership is treated as a company for Australian income tax purposes but not for New Zealand tax purposes;
- the Australian source income on which the tax was paid is assessable in New Zealand;
- the Australian tax paid was paid on the Australian source income that is assessable in New Zealand; and
- Australia has more than a residence based taxing right in respect of the income under the provisions of the Australia and New Zealand Double Tax Agreement.

Background

2. The question being considered is whether a foreign tax credit is available to New Zealand residents that earn Australian source income through a limited partnership registered in a state of Australia (that is an Australian limited partnership).
3. Previous versions of these public Rulings were:
   - BR Pub 18/01 to BR Pub 18/05 published in Tax Information Bulletin Vol 30, No 4 (April 2018) and expired on the last day of the 2021/22 income year.
   - BR Pub 14/01 to BR Pub 14/05 published in Tax Information Bulletin Vol 26, No 6 (July 2014) and expired on the last day of the 2016/17 income year.
   - BR Pub 10/01 to BR Pub 10/05 published in Tax Information Bulletin Vol 23, No 1 (February 2011) and expired on the last day of the 2012/13 income year.
4. The relevant Australian limited partnerships are those that are treated as corporate limited partnerships for Australian income tax purposes, under s 94D of the Income Tax Assessment Act 1936 (Aust), but do not meet the definition of "company" in s YA 1 of the New Zealand Income Tax Act 2007. The Australian law on limited partnerships registered in Australia and the Australian tax treatment must be considered before looking at the relevant foreign tax credit legislation in New Zealand.

Australian partnerships

5. There are three types of Australian partnerships. The three types are:
   - (ordinary) partnerships;[1]
   - limited partnerships; and
   - incorporated limited partnerships.
6. The three different types of partnerships are taxed differently under Australian income tax law.

(Ordinary) partnerships

7. The first, and most common, type of Australian partnership is an ordinary partnership. The regulation of ordinary partnerships in Australia falls under state law which includes the:
   - Partnership Act 1958 (Victoria);
   - Partnership Act 1892 (New South Wales);
   - Partnership Act 1891 (Queensland);
   - Partnership Act 1963 (Australian Capital Territory);
   - Partnership Act 1891 (South Australia);

[1] Referred to as "partnerships" in Australian state legislation.

BINDING RULINGS

- Partnership Act 1891 (Tasmania);
- Partnership Act 1997 (Northern Territory); and
- Partnership Act 1895 (Western Australia).

8. These Acts provide that an ordinary partnership is the relation between people carrying on a business in common with a view of profit. The partners are jointly and severally liable for the legal actions and debts of the partnership, have management control, share the profits of the partnership in predefined proportions, and have apparent authority as agents of the partnership to bind all the other partners in contracts with third parties. An ordinary partnership is not a separate legal entity.

Limited partnerships

9. The second type of Australian partnership is a limited partnership. Limited partnerships in Australia can be formed and registered only under:
   - Part 3, ss 49 – 79 Partnership Act 1958 (Victoria);
   - Part 3, ss 50A – 81A Partnership Act 1892 (New South Wales);
   - Chapter 3, ss 48 – 69 Partnership Act 1891 (Queensland);
   - Part 3, ss 47-84 – Partnership Act 1891 (South Australia);
   - Part 3, ss 50 – 101 Partnership Act 1891 (Tasmania); and
   - Limited Partnership Act 2016 (Western Australia).
10. The state laws require a limited partnership to satisfy the general law requirements of a partnership (set out at [8] above), as far as they are consistent with the requirements for a limited partnership discussed below. The partnership laws of the Australian Capital Territory and the Northern Territory do not allow for limited partnerships; they only allow for incorporated limited partnerships.
11. The provisions, listed above, provide that a limited partnership is one where there are both general partners and limited partners. The general partners have the rights and obligations as in an ordinary partnership. The limited partners are not jointly and severally liable for the debts of the partnership and their exposure is limited to their partnership investments, and a corresponding share of the profits. The limited partners also cannot participate in the management of the partnership or act as an agent for the partnership. Despite the limited liability of the limited partner(s), a limited partnership does not have a separate legal identity (unless it is an incorporated limited partnership).

Incorporated limited partnerships

12. The third type of Australian partnership is an incorporated limited partnership. An incorporated limited partnership is a type of limited partnership, but because of its incorporation it is treated differently under Australian law. Incorporated limited partnerships can be formed in all Australian states and territories. An incorporated limited partnership is a partnership that must have at least one general partner and one limited partner. Under the relevant state laws, the partnership is a separate legal entity with the powers and capacity of a natural person subject to the limitations in the partnership agreement. As discussed below, an incorporated limited partnership is not a partnership under New Zealand's Income Tax Act 2007 because it is a separate legal entity under Australian state laws. As a result, incorporated limited partnerships are not covered by these Rulings.

Australian tax treatment of Australian limited partnerships

13. A "limited partnership" is defined in s 995-1 of the Income Tax Assessment Act 1997 (Aust)[2] as:
    (a) an association of persons (other than a company) carrying on business as partners or in receipt of ordinary income or statutory income jointly, where the liability of at least one of those persons is limited; or
    (b) an association of persons (other than one referred to in paragraph (a)) with legal personality separate from those persons that was formed solely for the purpose of becoming a VCLP, an ESVCLP, an AFOF or a VCMP and to carry on activities that are carried on by a body of that kind.[3]

[2] The definition in the Income Tax Assessment Act 1936 (Aust) is the same and referenced to that in the Income Tax Assessment Act 1997 (Aust).

[3] A VCLP is a venture capital limited partnership and defined in s 118-405(2) of the Income Tax Assessment Act 1997 (Aust); an ESVCLP is an early stage venture capital limited partnership and defined in s 118-407(4) of the 1997 Act; an AFOF is an Australian venture capital fund of funds and defined in s 118-410(3) of the 1997 Act; and a VCMP is a venture capital management partnership and defined in s 94D(3) of the 1936 Act. In all cases these types of limited partnership must have been registered under Part 2 of the Venture Capital Act 2002 (Aust).

Corporate limited partnerships

14. Section 94D of the Income Tax Assessment Act 1936 (Aust), Corporate Limited Partnerships, provides that a limited partnership is a corporate limited partnership if:
    - the year of income is the 1995-96 or later year of income; or
    - the partnership was formed on or after 19 August 1992; or
    - the partnership was formed before 19 August 1992 and either it does not pass the continuity of business test set out in Division 5A at s 94E, or there has been a change in composition of the partnership after 19 August 1992 and no election has been made by the partners under s 94F that the partnership not be treated as a corporate limited partnership; and
    - the limited partnership is not either a foreign hybrid limited partnership[4] in relation to the particular year of income, or a VCLP, an ESVCLP, an AFOF or a VCMP.
15. These Rulings only apply to limited partnerships that are also corporate limited partnerships under s 94D of the Income Tax Assessment Act 1936 (Aust). Corporate limited partnerships do not have identities separate from their members. Section 94D excludes certain limited partnerships (VCLP, ESVCLP, AFOF, venture capital management partnerships, and foreign hybrid limited partnerships (defined in footnote 3 above)) from being corporate limited partnerships.
16. Division 5A concerns the taxation of limited partnerships. Nothing in Division 5A of the Income Tax Assessment Act 1936 (Aust) overrides the state partnership laws by recharacterising limited partnerships as companies. Division 5A simply treats a limited partnership that also meets the test for a corporate limited partnership as a company for certain Australian income tax purposes. In particular, subdivision C of Division 5A provides:
    - company includes a reference to a corporate limited partnership (s 94J);
    - partnership does not include a reference to a corporate limited partnership (s 94K); and
    - dividend (other than a dividend within the meaning of subs 44(1A) of the Income Tax Assessment Act 1936) includes a reference to a distribution made by a corporate limited partnership (s 94L).
17. This is discussed in the explanatory memorandum to the Taxation Laws Amendment Act (No. 6) 1992 (Aust) that accompanied the introduction of subdivision C Division 5A:

> Under the existing law, limited partnerships are treated as partnerships for taxation purposes. However, the structure of a limited partnership is comparable to that of a limited liability company in that there are “limited partners” who are similar to shareholders in a company; they do not take part in the management of the business, and their liability generally is limited to the extent of their investment.
>
> Limited partners are not at risk beyond the limit of their liability. Generally, their liability is limited to their investment. They are not required to make good losses of their partnership, nor are they liable to meet the obligations of the partnership. If limited partners are treated in the same way as partners in any other partnership, however, they may benefit from distributions of losses that exceed their limited liability. Those losses could be used to reduce taxable income, and so tax paid, even though the loss is not one that exposes the partner to any risk of having to meet obligations or make good losses.
>
> State legislation enabling the formation of limited partnerships currently exists in New South Wales, Victoria, Western Australia, Queensland and Tasmania.
>
> **Explanation of proposed amendments**
>
> The Bill will amend the Principal Act to introduce taxation arrangements in new Division 5A of Part III of the Act for taxing limited partnerships …
>
> **The object of this new Division is to ensure that limited partnerships will be treated as companies for taxation purposes. This is not confined to the payment of income tax by limited partnerships, but includes all other purposes under income tax law, including the payment of tax by partners in limited partnerships; for instance, imputation and the taxation of dividends to shareholders** …
>
> [Emphasis added]

[4] A foreign hybrid limited partnership is formed outside Australia as defined in ss 830-10(1) and (2) of Income Tax Assessment Act 1997 (Aust).

Australian tax consolidated groups

18. The introduction of Australia's consolidation rules reinforced that corporate limited partnerships are to be treated as companies for Australian income tax law. The explanatory memorandum to the New Business Tax System (Consolidation) Act (No. 1) 2002 (Aust) makes it clear that corporate limited partnerships can also be head companies within that regime because they are sufficiently equivalent to a company for Australian income tax purposes.

> 3.29 To qualify as a head company, an entity must be a company as defined in s 995-1 of the ITAA 1997.
>
> 3.30 A corporate limited partnership will also satisfy this requirement. This is consistent with the objective of ensuring consolidated groups generally receive a tax treatment like ordinary companies because these partnerships are effectively treated as companies for income tax purposes.

19. The effect of becoming a head company in an Australian consolidated group is that all the income of the group is deemed to have been earned by the head company and not by the individual companies in the group: s 701-1 of the Income Tax Assessment Act 1997 (Aust).

Application of the Legislation

Australian limited partnerships under New Zealand income tax law

20. As these Rulings focus on the ability of New Zealand partners to claim foreign tax credits for tax paid or deducted by an Australian limited partnership, the key provisions in the Act are:
    - the definitions of "company", "partnership", and "limited partnership" in s YA 1;
    - section HG 2, which sets out that partnerships are transparent;
    - section CB 35, which sets out that income arising from subpart HG is assessable income to the partner;
    - section BH 1, which sets out the relationship between the Double Taxation Relief (Australia) Order 2010 and subpart LJ. The Schedule to the Double Taxation Relief (Australia) Order 2010 contains the Convention between Australia and New Zealand for the avoidance of double taxation with respect to taxes on income and fringe benefits and the prevention of fiscal evasion (signed 29 June 2009, entered into force 18 March 2010) (the Australia and New Zealand Double Tax Agreement). The Australia and New Zealand Double Tax Agreement is modified by the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the MLI), which is contained in the Schedule to the Double Tax Agreements (Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting) Order 2018; and
    - subpart LJ, which determines the amount and timing of a foreign credit.
21. In addition to the above provisions, articles 1(2) and 23(3) of the Australia and New Zealand Double Tax Agreement provide New Zealand partners in an Australian limited partnership with relief for Australian income tax and dividend withholding tax paid by the limited partnership.
22. These provisions are discussed below.

Limited partnerships

23. Section YA 1 sets out the definition of a company:

> **company—**
>
> (a) means a body corporate or other entity that has a legal existence separate from that of its members, whether it is incorporated or created in New Zealand or elsewhere:
>
> (ab) does not include a partnership:
>
> …
>
> (ac) includes a listed limited partnership;
>
> (ad) includes a foreign corporate limited partnership;
>
> (b) includes a unit trust;
>
> …

24. A listed limited partnership and a foreign corporate limited partnership are also defined in s YA 1. In essence, they are defined respectively as a New Zealand or overseas limited partnership that is listed on a recognised exchange, and an overseas limited partnership that is treated as a separate legal entity under the partnership laws of the country concerned.

25. Unless an Australian limited partnership is listed on a recognised exchange or the underlying state partnership laws give it a separate legal personality, it will not meet the definition of a company in New Zealand. This is irrespective of whether it is treated as a company for Australian income tax purposes.
26. Section YA 1 defines:
    - "partnership" in paragraph (d) as meaning a limited partnership; and
    - "limited partnership" as including an overseas limited partnership as defined in s 4 of the Limited Partnerships Act 2008 but excluding a listed limited partnership or a foreign corporate limited partnership.
27. Section 4 of the Limited Partnerships Act 2008 defines an overseas limited partnership as:

> **overseas limited partnership** means a partnership formed or incorporated outside New Zealand with—
> (a) 1 or more general partners who are liable for all of the debts and liabilities of the partnership; and
> (b) 1 or more limited partners who have only limited liability for the debts and liabilities of the partnership

28. Therefore, an Australian limited partnership that:
    - meets the definition of an "overseas limited partnership" under s 4 of the Limited Partnerships Act 2008, and
    - is not listed on a recognised exchange, and
    - is not treated as a separate legal entity in Australia under Australian state partnership laws,

    will be treated as a partnership under New Zealand tax law.

Partners in limited partnerships

29. The tax treatment of New Zealand partners in Australian limited partnerships that meet the definition of "partnership" in s YA 1 is set out in s HG 2(2):

> (2) Despite subsection (1), for a partner in their capacity of partner of a partnership, the amount of income, tax credit, rebate, gain, expenditure, or loss that they have from a particular source, or of a particular nature, is calculated by multiplying the total income, tax credit, rebate, gain, expenditure, or loss of the partners of the partnership from the particular source or of the particular nature by the partner's partnership share in the partnership's income.

30. "Partnership share" is defined in s YA 1 as meaning for a particular right, obligation, or other property, status or thing, the share that a partner has in the partnership.
31. The effect of s HG 2(2) and the definition of "'partnership share" is that the assessable income of partners in a partnership includes their "partnership share" of the partnership income. Section CB 35 also confirms that this is assessable income of the partner:

> **CB 35 Amounts of income for partners**
> A person who is a partner has an amount of income to the extent to which an amount of income results from the application of subpart HG (Joint venturers, partners, and partnerships) to them and their partnership.

32. Section HG 2(2) also makes reference to tax credits. Section LA 10 provides that an amount is a tax credit of a person if it is their tax credit under a provision of Part L. Foreign tax credits arise under subpart LJ so are tax credits under s LA 10. Under s HG 2(2), therefore, partners are entitled to foreign tax credits in proportion to their partnership share.

Foreign tax credits, the Australia and New Zealand Double Tax Agreement and the MLI

33. The Australian tax considered in these Rulings is income tax and dividend withholding tax on Australian source income. Section BH 1(4) means the Australia and New Zealand Double Tax Agreement has an overriding effect as to New Zealand income tax, including the income and tax credit sections of the Income Tax Act 2007. The income and tax credit sections, therefore, must be read together with the relevant Australia and New Zealand Double Tax Agreement articles. Where there is any inconsistency between the two, the domestic law must be read subject to the Australia and New Zealand Double Tax Agreement.
34. Subject to the comments below, the combined effect of the Australia and New Zealand Double Tax Agreement, and s BH 1 and subpart LJ of the Income Tax Act 2007 is that a New Zealand tax resident is allowed a tax credit for Australian income tax and dividend withholding tax.

35. Articles 1(2) and 23(3) of the Australia and New Zealand Double Tax Agreement provide a New Zealand partner in an Australian limited partnership with relief for income tax or dividend withholding tax that the limited partnership pays in Australia. These articles are affected by the MLI. Relevantly, article 23 of the Australia and New Zealand Double Tax Agreement (referred to as the Convention) is affected by article 3(2) of the MLI, which provides:

> [*The provisions of Article 23 of the Convention that require a Contracting State to provide a credit equal to the tax paid under the laws of the other Contracting State in accordance with the Convention*] shall not apply to the extent that such provisions allow taxation by that other [*Contracting State*] solely because the income is also income derived by a resident of that other [*Contracting State*].

36. The approach to interpretation of the MLI and its effect on the Australia and New Zealand Double Tax Agreement is set out in Issues Paper IRRUIP15.[5] Effectively, article 3(2) of the MLI clarifies that New Zealand is not obliged to provide relief for tax levied in Australia exclusively on the basis of the residence of the taxpayer, and that New Zealand is only obliged to provide relief to the extent that taxation by Australia is in accordance with the provisions of the Convention that allow taxation of the relevant income as the State of source or as a State where there is a permanent establishment to which that income is attributable.

37. As these Rulings only address Australian source income and Australian limited partnerships that give rise to a permanent establishment in Australia, the MLI does not affect the foreign tax credit outcome of these Rulings.

38. The relief is in the form of a tax credit in New Zealand under subpart LJ. Subpart LJ calculates the amount of the tax credit on the basis of a segment of foreign-sourced income under ss LJ 1(1), LJ 1(2)(a), and LJ 2(1):

> **LJ 1 What this subpart does**
>
> *When tax credits allowed*
>
> (1) This subpart provides the rules for dividing assessable income from foreign-sourced amounts into segments and allows a tax credit for **foreign income tax paid in relation to a segment of that income.**
>
> *Limited application of rules*
>
> (2) The rules in this subpart apply only when—
>
> (a) a person resident in New Zealand derives assessable income that is sourced from outside New Zealand; and
>
> (b) foreign income tax is not paid in a country or territory listed in schedule 27 (Countries and types of income with unrecognised tax) to the extent to which the foreign income tax is paid on the types of income listed in the schedule.
>
> …
>
> **LJ 2 Tax credits for foreign income tax**
>
> *Amount of credit*
>
> (1) A person described in section LJ 1(2)(a) has a tax credit for a tax year for an amount of **foreign income tax paid on a segment of foreign-sourced income**, determined as if the segment were the net income of the person for the tax year. The amount of the New Zealand tax payable is calculated under section LJ 5.
>
> *Limitation on amount of credit*
>
> (2) The amount of the person's credit in subsection (1) must not be more than the amount of New Zealand tax payable by the person in relation to the segment calculated under section LJ 5(2), modified as necessary under section LJ 5(4).
>
> **Amount adjusted**
>
> (3) The amount of the person's credit in subsection (1) may be reduced or increased if either section LJ 6 or LJ 7 applies.
>
> [Emphasis added]

[5] Issues Paper: IRRUIP15: Income tax – trusts and the Australian-New Zealand Double Tax Agreement (18 December 2020).

39. A "segment of foreign-sourced income" is defined in s LJ 4 as:

> **LJ 4 Meaning of segment of foreign-sourced income**
>
> For the purposes of this Part, a person has a segment of foreign-sourced income equal to an amount of assessable income derived from 1 foreign country that comes from 1 source or is of 1 nature.

40. Therefore, three key elements must be satisfied for a New Zealand resident partner of an Australian limited partnership to be allowed a foreign tax credit under articles 1(2) and 23(3) of the Australia and New Zealand Double Tax Agreement (as modified by the MLI), ss BH 1 and HG 2, and subpart LJ of the Income Tax Act 2007:
    - A person resident in New Zealand must derive assessable income sourced from outside New Zealand.
    - Foreign income tax must be paid. In the context of an Australian limited partnership, Australia must have more than a residence based taxing right under the provisions of the Australia and New Zealand Double Tax Agreement.
    - That foreign income tax must be paid on that foreign-sourced assessable income.
41. It follows that a foreign tax credit is not available where:
    - There is no assessable income calculated under New Zealand tax law.
    - No foreign income tax has been paid.
    - The foreign income tax has not been paid on income that is assessable in New Zealand.
42. The foreign income tax could be Australian income tax or dividend withholding tax as appropriate.
43. The amount of foreign tax credit is calculated in accordance with subpart LJ and is, for example, limited to the notional tax liability that the taxpayer would have paid on the relevant segment of income in New Zealand under ss LJ 2(2) and LJ 5. Interpretation Statement IS 16/05[6] sets out how to calculate the amount of a foreign tax credit in accordance with subpart LJ. Also refer to Interpretation Statement IS 21/09.[7]

Hybrid mismatch rules

44. The Australian limited partnership in these Rulings will be a "hybrid entity" for the purposes of subpart FH of the Income Tax Act 2007. Accordingly, a New Zealand resident earning income through such an Australian limited partnership will need to consider whether any of the hybrid mismatch rules in subpart FH apply.
45. In particular, the New Zealand resident limited partner may wish to consider:
    - The potential application of ss FH 6 and FH 12 if there is some form of arrangement generating payments between the Australian limited partnership and the limited partner, where a deduction is allowed in Australia for the payment.
    - The potential application of ss FH 8 and FH 12 where the Australian limited partnership is allowed to set off under Australian tax laws its expenditure or loss against income of another person or entity.
46. The effect of one of the provisions in subpart FH applying is generally that the New Zealand resident either has assessable income or is denied a deduction in New Zealand. In the arrangements the subject of these Rulings, the application of subpart FH does not generally impact on the availability of a foreign tax credit under subpart LJ. However, the calculation of the amount of the foreign tax credit may be affected in some circumstances due to the person's deductions and net income in New Zealand being relevant to the calculation in s LJ 5(2).
47. A New Zealand resident could have made an election under s FH 14 in certain circumstances to treat a hybrid entity as a company for New Zealand tax purposes. If such an election has been made, the Australian limited partnership is treated as an opaque company rather than a transparent partnership for New Zealand tax laws. For the avoidance of doubt, these Rulings do not apply to any Australian limited partnership in respect of which such an election has been made.

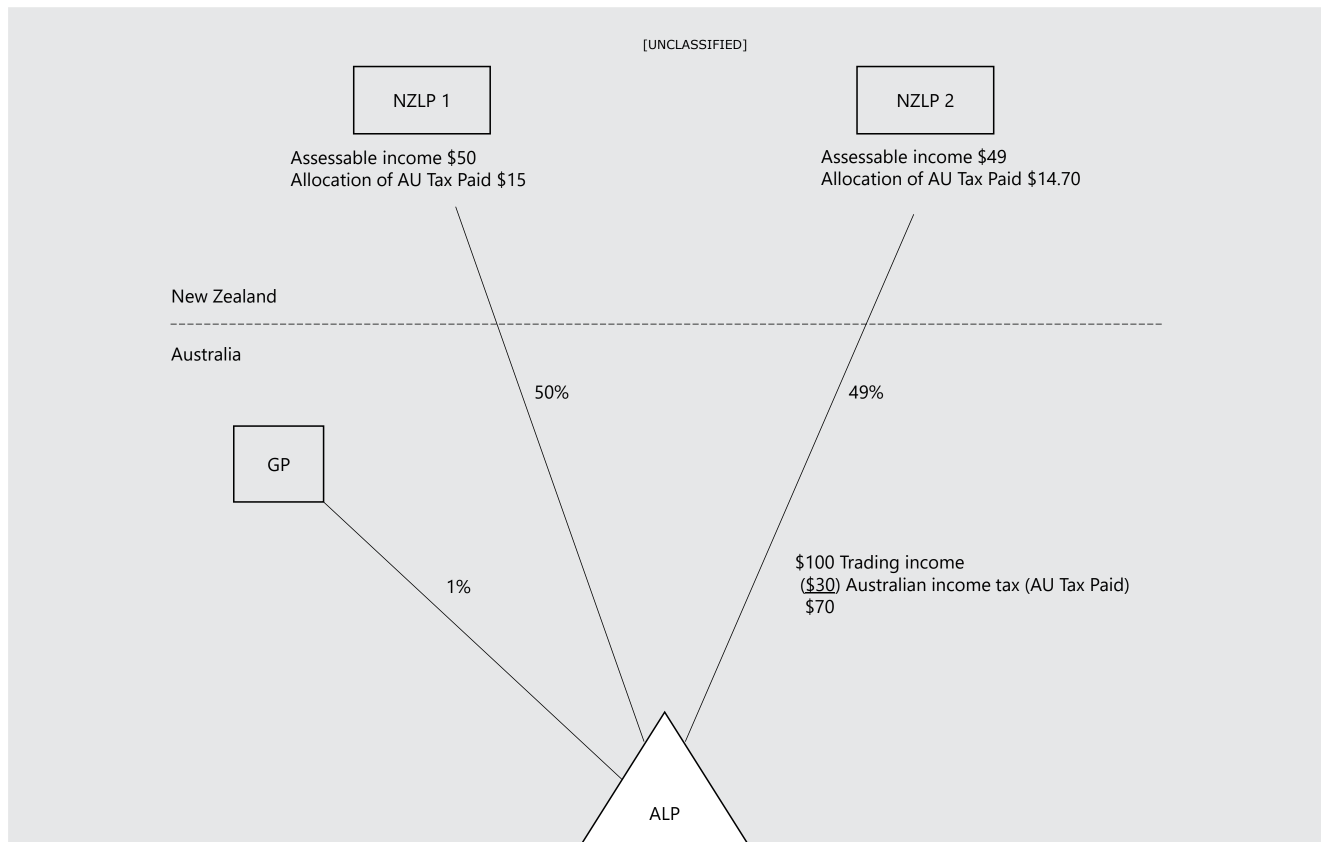
[6] "Interpretation Statement: IS 16/05: Income Tax – foreign tax credits – how to claim a foreign tax credit where the foreign tax paid is covered by a double tax agreement", *Tax Information Bulletin* Vol 28, No 12 (December 2016) at [159] to [182].

[7] "Interpretation Statement: IS 21/09: Income tax – foreign tax credits – how to calculate a foreign tax credit", *Tax Information Bulletin* Vol 34, No 1 (February 2022).

Examples

48. The following examples are included to assist in explaining the application of the law.
49. This section of the commentary discusses the specific factual scenarios related to each of the five Rulings. In all cases they involve Australian tax being paid on Australian source income, but the issue is whether a foreign tax credit is available to the New Zealand partners. Whether a foreign tax credit is available turns on whether the three key elements set out above at [40] are satisfied.
50. In all five examples the Australian limited partnership ("ALP") has three partners:
    - one general partner ("GP") based in Australia having a 1% partnership share; and
    - two New Zealand resident limited partners ("NZLP 1" and "NZLP 2") with 50% and 49% partnership shares respectively (the 50% and 49% partners). In Example 1, Example 2 and Example 5, NZLP 1 and NZLP 2 may be either a company or a natural person but in Example 3 and Example 4, NZLP 1 and NZLP 2 are natural persons only.
51. The partners in Example 3 and Example 4 are limited to natural persons. If the partners were New Zealand resident companies the dividends may be exempt income under s CW 9(1) and, in that circumstance, foreign tax credits would not be available.
52. As an aside, dividends received by a company in New Zealand are not exempt if one of the exclusions in s CW 9(2) applies. The exclusions in s CW 9(2) include dividends paid in relation to rights that are:
    - a direct income interest in a foreign company that is a non-attributing interest in a FIF because it falls within one of the relevant exclusions in s CW 9(2)(a); or
    - a fixed-rate foreign equity (s CW 9(2)(b)); or
    - rights to a deductible foreign equity distribution (s CW 9(2)(c)).
53. The Commissioner acknowledges that an exclusion set out in s CW 9(2) could apply, and any dividends received by a corporate partner in such circumstances would not be exempt income.
54. The Commissioner also acknowledges that a New Zealand partner could hold an attributing interest in a FIF through an ALP. If so, and a dividend is treated as not being income under s EX 59(2), s LJ 2(6) and (7) specify which amount of income is to be used for the foreign tax credit provisions.
55. The Australian limited partnership is treated as a corporate limited partnership for Australian income tax law but is treated as a partnership for New Zealand income tax law (as discussed above).
56. To avoid currency exchange issues, the reference to "$" is not a reference to any particular currency; it is used simply for illustrative purposes.

Example 1: Australian source income



In this example, each NZLP could be a natural person or a company.

ALP earns trading income in Australia of $100 and pays Australian income tax of $30 on it. As earning Australian source trading income by the ALP is a purely domestic transaction in Australia, article 1(2) of the DTA does not affect Australia's taxation rights on that transaction. This means that Australia is allowed to tax the ALP in example 1 to the extent allowed under its taxation laws (and is not limited by the articles of the DTA).

In accordance with the DTA, New Zealand is required to provide relief in the form of foreign tax credits for the income tax paid in Australia by the ALP on the income that is assessable in New Zealand. As the DTA does not allow Australia to tax the income solely because the income is derived by a resident of Australia (the ALP), the MLI does not impact this outcome.

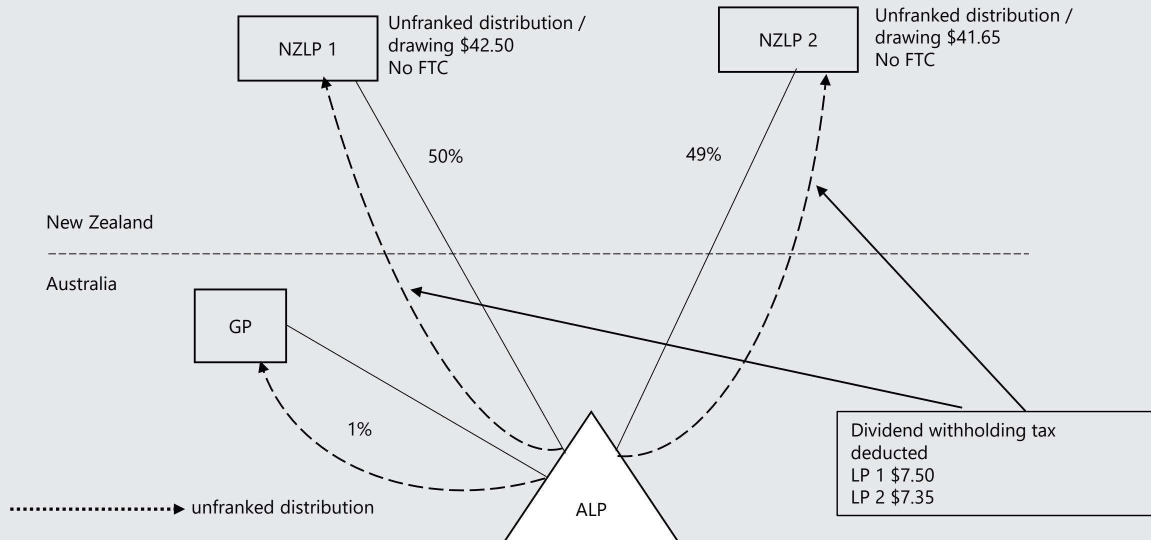
The trading income is income for New Zealand income tax purposes under s CB 1 and partnership income to the New Zealand partners under ss HG 2 and CB 35, so they must include their partnership share in their New Zealand assessable income. The Australian income tax is allowed as a foreign tax credit in the same proportion as the partner's partnership share. This is because the three key elements are met:

- The partnership income is assessable to the New Zealand partners under ss HG 2, CB 1 and CB 35.
- The ALP has paid Australian income tax on the income.
- The Australian income tax was paid on the trading income of the ALP (which is the income that is assessable in New Zealand).

In the specific example, the 50% partner – NZLP 1 – has assessable income of $50 and is allocated $15 of the Australian income tax paid and the 49% partner – NZLP 2 – has assessable income of $49 and is allocated $14.70 of the Australian income tax paid. These are their respective partnership shares of the trading income and the Australian income tax paid.

The amount of the foreign tax credit must be calculated in accordance with subpart LJ and is, for example, limited to the partner's notional tax liability in relation to the segment of foreign-sourced income (refer ss LJ 2(2) and LJ 5(2)).

Example 2: Distribution made by Australian limited partnership



In this example, each NZLP could be a natural person or a company.

The ALP makes an unfranked distribution to the partners of $100. For Australian income tax purposes, this distribution is treated as a dividend and Australian dividend withholding tax of 15% is deducted. The net amount distributed is then $85 in total.

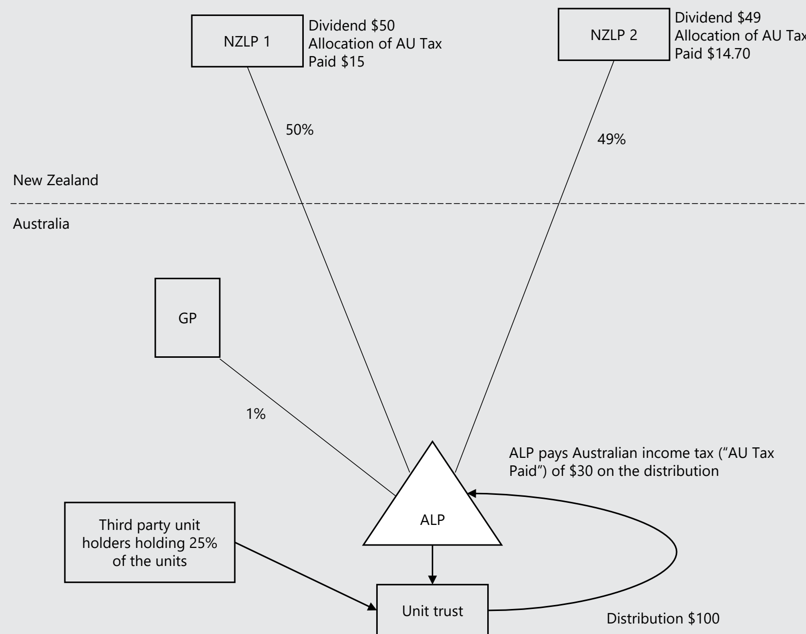
In this situation only the second of the three key elements has been met. While the Australian dividend withholding tax of 15% has been paid, it has not been paid on New Zealand assessable income. This is because, for New Zealand income tax purposes, the distribution from a partnership is not a dividend (under s CD 1) and would instead be drawings not subject to New Zealand income tax.

Therefore, no foreign tax credit is available to the New Zealand partners.

Example 2, therefore, differs from example 1. In example 1, the partners are treated (under ss HG 2 and CB 35) as deriving the income (under s CB 1) derived by the partnership. As a result, the partners in example 1 are treated as directly deriving the income. The income is taxable in the hands of the partners, and a foreign tax credit is available.

In example 2, the payment to the partners is a drawing down of the partners' capital: *Case F123* (1984) 6 NZTC 60,117. The payment does not relate to any income derived by the partnership that has flowed through to the partners under s HG 2. As the payment is drawings, it is not taxable in the hands of the partners, and so no foreign tax credit is available.

Example 3: Distribution made from unit trust



In this example, each NZLP is a natural person.

In example 3, the ALP owns units in a unit trust and the New Zealand partners are natural persons. As noted above at [8] and [10], one of the requirements for an ALP is that it is carrying on a business. The above ALP is in the business of managing various investments (including its investment in the unit trust). As seen above at [23], a unit trust is included in the definition of "company" for New Zealand income tax purposes. The unit trust distributes income of $100 to the ALP and the ALP pays income tax on the distribution of $30.[8]

The payment of the distribution from the unit trust to the ALP is a purely domestic transaction in Australia, so article 1(2) of the DTA does not affect Australia's taxation rights on that transaction. This means that Australia is allowed to tax the ALP in example 3 to the extent allowed under its taxation laws (and is not limited by the articles of the DTA).

In accordance with the DTA, New Zealand is required to provide relief in the form of foreign tax credits for the income tax paid in Australia by the ALP on the income that is assessable in New Zealand. As the DTA does not allow Australia to tax the income solely because the income is derived by a resident of Australia (the ALP), the MLI does not impact this outcome.

The distribution from an Australian unit trust is treated as a dividend for New Zealand income tax purposes under s CD 1 and partnership income to the New Zealand partners under ss HG 2 and CB 35, so they must include their partnership share in their New Zealand taxable income. The Australian income tax is allowed as a foreign tax credit in the same proportion as the partner's partnership share.

This is because the three key elements are met:

- The dividend will be assessable income to the New Zealand partners under ss CD 1, CB 35 and HG 2.
- The ALP has paid Australian income tax on the income.
- The Australian income tax was paid on the distribution (which is the income that is assessable in New Zealand).

In the specific example, the 50% partner – NZLP 1 – has dividend income of $50 and is allocated $15 of the Australian income tax paid and the 49% partner – NZLP 2 – has dividend income of $49 and is allocated $14.70 of the Australian income tax paid. These are their respective partnership shares of the trading income and the Australian income tax paid.

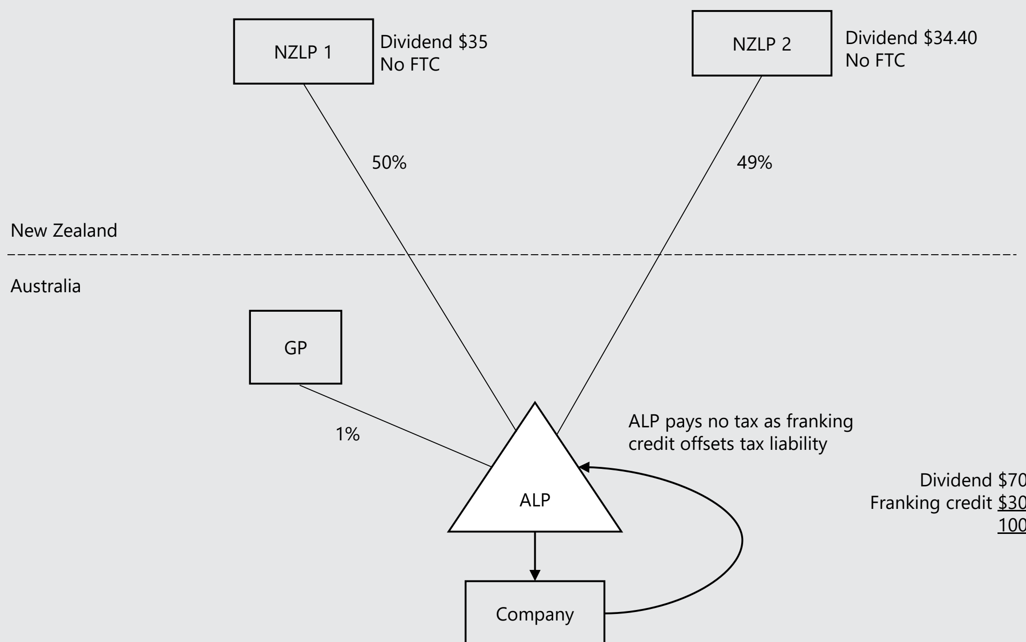
The amount of the foreign tax credit must be calculated in accordance with subpart LJ and is, for example, limited to the partner's notional tax liability in relation to the segment of foreign-sourced income (refer ss LJ 2(2) and LJ 5(2)).

[8] Under Australian tax law, a distribution from a unit trust is taxed as a distribution from a trust or as a dividend from a company (depending on the circumstances of the unit trust). The reference in this example to a distribution includes both situations.

If no Australian income tax is paid on the distribution, the New Zealand partners will not be entitled to a foreign tax credit. This example only addresses the situation where the ALP pays Australian income tax on the same segment of income that is taxable to the New Zealand partners (ie, the distribution). The example does not consider whether a foreign tax credit arises where the Australian unit trust pays tax on the income it derives.

Example 3 differs from example 2. The difference between the two examples is that there is assessable dividend income under s CD 1 in New Zealand in example 3. Specifically, the payment to the partners in example 2 is a drawing down of the partners' capital and so is not assessable dividend income under s CD 1 in New Zealand. In contrast, in example 3 the partners are deemed to derive directly the dividend income derived by the partnership under s HG 2. The dividend is assessable income of the partners in New Zealand.

Example 4: Franked dividend received by Australian limited partnership



In this example, each NZLP is a natural person.

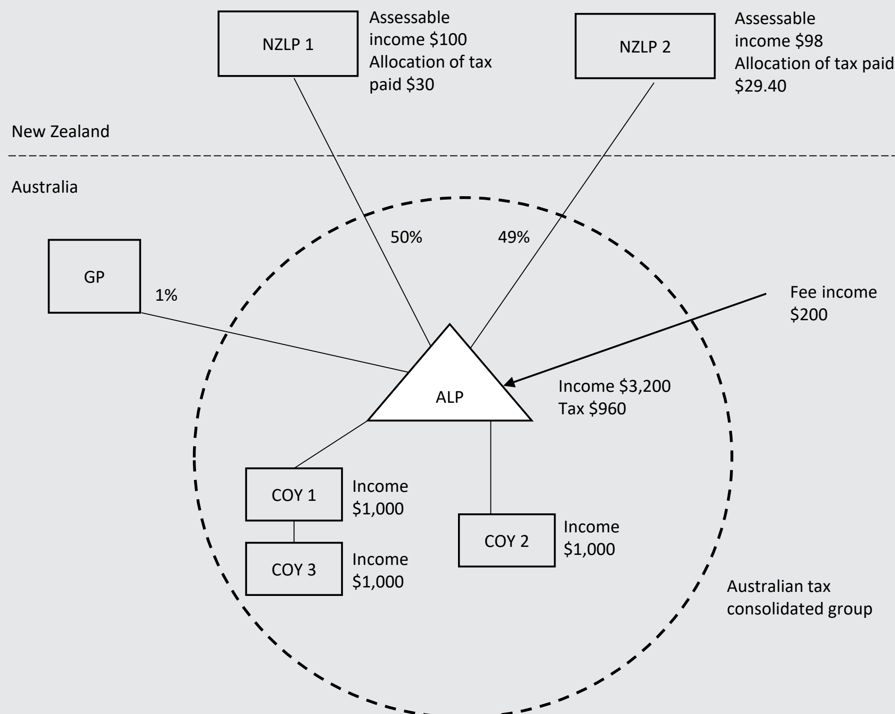
The ALP is treated as owning a subsidiary company under Australian tax law. The company pays a $70 franked dividend to the ALP. The underlying basis of the franking credit was income tax the subsidiary company had paid previously on its trading income. While dividends received by the ALP are subject to tax in Australia, the attached franking credit offsets any tax liability on this dividend so the ALP does not pay tax on that income.

In this case, only the first key element is satisfied. The dividend is assessable income to the New Zealand partners under ss CD 1, HG 2 and CB 35. The second and third key elements are not satisfied because no Australian income tax has been paid on the dividend by the ALP. In Australia, a franking credit reduces the amount of income tax that a taxpayer has to pay: s 4-10 of the Income Tax Assessment Act 1997 (Aust.). As a result, under the arrangement the ALP had a nil income tax liability for the relevant period, and so paid no income tax. Whatever income tax may have been paid by the subsidiary, the tax was not paid on the segment of income that the New Zealand partners are liable for income tax on (namely the dividend income).

In terms of New Zealand assessable income, however, there is dividend income of $35 and $34.30 to the 50% partner and 49% partner respectively. The dividend income derived by the New Zealand partners excludes the amount of franking credits used to reduce the amount of Australian income tax payable.

The Commissioner acknowledges that there may be situations where an ALP has insufficient franking credits to reduce the Australian income tax liability to nil. The ALP may then be required to pay the residual income tax liability. The second element would be satisfied in that situation to the extent of the residual income tax paid. In other words, where a dividend is only partially franked or not franked at all, then a foreign tax credit may arise for the income tax actually paid.

Example 5: Tax paid by Australian limited partnership as "head company" of an Australian tax consolidated group



In this example, each NZLP could be a natural person or a company.

The ALP, as the head company for a consolidated group of companies (COY 1, COY 2 and COY 3), pays tax on all the taxable income of the consolidated group in Australia. This example excludes situations where one or more of the group entities are in a loss position.

The taxable income of the consolidated group is $3,200 and the income tax paid is $960. The group income includes income from the subsidiary companies of $3,000 and the fee income derived by the ALP of $200.

As earning Australian fee income by the ALP is a purely domestic transaction in Australia, article 1(2) of the DTA does not affect Australia's taxation rights on that transaction. This means that Australia is allowed to tax the ALP in example 5 to the extent allowed under its taxation laws (and is not limited by the articles of the DTA).

In accordance with the DTA, New Zealand is required to provide relief in the form of foreign tax credits for the income tax paid in Australia by the ALP on the income that is assessable in New Zealand. As the DTA does not allow Australia to tax the income solely because the income is derived by a resident of Australia (the ALP), the MLI does not impact this outcome.

The fee income is income for New Zealand income tax purposes under s CB 1 and partnership income to the New Zealand partners under ss HG 2 and CB 35. The fee income is treated as assessable income of the partners sourced from outside New Zealand (satisfying the first element). The ALP has paid income tax on the fee income (satisfying the second and third elements). As a result, the three elements are met and a foreign tax credit will be available to the partners of the ALP but only to the extent that the tax paid relates to the fee income.

As noted above, the first element requires the New Zealand resident partner to derive assessable income sourced from outside New Zealand. The New Zealand partner, therefore, must derive income according to New Zealand tax law. In the case of the income from the Australian consolidated group of companies that income is not derived by the ALP for New Zealand tax purposes.

The New Zealand partners must return their share of the income derived directly by the ALP. That is, $100 and $98 for the 50% partner and 49% partner respectively. The New Zealand partners do not need to return income that was derived by the subsidiary companies.

A foreign tax credit will be available for the Australian income tax paid on the income earned directly by the ALP (subject to calculation in accordance with subpart LJ). In the specific example, Australian tax paid of $30 will be allocated to the 50% partner – NZLP 1 – and Australian tax paid of $29.40 will be allocated to the 49% partner – NZLP 2. These are their respective partnership shares of the income earned directly by the ALP and the Australian income tax paid on that income.

As an aside, ss FH 8 and FH 12 would apply in this example to any expenditure incurred by the ALP due to it being part of a consolidated group in Australia, as Australia's tax laws allow its expenditure to be set off against income of the subsidiary companies.

References

Expired Rulings

BR Pub 10/01 "Australian source income earned by Australian limited partnership and foreign tax credits" *Tax Information Bulletin* Vol 23, No 1 (February 2011): 4-14.

BR Pub 10/02 "Distributions made by Australian limited partnership and foreign tax credits" *Tax Information Bulletin* Vol 23, No 1 (February 2011): 4-14.

BR Pub 10/03 "Distributions made by Australian unit trust to Australian limited partnership and foreign tax credits" *Tax Information Bulletin* Vol 23, No 1 (February 2011): 4-14.

BR Pub 10/04 "Franked dividend received by Australian limited partnership and foreign tax credits" *Tax Information Bulletin* Vol 23, No 1 (February 2011): 4-14.

BR Pub 10/05 "Tax paid by an Australian limited partnership as a "head company" and foreign tax credits" *Tax Information Bulletin* Vol 23, No 1 (February 2011): 4-14.

BR Pub 14/01 "Australian source income earned by Australian limited partnership and foreign tax credits" *Tax Information Bulletin* Vol 26, No 6 (July 2014): 10-25.

BR Pub 14/02 "Distributions made by Australian limited partnership and foreign tax credits" *Tax Information Bulletin* Vol 26, No 6 (July 2014): 10-25.

BR Pub 14/03 "Distributions made by Australian unit trust to Australian limited partnership and foreign tax credits" *Tax Information Bulletin* Vol 26, No 6 (July 2014): 10-25.

BR Pub 14/04 "Franked dividend received by Australian limited partnership and foreign tax credits" *Tax Information Bulletin* Vol 26, No 6 (July 2014): 10-25.

BR Pub 14/05 "Tax paid by an Australian limited partnership as a "head company" and foreign tax credits" *Tax Information Bulletin* Vol 26, No 6 (July 2014): 10-25.

BR Pub 18/01 "Australian source income earned by Australian limited partnership and foreign tax credits" *Tax Information Bulletin* Vol 30, No 3 (April 2018): 4-23.

BR Pub 18/02 "Distributions made by Australian limited partnership and foreign tax credits" *Tax Information Bulletin* Vol 30, No 3 (April 2018): 4-23.

BR Pub 18/03 "Distributions made by Australian unit trust to Australian limited partnership and foreign tax credits" *Tax Information Bulletin* Vol 30, No 3 (April 2018): 4-23.

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BR Pub 18/05 "Tax paid by an Australian limited partnership as a "head company" and foreign tax credits" *Tax Information Bulletin* Vol 30, No 3 (April 2018): 4-23.

Legislative references

Double Taxation Relief (Australia) Order 2010.

Double Tax Agreements (Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting) Order 2018.

Income Tax Act 2007, ss BB 1, BG 1, BH 1, CB 1, CB 35, CD 1, FH 6, FH 8, FH 12, FH 14, HG 2, LA 10, LJ 1–LJ 5, YA 1 "company", "foreign corporate limited partnership", "limited partnership", "listed limited partnership", "partnership" and "partnership share", YD 1, YD 2.

Income Tax Assessment Act 1936 (Aust), Division 5A, ss 94D, 94E, 94F, 94J, 94K, 94L, 128B.

Income Tax Assessment Act 1997 (Aust), ss 4-10, 4-15, 205-15, 701-1, 703-15(2), 830-10(1)-(2) 995-1 "limited partnership".

Income Tax Rates Act 1986 (Aust), s 23(2).

Limited Partnerships Act 2008, s 4.

Limited Partnership Act 2016 (Western Australia).

Partnership Act 1963 (Australian Capital Territory).

Partnership Act 1892 (New South Wales), Part 3, ss 50A–81A.

Partnership Act 1997 (Northern Territory).

Partnership Act 1891 (Queensland), Chapter 3, ss 48–69.

Partnership Act 1891 (South Australia), Part 3, ss 47-84.

Partnership Act 1891 (Tasmania), Part 3, ss 50 – 101.

Partnership Act 1958 (Victoria), Part 3, ss 49-79.

Partnership Act 1895 (Western Australia).

Partnership Law Act 2019.

Other references

New Business Tax System (Consolidation) Act (No. 1) 2002 (Aust), explanatory memorandum.

Taxation Laws Amendment Act (No. 6) 1992 (Aust), explanatory memorandum.

Issues Paper: IRRUIP15: Income tax – trusts and the Australian-New Zealand Double Tax Agreement (18 December 2020).

Interpretation Statement: IS 16/05: Income Tax – foreign tax credits – how to claim a foreign tax credit where the foreign tax paid is covered by a double tax agreement", *Tax Information Bulletin* Vol 28, No 12 (December 2016) at [159] to [182].

Interpretation Statement: IS 21/09: Income tax – foreign tax credits – how to calculate a foreign tax credit", *Tax Information Bulletin* Vol 34, No 1 (February 2022).

Case F123 (1984) 6 NZTC 60,117.

Appendix – Legislation

New Zealand Tax Legislation

Australia and New Zealand Double Tax Agreement (as modified by the MLI)

Article 1

Persons covered

(1) This Convention shall apply to persons who are residents of one or both of the Contracting States.

The following paragraph 1 of Article 3 of the MLI replaces paragraph 2 of Article 1 of this Convention:

(2) For the purposes of [*the Convention*], income derived by or through an entity or arrangement that is treated as fiscally transparent under the tax law of either [*Contracting State*] shall be considered to be income of a resident of a [*Contracting State*] but only to the extent that the income is treated, for purposes of taxation by that [*Contracting State*] as the income of a resident of that [*Contracting State*].

Article 23

Elimination of double taxation

(1) …

(2) ...

(3) Where, in accordance with paragraph 2 of Article 1, an item of income is taxed in a Contracting State in the hands of a person that is fiscally transparent under the laws of the other State, and is also taxed in the hands of a resident of that other State as a participant in such person, that other State shall provide relief in respect of taxes imposed in the first-mentioned State on that item of income in accordance with the provisions of this Article.

The following paragraph 2 of Article 3 of the MLI applies and supersedes the provisions of this Convention:

The provisions of Article 23 of the Convention that require a Contracting State to provide a credit equal to the tax paid under the laws of the other Contracting State in accordance with the Convention] shall not apply to the extent that such provisions allow taxation by that other [*Contracting State*] solely because the income is also income derived by a resident of that other [*Contracting State*].

Income Tax Act 2007

BH 1 Double tax agreements

Meaning

(1) **Double tax agreement** means an agreement that—

(a) has been negotiated for 1 or more of the purposes set out in subsection (2); and

(b) has been agreed between—

(i) 1 or more governments of territories outside New Zealand and the government of New Zealand; or

(ii) the Taipei Economic and Cultural Office in New Zealand and the New Zealand Commerce and Industry Office; and

(c) has entered into force as a result of a declaration by the Governor-General by Order in Council under subsection (3).

Purposes

(2) The following are the purposes for which a double tax agreement may be negotiated:

(a) to provide relief from double taxation:

(b) to provide relief from tax:

(c) to tax the income derived by non-residents from any source in New Zealand:

(d) to determine the income to be attributed to non-residents or their agencies, branches, or establishments in New Zealand:

(e) to determine the income to be attributed to New Zealand residents who have special relationships with non-residents:

(f) to prevent fiscal evasion:

(g) to facilitate the exchange of information:

(h) to assist in recovering unpaid tax.

Entry into force

(3) An agreement to which subsection (1)(a) and (b) apply comes into force as declared by the Governor-General by Order in Council and on the date determined under the agreement.

Overriding effect

(4) Despite anything in this Act, except subsection (5), or section RF 11C (Interest paid by non-resident companies to non-residents) or (5B) or section BG 1 or GB 54 (which relate to tax avoidance) or, in any other Inland Revenue Act or the Official Information Act 1982 or the Privacy Act 1993, a double tax agreement has effect in relation to—

(a) income tax:

(b) any other tax imposed by this Act:

(c) the exchange of information that relates to a tax, as defined in paragraphs (a)(i) to (v) of the definition of "**tax**" in section 3 of the Tax Administration Act 1994.

…

CB 35 Amounts of income for partners

A person who is a partner has an amount of income to the extent to which an amount of income results from the application of subpart HG (Joint venturers, partners, and partnerships) to them and their partnership.

HG 2 Partnerships are transparent

Look-through in accordance with share

(1) For the purposes of a partner's liabilities and obligations under this Act in their capacity of partner of a partnership, unless the context requires otherwise,—

(a) the partner is treated as carrying on an activity carried on by the partnership, and having a status, intention, and purpose of the partnership, and the partnership is treated as not carrying on the activity or having the status, intention, or purpose:

(b) the partner is treated as holding property that a partnership holds, in proportion to the partner's partnership share, and the partnership is treated as not holding the property:

(c) the partner is treated as being party to an arrangement to which the partnership is party, in proportion to the partner's partnership share, and the partnership is treated as not being a party to the arrangement:

(d) the partner is treated as doing a thing and being entitled to a thing that the partnership does or is entitled to, in proportion to the partner's partnership share, and the partnership is treated as not doing the thing or being entitled to the thing.

No streaming

(2) Despite subsection (1), for a partner in their capacity of partner of a partnership, the amount of income, tax credit, rebate, gain, expenditure, or loss that they have from a particular source, or of a particular nature, is calculated by multiplying the total income, tax credit, rebate, gain, expenditure, or loss of the partners of the partnership from the particular source or of the particular nature by the partner's partnership share in the partnership's income.

…

LJ 1 What this subpart does

When tax credits allowed

(1) This subpart provides the rules for dividing assessable income from foreign-sourced amounts into segments and allows a tax credit for foreign income tax paid in relation to a segment of that income.

Limited application of rules

(2) The rules in this subpart apply only when—

(a) a person resident in New Zealand derives assessable income that is sourced from outside New Zealand; and

(b) foreign income tax is not paid in a country or territory listed in schedule 27 (Countries and types of income with unrecognised tax) to the extent to which the foreign income tax is paid on the types of income listed in the schedule.

(3) [Repealed]…

Source of dividends

(4) If a company is not resident in New Zealand, and is resident in another territory or is resident in another territory for the purposes of a double tax agreement between New Zealand and the territory, and foreign income tax is imposed by the territory on a dividend paid by the company, a dividend paid by the company has a source in the territory.

(5) [Repealed]…

Relationship with section YD 5

(6) Section YD 5 (Apportionment of income derived partly in New Zealand) applies to determine how an amount is apportioned to sources outside New Zealand.

LJ 2 Tax credits for foreign income tax

Amount of credit

(1) A person described in section LJ 1(2)(a) has a tax credit for a tax year for an amount of foreign income tax paid on a segment of foreign-sourced income, determined as if the segment were the net income of the person for the tax year. The amount of the New Zealand tax payable is calculated under section LJ 5.

Limitation on amount of credit

(2) The amount of the person's credit in subsection (1) must not be more than the amount of New Zealand tax payable by the person in relation to the segment calculated under section LJ 5(2), modified as necessary under section LJ 5(4).

Amount adjusted

(3) The amount of the person's credit in subsection (1) may be reduced or increased if either section LJ 6 or LJ 7 applies.

…

When subsection (7) applies

(6) Subsection (7) applies to a person who derives an amount from an attributing interest in a FIF when the amount is treated as not being income under section EX 59(2) (Codes: comparative value method, deemed rate of return method, fair dividend rate method, and cost method).

Tax credit: attributing interest in FIF

(7) The person has a tax credit under this subpart for foreign income tax paid on or withheld in relation to the amount. The calculation of the maximum amount of the tax credit is made under section LJ 5(2), modified so that the item **segment** in the formula is the amount of FIF income from the attributing interest that the person derives in the period referred to in section EX 59(2).

…

LJ 3 Meaning of foreign income tax

For the purposes of this Part, **foreign income tax** means –

(a) an amount of a tax of another country meeting the requirements of section YA 2(5) (Meaning of income tax varied):

(b) in relation to a double tax agreement providing relief from tax or double taxation, an amount of tax to which the double tax agreement applies.

LJ 4 Meaning of segment of foreign-sourced income

For the purposes of this Part, a person has a **segment of foreign-sourced income** equal to an amount of assessable income derived from 1 foreign country that comes from 1 source or is of 1 nature.

Section YA 1

company—

(a) means a body corporate or other entity that has a legal existence separate from that of its members, whether it is incorporated or created in New Zealand or elsewhere:

(ab) does not include a partnership:

…

(ac) includes a listed limited partnership;

(ad) includes a foreign corporate limited partnership;

(b) includes a unit trust;

…

foreign corporate limited partnership means an entity or group of persons that—

(a) meets the definition of overseas limited partnership in section 4 of the Limited Partnerships Act 2008; and

(b) is treated as a separate legal entity under the laws (other than taxation laws) of the country, territory, or jurisdiction where it is established

limited partnership—

(a) means a limited partnership registered under the Limited Partnerships Act 2008; and

(b) includes an "overseas limited partnership" as defined in section 4 of that Act; and

(c) despite paragraph (a) or (b), does not include a listed limited partnership or a foreign corporate limited partnership

listed limited partnership means an entity or group of persons that is listed on a recognised exchange, and that entity or group of persons—

(a) is a limited partnership registered under the Limited Partnerships Act 2008; or

(b) meets the definition of **overseas limited partnership** in section 4 of that Act

partnership means—

(a) a group of 2 or more persons who have, between themselves, the relationship described in section 8(1) of the Partnership Law Act 2019:

(b) a joint venture, if the joint venturers all choose to be treated as a partnership for the purposes of this Act and the Tax Administration Act 1994:

(c) co-owners of property, other than persons who are co-owners only because they are shareholders of the same company, or settlors, trustees, or beneficiaries of the same trust, if the co-owners all choose to be treated as a partnership for the purposes of this Act and the Tax Administration Act 1994:

(d) a limited partnership

partnership share means, for a particular right, obligation, or other property, status, or thing, the share that a partner has in the partnership.

New Zealand partnership legislation

Partnership Law Act 2019

8 Definition of partnership

(1) **Partnership** is the relationship that exists between persons carrying on a business in common with a view to profit.

(2) This section is subject to section 9.

9 Relationships that are not partnerships

The relationship between the shareholders of members of any of the following is not a partnership within the meaning of this Act:

(a) a company registered under the Companies Act 1993:

(b) a limited partnership that is registered under the Limited Partnerships Act 2008:

(c) an association registered as a body corporate under or any other Act:

(d) a body corporate or other association formed or incorporated by or under any Act or letters patent, or Royal Charter.

Limited Partnership Act 2008

Section 4

overseas limited partnership means a partnership formed or incorporated outside New Zealand with—

(a) 1 or more general partners who are liable for all of the debts and liabilities of the partnership; and

(b) 1 or more limited partners who have only limited liability for the debts and liabilities of the partnership

Australian Tax Legislation

Income Tax Assessment Act 1936

94D Corporate limited partnerships

(1) For the purposes of this Division, a limited partnership is a corporate limited partnership in relation to a year of income of the partnership if:

(a) the year of income is the 1995-96 year of income or a later year of income; or

(b) the partnership was formed on or after 19 August 1992; or

(c) both:

(i) the partnership was formed before 19 August 1992; and

(ii) the partnership does not pass the continuity of business test set out in section 94E; or

(d) all of the following apply:

(i) the partnership was formed before 19 August 1992;

(ii) a change in the composition of the partnership occurs during the period:

(A) beginning on 19 August 1992; and

(B) ending at the end of the year of income;

(iii) the partners do not elect, in accordance with section 94F, that the partnership is not to be treated as a corporate limited partnership in relation to the year of income.

(2) However, a partnership that is a VCLP, an ESVCLP, an AFOF or a venture capital management partnership cannot be a corporate limited partnership.[9]

[9] A VCLP is a venture capital limited partnership and defined in s 118-405(2) of the Income Tax Assessment Act 1997 (Aust); an ESVCLP is an early stage venture capital limited partnership and defined in s 118-407(4) of the 1997 Act; and an AFOF is an Australian venture capital fund of funds and defined in s 118-410(3) of the 1997 Act. In all cases these types of limited partnership must have been registered under Part 2 of the Venture Capital Act 2002 (Aust).

Income Tax Assessment Act 1997

Section 995-1

limited partnership means:

(a) an association of persons (other than a company) carrying on business as partners or in receipt of *ordinary income or *statutory income jointly, where the liability of at least one of those persons is limited; or

(b) an association of persons (other than one referred to in paragraph (a)) with legal personality separate from those persons that was formed solely for the purpose of becoming a *VCLP, an *ESVCLP, an *AFOF or a *VCMP and to carry on activities that are carried on by a body of that kind.

Income Tax Rates Act 1986

23 Rates of tax payable by companies

…

(2) The rate of tax in respect of the taxable income of a company is:

(a) if the company is a base rate entity for a year of income – 25%; or

(b) otherwise – 30%;

if subsections (3) to (5) and section 23A do not apply to the company.

About this document

Public Rulings are issued by the Tax Counsel Office. Public Rulings set out the Commissioner's view on how tax laws apply to a specific set of facts – called an arrangement. Taxpayers whose circumstances match the arrangement described in a Public Ruling may apply the ruling but are not obliged to do so. Public Rulings are binding on the Commissioner. This means that if you are entitled to apply a Public Ruling and you have calculated your tax liability in accordance with the ruling, the Commissioner must accept that assessment. A Public Ruling applies only to the taxation laws and arrangement set out in the ruling, and only for the period specified in the ruling. It is important to note that a general similarity between a taxpayer's circumstances and the arrangement covered by a Public Ruling will not necessarily lead to the same tax result.

LEGISLATION AND DETERMINATIONS

This section of the *TIB* covers items such as recent tax legislation and depreciation determinations, livestock values and changes in FBT and GST interest rates.

COV 22/17: Variation in relation to ss HM 25(3)(a) and HM 72(2)(b) of the Income Tax Act 2007 (PIE exit rules)

Variation

The Commissioner of Inland Revenue has, under the discretion provided under section 6I of the Tax Administration Act 1994, made the following statutory variation:

For the purposes of meeting the requirements of ss HM 14 and/or HM 15, the time period specified in s HM 25(3)(a) of "6 months plus one day" is extended to "12 months".

If the above variation is applied, the time period in s HM 72(2)(b) is extended by replacing "12-month" period with "18-month" period.

This is subject to the conditions that:

- The failure to meet any of the requirements of ss HM 14 and HM 15, under s HM 25(1)(a)(ii), and remedy that failure as required by s HM 25(1)(b)(ii), is due to circumstances arising either from the imposition of COVID-19 response measures or as a consequence of COVID-19.
- When applying the extended period of time in s HM 25(3)(a) under this variation, the last day of the quarter to remedy a failure to meet a requirement, described as the "the second quarter" in s HM 25(1)(b)(ii), must be on or before 30 September 2022.
- The entity has taken all reasonable steps within its control to attract investors and limit investor interests, as required by ss HM 14 and HM 15, within the first 12 months of the date on which the entity becomes a PIE.

Application date

This variation applies from 18 March 2022 to 30 September 2022.

Dated at Wellington on 20 April 2022.

Jonathan Rodgers
Group Leader – Tax Counsel Office
Inland Revenue

Background (material under this heading does not form part of the variation)

Summary of effect

1. The effect of the variation to s HM 25(3)(a) is to extend the period of time after which an entity becomes a PIE, or an investor class is formed, before s HM 25(1) applies. The variation will mean that an entity will have 12 months from the day the entity becomes a PIE, or an investor class is formed, before s HM 25(1) applies.
2. The variation effectively extends the maximum period of time to remedy a failure to meet the requirements in ss HM 14 and HM 15 to 18 months (from 12 months) from the day the entity becomes a PIE, or an investor class is formed. The variation only applies to failures to meet s HM 14 and/or s HM 15 under s HM 25(1)(a)(ii). The variation will not apply to any failure to meet the requirements of ss HM 11 to HM 13.

3. The effect of the variation to s HM 72(2)(b) is that, for newly formed funds, the entity's PIE election does not take effect if there is a failure to meet the requirements of s HM 14 and/or s HM 15 in every quarter of the 18-month period, after the date on which the election would be effective, and there was a loss of PIE status under s HM 25 (as varied). This is to ensure that an entity that still does not meet the relevant requirements of s HM 25(1)(a)(ii) following the extended period of time in the variation, is treated as if its election did not take effect.
4. This extension of the timeframe in s HM 72(2)(b) is intended to mirror the extension of the timeframe in s HM 25(3)(a).

Provisions affected

5. Sections HM 25(3)(a) and HM 72(2)(b) of the Income Tax Act 2007.

Application of variation

6. This variation applies to an entity that has failed to meet the requirements under the PIE rules in ss HM 14 (minimum number of investors) or HM 15 (maximum investor interests) and has failed to remedy those requirements within the timeframe under s HM 25, due to circumstances arising either from the imposition of COVID-19 response measures or as a consequence of COVID-19.
7. Customers can choose not to apply the variation to their circumstances. You can make that decision by taking a tax position, such as in a tax return, or by telling us. If you've already complied with the existing legislation in taking a tax position, we will consider that you have not chosen to apply the variation.

References

Legislative references

Tax Administration Act 1994: ss 6H and 6I

Income Tax Act 2007: ss HM 25(3)(a) and HM 72(2)(b)

CFC 2022/01: Non-attributing active insurance CFC status Tower Limited

Reference

This determination is made under section 91AAQ of the Tax Administration Act 1994.

Explanation (which does not form part of the determination)

A person has no attributed CFC income or loss from a CFC under sections CQ 2 and DN 2 of the Income Tax Act 2007 if the CFC is a non-attributing active CFC under section EX 21B of the Income Tax Act 2007 because the requirements of sections CQ 2(1)(h) and DN 2(1)(h) are not satisfied.

Section EX 21B(3) of the Income Tax Act 2007 provides that a CFC is a non-attributing active CFC if it is an insurer that meets the requirements of section 91AAQ of the Tax Administration Act 1994 and the Commissioner makes a determination under that section. In the absence of such a determination, a CFC carrying on an insurance business is unlikely to be a non-attributing active CFC, because an attributable CFC amount includes the CFC's income from an insurance business or from being an insurer under s EX 20B(3)(f) of the Income Tax Act 2007.

Section 91AAQ(1)(a) of the Tax Administration Act 1994 allows a person to apply to the Commissioner for such a determination in respect of a CFC, if the CFC satisfies subsection (2). Pursuant to section 91AAQ(1)(a) and (6), Tower Limited has made an application for a determination in respect of the CFC set out below. Tower Limited has a 30 September balance date.

It has been determined, having regard to the matters set out in subsections (4) and (5) of section 91AAQ of the Tax Administration Act 1994, that the CFC satisfies the requirements set out in section 91AAQ(2) of the Tax Administration Act 1994 and is accordingly a non-attributing active CFC for the purposes of section EX 21B of the Income Tax Act 2007.

Scope of the determination

The CFC to which this determination applies is:

Name	*Jurisdiction*
National Pacific Insurance (American Samoa) Limited	American Samoa

Interpretation

In this document, unless the context otherwise requires –

"Attributed CFC income or loss" means attributed CFC income under section CQ 2 or attributed CFC loss under section DN 2 of the Income Tax Act 2007.

"CFC" means a "controlled foreign company" as defined in section YA 1 of the Income Tax Act 2007.

"Non-attributing active CFC" means a non-attributing active CFC under section EX 21B of the Income Tax Act 2007.

Condition

This determination is made subject to the following conditions:

- That the nature of the operation of National Pacific Insurance (American Samoa) Limited shall not be materially different from the American Samoa branch of National Pacific Insurance Limited prior to 30 September 2020.
- That National Pacific Insurance (American Samoa) Limited's capital must not have less than USD1,000 as required by the American Samoa Code Annotated.

Determination

Pursuant to section 91AAQ of the Tax Administration Act 1994, I hereby determine that the above CFC is a non-attributing active CFC for the purposes of section EX 21B of the Income Tax Act 2007.

Application date

This determination applies for the 2022 and 2023 income years.

This determination is signed by me this 27th day of April 2022.

Shane Paterson
Group Lead – Customer Compliance

CFC 2022/02: Non-attributing active insurance CFC status Tower Limited

Reference

This determination is made under section 91AAQ of the Tax Administration Act 1994.

Explanation (which does not form part of the determination)

A person has no attributed CFC income or loss from a CFC under sections CQ 2 and DN 2 of the Income Tax Act 2007 if the CFC is a non-attributing active CFC under section EX 21B of the Income Tax Act 2007 because the requirements of sections CQ 2(1)(h) and DN 2(1)(h) are not satisfied.

Section EX 21B(3) of the Income Tax Act 2007 provides that a CFC is a non-attributing active CFC if it is an insurer that meets the requirements of section 91AAQ of the Tax Administration Act 1994 and the Commissioner makes a determination under that section. In the absence of such a determination, a CFC carrying on an insurance business is unlikely to be a non-attributing active CFC, because an attributable CFC amount includes the CFC's income from an insurance business or from being an insurer under s EX 20B(3)(f) of the Income Tax Act 2007.

Section 91AAQ(1)(a) of the Tax Administration Act 1994 allows a person to apply to the Commissioner for such a determination in respect of a CFC, if the CFC satisfies subsection (2). Pursuant to section 91AAQ(1)(a) and (6), Tower Limited has made an application for a determination in respect of the CFC set out below. Tower Limited has a 30 September balance date.

It has been determined, having regard to the matters set out in subsections (4) and (5) of section 91AAQ of the Tax Administration Act 1994, that the CFC satisfies the requirements set out in section 91AAQ(2) of the Tax Administration Act 1994 and is accordingly a non-attributing active CFC for the purposes of section EX 21B of the Income Tax Act 2007.

Scope of the determination

The CFC to which this determination applies is:

Name	*Jurisdiction*
National Pacific Insurance Limited	Samoa

Interpretation

In this document, unless the context otherwise requires –

"Attributed CFC income or loss" means attributed CFC income under section CQ 2 or attributed CFC loss under section DN 2 of the Income Tax Act 2007.

"CFC" means a "controlled foreign company" as defined in section YA 1 of the Income Tax Act 2007.

"Non-attributing active CFC" means a non-attributing active CFC under section EX 21B of the Income Tax Act 2007.

Condition

This determination is made subject to the following conditions:

- That the nature of the operation of National Pacific Insurance Limited shall not be materially different from National Pacific Insurance Limited operations prior to 30 September 2020.

Determination

Pursuant to section 91AAQ of the Tax Administration Act 1994, I hereby determine that the above CFC is a non-attributing active CFC for the purposes of section EX 21B of the Income Tax Act 2007.

Application date

This determination applies for the 2022 and 2023 income years.

This determination is signed by me this 27th day of April 2022.

Shane Paterson
Group Lead – Customer Compliance

2022 Consumers Price Index Adjustment to standard-cost amounts for household services (childcare, boarding services, or short-stay accommodation)

In accordance with Section 91AA of the Tax Administration Act 1994, the Commissioner advises adjustments have been made to the standard-cost amounts for the 2022 income year (1 April 2021 to 31 March 2022), as follows:

Determination DET 09/02 (CPI 2022) Childcare household service

–	Hourly standard cost (per child)	$4.00
–	Annual fixed administration and record keeping standard-cost	$392.00

Determination DET 19/01 (CPI 2022) Household boarding service providers

–	Weekly standard-cost (per boarder)	$207.00

Determination DET 19/02 (CPI 2022) Short-stay accommodation

–	daily standard-cost (for each guest)	
	Owned dwelling	$55.00
	Rented dwelling	$50.00

These amounts reflect the annual movement of the Consumers Price Index for the twelve months to March 2022, which showed an increase of 6.9%.

OPERATIONAL STATEMENT

Operational statements set out the Commissioner of Inland Revenue's view of the law in respect of the matter discussed and deal with practical issues arising out of the administration of the Inland Revenue Acts.

OS 19/03 (CPI 2022): CPI adjustment to Operational Statement OS 19/03

2022 Adjustment to the Square Metre Rate amount

In accordance with Section DB 18AA of the Income Tax Act 2007, the Commissioner advises that the square metre rate for the 2022 income year (1 April 2021 to 31 March 2022) is set at $47.85. The amount reflects the June 2019 Household Economic Survey utility costs information sourced from Statistics New Zealand (adjusted for inflation) and the annual movement of the Consumers Price Index for the twelve months to March 2022, which showed an increase of 6.9%.

Operational Statement 19/03 provides further information on the use of the square metre rate.

INTERPRETATION STATEMENT

This section of the *TIB* contains interpretation statements issued by the Commissioner of Inland Revenue.

These statements set out the Commissioner's view on how the law applies to a particular set of circumstances when it is either not possible or not appropriate to issue a binding public ruling.

In most cases Inland Revenue will assess taxpayers in line with the following interpretation statements. However, our statutory duty is to make correct assessments, so we may not necessarily assess taxpayers on the basis of earlier advice if at the time of the assessment we consider that the earlier advice is not consistent with the law.

IS 22/01: Income Tax – deductibility of costs incurred due to COVID-19

Summary

1. The COVID-19 pandemic has caused significant disruption to businesses. Many businesses have had to incur additional costs (that might be described as unusual or abnormal) due to the pandemic. In addition, businesses may be incurring depreciation loss or other holding costs on assets that they cannot use because of COVID-19 restrictions or temporary downsizing.
2. The fact a cost is unusual does not, of itself, mean the cost is not deductible. Ordinary deductibility principles apply. Whether a cost is deductible depends on its relationship (or nexus) with the business and the way the business earns its income. A cost will be deductible where it has a relationship with the way the business earns its income, and also where it is not disallowed by one of the general limitations (such as the capital limitation).[1]
3. Deductions are still available in situations where assets are not being used in the business temporarily (due to COVID-19 restrictions or temporary downsizing). This is provided the assets remain available for use in the business when restrictions ease.
4. This item discusses the following types of costs a business might incur due to the pandemic:
   - costs relating to its employees, such as:
     - bringing employees into New Zealand or retaining teams who are unable to work
     - providing accommodation to keep teams housed together in a bubble (during COVID-19 restrictions)
     - providing employees with vouchers or incentive payments
     - redundancy payments
   - costs incurred on terminating contracts and legal fees
   - repairs and maintenance costs or depreciation loss on assets or equipment not being used (due to COVID-19 restrictions or a temporary reduction in business activities)
   - premises costs including lease break fees and costs incurred to keep people appropriately distanced within a work place.
5. This item sets out principles to help a business decide whether a particular cost has a relationship with the way the business earns its income, and also whether the cost might be capital (and non-deductible). These principles can also be applied to other costs incurred due to COVID-19 that are not specifically mentioned.
6. Examples included from [88] explain how the law applies to certain scenarios involving a hotel chain, café, construction company, tourism business and an office.

Introduction

7. Businesses have incurred a wide range of additional costs due to the COVID-19 pandemic. Common examples include costs incurred to set up premises for physical distancing, cancel or vary contracts or to enable employees or contractors to enter or remain in New Zealand. In addition, businesses are still incurring ongoing costs such as depreciation loss on assets that are temporarily unable to be used due to COVID-19 restrictions.

[1] The necessary relationship (or nexus) with a business is set out in s DA 1. The general limitations are set out in s DA 2.

8. There has been some uncertainty on how these costs are treated for tax purposes. This statement explains whether such costs are generally deductible. Deductibility depends on whether the cost has the required relationship or nexus with the carrying on of the business and whether the cost is capital in nature. In cases concerning depreciable property or repairs and maintenance, it is not clear whether the property is still used or available for use by the business in deriving its income.

Whether the cost has a relationship with the way the business earns its income

Section DA 1 – general rule allowing deductions

9. Section DA 1 contains the general rule allowing deductions. This rule is known as the general permission:

DA 1 General permission

Nexus with income

(1) A person is allowed a deduction for an amount of expenditure or loss, including an amount of depreciation loss, to the extent to which the expenditure or loss is—

(a) incurred by them in deriving—

(i) their assessable income; or

(ii) their excluded income; or

(iii) a combination of their assessable income and excluded income; or

(b) incurred by them in the course of carrying on a business for the purpose of deriving—

(i) their assessable income; or

(ii) their excluded income; or

(iii) a combination of their assessable income and excluded income.

General permission

(2) Subsection (1) is called the general permission.

10. A person is allowed a deduction for an amount of expenditure or loss to the extent they incur it in deriving their income, or in the course of carrying on a business for the purpose of deriving their income. These are referred to as the first and second limbs of s DA 1.

11. A person (whether or not they are in business) may claim deductions for expenditure incurred in deriving their income under the first limb of s DA 1. This item addresses deductions that are available to businesses, which could be under either the first or the second limbs of s DA 1. Accordingly, businesses could claim a deduction under the first limb for expenditure or loss incurred in deriving their income, or under the second limb for expenditure or loss they incur in the course of carrying on their business for the purpose of deriving income.

12. Under the second limb, the expenditure or loss must be incurred "in the course of carrying on" a business. A sufficient relationship (or nexus) must exist between the expenditure and the business that is being carried on (*CIR v Banks* (1978) 3 NZTC 61,236 (CA) and *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 (CA)).

General deductibility principles for costs incurred by a business

13. The following general principles are drawn from case law on s DA 1.[2]

14. For a cost to be deductible, a relationship (or nexus) must exist between the cost and the person's income-earning process. It is a question of fact and degree in each case (*Banks* and *Buckley & Young*).

15. The true character of the cost and its relevance to the taxpayer's income-earning process are relevant for deciding whether that relationship exists. This includes looking at the scope of the taxpayer's income-earning process (that is, how their income is earned) and the factual situation at the time the cost is incurred (*Banks* and *Buckley & Young*).

16. For a cost to be deductible, it does not need to be linked to a particular item of income. Also, income does not need to be produced in the same year the cost was incurred (*Commissioner of Taxation (NSW) v Ash* (1938) 5 ATD 76 (HCA) and *Eggers v CIR* (1988) 10 NZTC 5,153 (CA)).

[2] For more detail on deductibility principles, see IS 14/04: Income tax — deductibility of company administration costs", *Tax Information Bulletin* Vol 26, No 7 (August 2014): 5.

17. The business must incur the cost as part of its operations to earn its income (*FCT v Wells* 71 ATC 4,188 (HCA) and *John Fairfax and Sons Pty Ltd v FCT* (1959) 101 CLR 30 (HCA)). Whether a business incurs a cost as part of its operations to earn income is usually determined objectively. However, subjective matters may be relevant where the cost was incurred by choice and the relationship between the cost and the business operations is more indirect and remote (*Banks*; *Magna Alloys & Research Pty Ltd v FCT* 80 ATC 4,542 (FCAFC); *Fletcher v FCT* 91 ATC 4,950 (HCA); *Putnin v FCT* 91 ATC 4,097 (FCAFC) and *Schokker v FCT* 99 ATC 4,504 (FCAFC)).
18. Longer-term objectives can be considered. In relation to expenditure incurred in carrying on a business, a deduction is allowed for costs incurred to protect or advance a business, or to avoid or reduce expenditure (*Europa Oil (NZ) Ltd (No 2) v CIR* (1974) 1 NZTC 61,169 (CA) and *Cox v CIR* (1992) 14 NZTC 9,164 (HC)).
19. Applying these concepts in the context of costs incurred due to the pandemic:
    - how the business earns its income and whether the cost relates to that process is important
    - the factual situation at the time the cost is incurred is relevant
    - a cost does not need to be linked to a particular amount of income, or even be incurred in the same year
    - costs incurred to protect a business can be deductible.

Whether any limitations to deductibility apply

20. If a cost satisfies the nexus test above, the next step is to consider whether any general limitations apply to deny a deduction.

Overview of the limitations to deductibility

21. Even where a deduction is available under s DA 1, it may be disallowed under the limitations to deductibility set out in s DA 2. Relevantly, under s DA 2(1) a person is denied a deduction to the extent the cost is of a capital nature (the capital limitation).
22. This statement focuses on the capital limitation as this is the most common limitation to deductibility for businesses incurring additional costs due to the pandemic. However, there are other limitations to deductibility such as the private limitation. Businesses need to ensure no other limitations apply to their particular fact situation.

When the capital limitation applies

23. In *Sun Newspapers Ltd v FCT* (1938) 61 CLR 337 (HCA), Dixon J described (at 359) the distinction between capital and revenue expenditure as corresponding with the distinction:

    > … between the business entity, structure, or organisation set up or established for the earning of profit and the process by which such an organisation operates to obtain regular returns by means of regular outlay, the difference between the outlay and returns representing profit or loss.

24. Dixon J identified three matters to be considered (at 363):

    > (a) the character of the advantage sought, and in this its lasting qualities may play a part,
    >
    > (b) the manner in which the advantage is to be used, relied upon or enjoyed, and in this and under the former head recurrence may play its part, and
    >
    > (c) the means adopted to obtain it; that is, by providing a periodical reward or outlay to cover its use or enjoyment for periods commensurate with the payment or by making a final provision or payment so as to secure further use or enjoyment.

25. Dixon J considered the character of the advantage sought, the manner in which it is to be used, and the means to obtain it were relevant factors for deciding whether an expense was capital in nature.
26. In *Hallstroms Pty Ltd v FCT* (1946) 72 CLR 634 (HCA), Dixon J again summarised the distinction between capital and revenue expenditure (at 647):

    > The contrast between the two forms of expenditure corresponds to the distinction between the acquisition of the means of production and the use of them; between establishing or extending a business organisation and carrying on the business; between the implements employed in work and the regular performance of the work in which they are employed; between an enterprise itself and the sustained effort of those engaged in it.

27. His Honour stated (at 648) that determining whether expenditure was capital or revenue:

> depends on what the expenditure is calculated to effect from a practical and business point of view rather than upon the juristic classification of the legal rights, if any, secured employed or exhausted in the process.

28. Similarly, in *Commissioner of Taxes v Nchanga Consolidated Copper Mines* [1964] AC 948 (PC), Viscount Radcliffe stated (at 960):

> Again courts have stressed the importance of observing a demarcation between the cost of creating, acquiring or enlarging the permanent (which does not mean perpetual) structure of which the income is to be the produce or fruit and the cost of earning that income itself or performing the income earning operations. Probably this is as illuminating a line of distinction as the law by itself is likely to achieve...

29. The principles from these cases were adopted by the Privy Council in *BP Australia Ltd v FCT* [1965] 3 All ER 209 (PC) which in turn was adopted in several New Zealand cases.[3] In *Wattie* (PC) the Privy Council noted that the approach adopted in *Hallstroms* had been recognised as exemplifying the "governing approach" in New Zealand.[4]
30. The courts have identified various factors to help decide whether a cost is capital or revenue:
    - the need or occasion for the expenditure
    - whether the expenditure is recurrent
    - whether the expenditure creates an identifiable asset
    - whether the expenditure creates an advantage that is of enduring benefit to the business
    - whether the expenditure is on the profit-making structure or on the profit-making process of the business
    - whether the source of the payment is from fixed or circulating capital
    - the treatment of the expenditure according to the ordinary principles of commercial accounting.
31. Many of these factors overlap and some carry more weight in different circumstances. Also, these factors are helpful as a starting point, but a judgement must still be made about whether the expenditure is capital or revenue. This can be done by looking at the facts as a whole and determining which factors carry the most weight in light of those specific facts. Also some of the above factors may now have limited relevance.
32. For example, as stated by the Court of Appeal in *CIR v Trustpower*, accounting treatment is not determinative because the Income Tax Act 2007 prescribes what deductions are permissible for taxation purposes, irrespective of financial accounting principles. In this respect, it is noted that accounting may treat some abnormal expenses on capital assets as not able to be capitalised for accounting purposes. This treatment is not determinative for tax purposes, and general deductibility principles need to be applied, as outlined in this statement.

Deductibility of specific types of costs

33. The above analysis is now applied to certain types of costs a business may incur due to the COVID-19 pandemic. The costs mentioned in this statement are generally ones that a business would not typically incur before the pandemic (although some costs such as legal fees would be incurred in other situations). The statement also discusses more common costs such as depreciation loss, where the pandemic has impacted on the use of property. This statement does not cover every type of cost that arises from the pandemic but sets out general principles that may be applied to other situations.

Employee costs

34. Due to the pandemic, a business might incur the following types of costs on its employees:
    - relocating new or existing employees to New Zealand, including obtaining visas, exemptions, places at managed isolation and quarantine facilities and transport
    - retaining teams in New Zealand where they may be unable to work (such as paying retainers to contractors) or keeping teams housed together in a bubble
    - payments to employees such as vouchers for going back to the office, incentive payments for vaccinations or the provision of mental health and wellbeing services
    - redundancy payments.

[3] For example, *CIR v LD Nathan & Co Ltd* [1972] NZLR 209 (CA), *Buckley & Young, CIR v McKenzies New Zealand Ltd* (1988) 10 NZTC 5,233 (CA), *Christchurch Press Co Ltd v CIR* (1993) 15 NZTC 10,206 (HC), *CIR v Wattie* (1998) 18 NZTC 13,991 (PC), *Poverty Bay Electric Power Board v CIR* (1999) 19 NZTC 15,001 (CA), and *Birkdale Service Station Ltd v CIR* (2000) 19 NZTC 15,981 (CA).

[4] This general approach was similarly recognised by the Court of Appeal in *CIR v Trustpower* [2015] 3 NZLR 658 (and was not discussed in any further detail by the Supreme Court on appeal in *Trustpower v CIR* [2017] 1 NZLR 155).

35. In general terms, costs that relate to the employees of a business will likely have a relationship with how the business derives its income.

Costs for relocating employees, paying retainers or providing accommodation

36. Whether costs incurred to bring employees (or contractors) into New Zealand are deductible depends on the facts. Costs relating to hiring new employees relate to the carrying on of the business, and so the general permission would be satisfied. The question turns on whether the capital (or any other) limitation would apply.
37. For example, deductibility will depend on whether the person is engaged to undertake work to bring into use a capital asset for the business. In that case, the payments also take that capital nature. This occurred in *Christchurch Press*. In that case, the taxpayer was a newspaper publisher who employed tradespeople to service and maintain printing presses and other machinery used in producing the newspaper. Some were employed to install and wire up new capital equipment and replace electrical wiring. The court found that the purpose of the labour for which wages were paid was the installation of a capital asset. Gallen J concluded that the expenditure on the employees was as much a part of the capital asset as it would have been if a contractor was paid to install the equipment. He said that if a contractor had been so paid, it could not have been said that the payment was not a capital payment. In addition, the regular payment of the wages did not mean that the expenditure was necessarily of a revenue nature. The work was done to bring into use new equipment that was both an asset and intended to be of enduring benefit.
38. The same reasoning applies for costs incurred in keeping contractors in New Zealand (such as paying a retainer when they are unable to work due to COVID-19 restrictions), and in housing employees together as a bubble when there are COVID-19 restrictions in place. That is, generally these costs would be deductible unless the employee or contractor is engaged to bring into use a capital asset for the business. Whether these costs are deductible will depend on the specific fact situation, applying the principles previously discussed.
39. Further information on employee relocation costs can be found in IS 10/06, "Deductibility of business relocation costs" *Tax Information Bulletin* Vol 22, No 8, September 2010 at 20. There are also specific provisions a business should be aware of in relation to the relocation of employees in subpart CW of the Act, and in relation to accommodation costs in subparts CE and CW.

Incentive payments and vouchers

40. Incentive payments to employees are generally deductible to an employer if they are made in relation to the employee's employment in the business. For example, a business may wish to incentivise employees to get vaccinated to lessen the risk of future business disruption. Such payments would form part of the employee's employment income.
41. In addition, non-monetary benefits provided to employees (which may be subject to fringe benefit tax – such as vouchers encouraging staff back to the office) are also generally a deductible expense to an employer (including any FBT payable).

Redundancy payments

42. Payments made to an employee could include redundancy or termination payments. These types of payments are specifically deductible to a business where they satisfy s DC 1 (which allows deductions for certain lump sum payments paid by businesses for ending employment or service).

Contract and legal costs

43. Due to the pandemic, a business might incur the following types of costs relating to contracts or legal fees:
    - costs for terminating contracts, including any settlement payments for breach of contract
    - legal costs incurred in contractual or employment disputes.
44. Where a person's total legal expenses are equal to or less than $10,000 in an income year, the person is allowed a deduction under s DB 62 for the expense provided that the nexus requirement in s DA 1 is satisfied. This provision overrides the capital limitation.
45. Contractual and legal expenses incurred on an income-producing aspect of the business would satisfy the nexus test. However, deductions are not available in situations where legal expenses (exceeding $10,000) or contractual expenses relate to capital items. This will depend on the nature of the contract or the matter to which the legal services relate.
46. While in the context of taxability of receipts, in *The Federal Coke Co Ltd v FCT* 77 ATC 4255 Brennan J said:

> the character of a cause of action discharged by a payment will ordinarily determine, unless it be a sham transaction, the character of the receipt of the price or payment. ... Thus, when moneys are received in consideration of surrendering a benefit to which the recipient is entitled under a contract, it is relevant to enquire whether or not that benefit was a capital asset in his hands.

47. For payments for cancelled contracts and legal fees, the underlying cause of action or contract is what determines whether a payment is capital or revenue. While the above comment relates to receipts, it applies equally to expenditure incurred.
48. In *Fullers Bay of Islands Ltd v CIR* (2006) 22 NZTC 19,716 (CA) the taxpayer provided sea and land transport services and wanted to expand its business. The taxpayer submitted a tender for a passenger ferry service and was initially the preferred bidder. However, a competitor's bid was accepted, and the tender round was cancelled. The taxpayer sought damages or the transfer of the ferry service contract. The taxpayer's claims were dismissed, and the taxpayer claimed a deduction for its legal fees. The court considered that the need or occasion for the expenditure was the taxpayer's desire to expand its business. The cost of creating, acquiring or enlarging the permanent structure by which income is produced was capital in nature. Accordingly, the legal fees were not deductible.
49. The character of a settlement payment can be determined by the nature of the claim for payment. The nature of such claims could be for the cancellation of a supply contract, a loss of an ability to earn profits or the loss of a capital asset.
50. The courts have tended to focus their enquiry on whether the cancelled contract was of such a nature and significance to the taxpayer's activity so as to form part of the taxpayer's profit-making structure. The more fundamental to the taxpayer's activity a particular contract is, the more likely it is that a payment relates to an enduring asset that forms part of the profit making structure. For example, in *CIR v Thomas Borthwick & Sons (Australasia) Ltd* (1992) 14 NZTC 9,101 (CA) the key to categorising a supply and marketing contract as capital or revenue was the nature and significance of the contract in the operations of the business.
51. Accordingly, a business can deduct costs for cancelling or breaching contracts and on its legal fees where the contract or cause of action relate to the income earning process of the business and are not capital. This will depend on the nature of the contract or the underlying cause of action and its relationship to the business.
52. In summary, a payment made to cancel a contract is generally deductible if the contract is an ordinary trading contract such as for the sale or purchase of trading stock, or for services that are supplied or purchased in the ordinary course of the business.

Assets and equipment

53. Due to the pandemic, a business might incur the following types of costs on their assets or equipment:
    - repairs and maintenance on assets or equipment not being used due to COVID-19 restrictions or a temporary reduction in business activities
    - re-activating costs so equipment can be put back into use
    - ongoing depreciation loss for depreciable assets that are not being used due to COVID-19 restrictions or a temporary reduction in business activities
    - security costs.

Repairs and maintenance expenditure

54. Repairs and maintenance of capital assets that do not improve the asset are generally deductible. However, where they result in an improvement, then the costs are capitalised.[5] Where the assets are temporarily unavailable for use in deriving income due to COVID-19 restrictions or temporary downsizing of the business, deductions for repairs and maintenance are still generally available.[6]
55. Similarly, costs incurred in re-activating equipment so it can be put back to use would also generally be deductible (provided it did not result in an improvement of the asset). Also, costs involved in ensuring the asset remains secure when not being used (such as security or monitoring costs) would similarly generally be deductible.
56. The above principles apply on the basis that the business is still being carried on and any disuse of the asset is only temporary due to effects of the pandemic.

[5] See for example, *Auckland Gas Co Ltd v CIR* (2000) 19 NZTC 15,702 (PC), *Auckland Trotting Club v CIR* [1968] NZLR 967 (CA), *Poverty Bay Electric Power Board*, *Case T43* (1998) 18 NZTC 8,287 (TRA), *Case L68* (1989) 11 NZTC 1,398 (TRA).

[6] See Example 1 in "IS 12/03 Income tax - deductibility of repairs and maintenance expenditure", *Tax Information Bulletin* Vol 24, No 7 (August 2012): 68. See IS 12/03 more generally for more information on deductibility of repairs and maintenance expenditure.

Depreciation loss

57. Section DA 1 clarifies that a deduction is available for an amount of depreciation loss, to the extent to which it is incurred in deriving income, or in the course of carrying on a business for the purpose of deriving its income.
58. Depreciation loss deductions effectively allow deductions for the cost of a capital asset, which are spread over the life of the asset. Subpart EE applies to quantify the amount of depreciation loss that is deductible. Section EE 1 provides that a person has an amount of depreciation loss where the person owns an item of depreciable property which is used or available for use by the person in the income year, and the amount of loss is calculated under subpart EE.
59. "Depreciable property" is defined in s EE 6 as property that might be expected to decline in value while used or available for use in either deriving assessable income or carrying on a business for the purpose of deriving assessable income. Generally, most assets of a business and building fit-out would be depreciable property, and so depreciation loss deductions for such property are calculated under subpart EE.
60. An important step is to identify whether the particular item of property is a separate asset or part of a larger asset. This could be relevant for assets such as protective plastic barriers that may be erected in a workplace (e.g. at reception desks). If the item is part of a larger depreciable asset, then expenditure on that item is either depreciable as part of the cost of the larger asset or may be deductible if it comprises repairs and maintenance of that asset. If the item is a separate asset, then expenditure may be either deductible or depreciable, depending on the circumstances.
61. The Commissioner has provided guidance for doing this by way of a three-step test set out in IS 10/01 "Residential rental properties – Depreciation of items of depreciable property".[7] While that statement relates to residential property, the same principles apply for other assets. In summary, the steps are to determine whether the item:
    - is in some way attached or connected to the larger asset
    - is an integral part of the larger asset (such that the larger asset would be incomplete or unable to function without it)
    - is built-in or attached or connected in such a way that it is part of the "fabric" of the larger asset.
62. As noted earlier, this statement applies only to businesses that are being carried on. It does not apply to businesses that are ceasing (temporarily or permanently). For such businesses, see IS 21/04: Income tax and GST – deductions for businesses disrupted by the COVID-19 pandemic", *Tax Information Bulletin* Vol 33, No 9 (October 2021): 8. Accordingly, the relevant depreciation loss is still incurred in the course of carrying on a business for the purpose of deriving income until such time as a business ceases (or the asset is no longer used or available for use in the business). This is the case even if a business may be temporarily ceasing in the sense that income is not being derived at that particular point in time due to COVID-19 restrictions, as long as the business is still being carried on for the purpose of deriving income. Ultimately, whether a business has ceased is a question of fact. Examples three, four and seven of IS 21/04 illustrate this point and depreciation loss would remain available.
63. Where property is no longer used or available for use in the business then deductions for depreciation loss are no longer available. This requires a change of use calculation. Under the change of use calculation, the property is treated as being disposed of for its market value. The losses claimed are compared with the loss that the taxpayer would incur on the deemed disposal of the property. If the loss is less than the depreciation deductions claimed, an adjustment must be made to recover that amount.
64. This gives rise to an issue where property is not being used by the business due to COVID-19 restrictions or temporary downsizing. While it might be clear that the property is not being used, the question is whether the property is still available for use during this time.
65. The *Concise Oxford English Dictionary* (11th ed, 2012) defines the terms as follows:

    available adj **1** able to be used or obtained. **2** not otherwise occupied. free

    use take, hold or deploy as a means of achieving something…. Treat in a particular way.
66. Accordingly, provided that property is not otherwise being used and is able to be used by the business, then it appears the property will be "available for use" in the business for the purposes of the depreciation regime.
67. While in a different context, the Court of Appeal in *Trustpower* discussed the meaning of "available for use" at [27]:

    Clearly, once the resource consents were granted, they were "available for use" by Trustpower. The fact that they were not being used and would not be used unless and until Trustpower decided to use them and obtained land

[7] *Tax Information Bulletin*, Vol 22 No 4 (May 2010), 16.

access did not mean that they were not "available" for use. The expression "available" simply means "capable of being used". Once Trustpower decided to use them and obtained land access, they would be used. Prior to that they were available for that purpose.

68. In *Hunter v C of T* [1937] NZLR 204 (HC) Smith J noted that the question was whether the depreciable property "remains a part of the whole producing asset for the time being". Smith J noted that a manufacturer may be unable to use machinery due to supply issues but that machinery still makes up his manufacturing asset "ready to play its part so soon as supplies became available".
69. In *Mason v C of T (NSW)* (1935) 3 ATD 181, it was held that depreciation for a fleet of buses was available even though the buses were kept off the roads. The court said that the buses were used "as far as they were able to" for the purpose of carrying on a business, and compared it to the situation where cars were available for hire but there was no custom. The court noted that there was still wear and tear on the buses, which may result from "simply keeping them available for custom in the course of the business".
70. Consistent with this, s EE 10 provides that an item of depreciable property is treated as being available for use while subject temporarily to repair or inspection, if it was used or available for use immediately before going for repair or inspection.
71. Also, s EE 39 applies when a person has depreciable property that is no longer used nor intended to be used, and is not disposed of. The section provides that a person will have an amount of depreciation loss if:
    - they no longer use the item in their business
    - they do not intend to use the item in carrying on the business for the purpose of deriving assessable income and
    - the costs of disposing of the item would be more than any consideration they could derive from disposing of it.
72. This section indicates that an intention to use the property in the business is sufficient for the property to still be considered available for use.
73. This, combined with the nature of change of use calculations, imply that the change of use is intended to be a permanent one. The change of use calculation applies to ensure that the person has not claimed a higher or lower deduction than they are entitled to at the time the property is removed from the tax base. It operates to ensure that the property owner was appropriately taxed in relation to that asset while it was used for business purposes.
74. Where property cannot be used either due to COVID-19 restrictions or where businesses have temporarily reduced some of their operations due to the pandemic, any disuse of the property is temporary. However, this does not mean that the property is unavailable or there is no intention to use the property in the business. This is contrasted to where the property has left the tax base (e.g. it is sold, discarded or used for private use). For instance, where the business decides to sell the property or downsizes more permanently and no longer requires some assets, there is no question that there will be a change of use of that property.
75. Accordingly, where depreciable property is available for the business to use but cannot be used due to temporary COVID-19 restrictions, that property is still considered to be available for use in the business for the purposes of the depreciation regime. This is because, as soon as the restrictions are lifted, that property will be able to be used in the business again. It is not otherwise being used. It would make no sense to treat this property as having been taken out of the tax base when any disuse is merely temporary.
76. Where a business is reducing its activities and so temporarily stops using the property for deriving its income, then whether there has been a change of use will depend on the facts. Whether the property is still available for use in that case depends on whether the business intends to use that property again and whether the property is actually available to be used. If the business intends to only temporarily restrict its activities, then the property could be said to still be available for use. However, where the business intends the downsizing to be permanent and does not intend to use the property in the business again, then it would likely be considered to no longer be available.

Premises expenses

77. Due to the pandemic, a business might incur the following types of costs in relation to its premises:
    - payments made to terminate a lease (by the lessee)
    - incentive payments to encourage new tenants (by the lessor)
    - additional costs incurred to keep teams appropriately distanced within a work place, including changes to relevant fitout (such as erecting barriers)
78. Section DB 20C provides that a person who pays an amount for the surrender or termination of a lease is allowed a deduction for the amount (provided that nexus is satisfied).
79. Similarly, s CC 1B confirms that consideration for the grant, renewal, extension or transfer of a lease is income to the recipient of a payment, and s DB 20B provides that a deduction is available to the payer.
80. Costs incurred to keep teams appropriately distanced at work would likely form part of the general operational costs of a business, but this depends on whether the measures put in place involve capital assets.
81. For example, costs incurred in rearranging workspaces or costs of providing face masks, hand sanitisers, rapid antigen tests and cleaning equipment would likely be deductible. See Example 5 regarding these types of costs.
82. However, some costs would relate to capital assets. An example of capital expenditure is the erection of barriers at reception desks. This could be a depreciable asset in itself, form part of another depreciable asset (e.g. when permanently attached to a reception desk) or even potentially become a building fixture. See Example 1 below, regarding when a barrier would form a separate item of depreciable property.
83. Accordingly, deductibility or the availability of depreciation loss would depend on the particular item of property and general principles would apply.
84. A business may also choose or need to relocate due to the pandemic. There are various expenses that may be incurred when a business relocates, and generally deductibility depends on whether the relocation is undertaken to expand the business operations (which would be capital). Where a relocation does not expand the business operations and is not for the owner's private reasons, then expenses are likely deductible.
85. IS 10/06: "Deductibility of business relocation costs", *Tax Information Bulletin* Vol 22, No 8 (September 2010): 20 states:

    > On balance, the Commissioner concludes that business relocation expenditure will be deductible where the principal purpose of the relocation is to maintain and preserve the existing structure of the business. The Commissioner does not consider that a move to new, and possibly larger, premises is necessarily expansionary (and therefore capital expenditure). Where the principal purpose of a relocation is merely to enable a business to carry on operating in much the same way as it did before the move, and not to extend or enlarge the structure of the business, then the capital limitation will not prevent a deduction. This will be the case even if the new premises are larger or if there is a possibility that the business may make profitability gains over time as a result of the relocation. The Commissioner does not consider that business relocations that are made to take account of the organic growth or decline of a business are made for the purpose of extending or enlarging the structure of the business.

86. For more details of deductibility of business relocation costs generally, see IS 10/06.

Examples

87. The principles discussed above are applied in the following five examples to illustrate how they affect the deductibility of COVID-related expenditure incurred by businesses.

Example 1 – Boutique hotel chain temporarily reduces operations

Hine's Hotels Ltd (HHL) is a boutique hotel chain with four hotels across the North Island.

In late 2020, HHL was planning on constructing a fifth hotel in Queenstown and had a site, relevant plans and consents, and had engaged a construction firm to begin work. Foundations and the concrete base were laid in July 2021.

Shortly after beginning this initial work, HHL realised it would be months before tourism would pick up, so cancelled the construction contract (although was hoping to restart work again in the future). The contract set out how to calculate a termination fee, and HHL paid the agreed amount.

The other hotels were running at reduced capacity and the Auckland hotel had no guests due to COVID-19 restrictions. HHL decided to temporarily close the Auckland hotel for three months while restrictions were in place. HHL set up monitored security cameras with a security firm and continued to pay rent, rates, power, water and insurance. HHL had to make some of the positions in Auckland redundant.

HHL engaged a cleaning company to keep the Auckland premises clean and check equipment was usable, and put up temporary removable plastic barriers at the reception desks. When restrictions eventually eased, the Auckland hotel re-opened.

HHL can claim deductions for these costs:

- redundancy payments
- security and cleaning costs for the temporarily closed hotel
- rates, power, water and insurance on the temporarily closed hotel
- depreciation loss on depreciable property in the temporarily closed hotel provided the depreciable property was available for use before being closed and remains usable.
- For depreciation purposes, HHL applied the three step test and identified that the removable temporary barriers did not form part of the reception desks but were separate depreciable assets.
- The expenditure incurred on cancelling the contract is not deductible as it relates to a capital asset. If the hotel construction was abandoned, HHL may be able to claim deductions for feasibility expenditure under ss DB 66 and DB 67.

Example 2 – Cafe downsizing and relocating

Paolo's Pies Ltd is a café and pie bakery business in central Auckland that was a quick lunch stop for office workers. During strict COVID-19 restrictions, the café was unable to open. Once restrictions eased, Paolo's Pies opened for takeaways and sold cook-at-home family pie packs. The pie packs were a success and after several months Paolo's Pies decided it could operate out of a smaller kitchen.

Paolo's Pies found a smaller commercial kitchen to operate from out of the city centre and relocated the pie bakery there to save costs. Paolo's Pies terminated the central city lease, and had to pay an early termination fee.

Paolo's Pies had a supply contract under which it supplied pies to Timmy's Takeaways Ltd. Paolo's Pies tried to cancel that contract to focus on the pie packs. The contract was only a supplement to Paolo's Pies' income and had not been substantial to the business. However, it was a substantial supply contract to Timmy's Takeaways, who would be left without any pies to sell if the contract were cancelled.

Timmy's Takeaways engaged a lawyer to enforce the remaining period of the contract and Paolo's Pies also had to engage a lawyer. They ultimately settled on Paolo's Pies providing pies for a further two months so Timmy's Takeaways could find a new supplier.

Paolo's Pies can claim deductions for these costs:

- legal costs incurred on the cancelled pie contracts, since these contracts were not an enduring asset of the business and did not form an integral part of its profit making structure.
- relocation costs to smaller premises, as Paolo's Pies is not expanding the business structure but simply finding more fit-for-purpose premises
- the payment made for terminating the existing lease.
- Timmy's Takeaways can deduct its legal costs as its total legal costs for the income year were less than $10,000. However, if its total legal costs exceeded this amount, the fees would not be deductible if the pie supply contract was capital in nature.

Example 3 – Construction company with employee expenses

Carla's Construction Company Ltd (CCCL) is a medium-sized construction company that hires a mix of employees and short-term contractors on particular sites.

CCCL was working on a difficult build site that required specialised engineers, but was struggling to find appropriately qualified staff in New Zealand during the pandemic.

CCCL found two new employees based in Australia. CCCL obtained work visas and border exemptions for them along with two spots in managed isolation and quarantine facilities. CCCL paid these costs to help the new employees with their relocation to New Zealand.

CCCL had a contractor in Auckland who was unable to work during the COVID-19 lockdown. This contractor was involved across multiple projects and couldn't be replaced, so CCCL paid him a retainer so he did not look for other contracting work in the meantime.

CCCL also had a group of young labourers on a site in Hamilton. To ensure they could continue working once alert levels allowed, CCCL put them up in temporary accommodation during the lockdown.

CCCL can claim deductions for these costs:

- relocation expenses for employees moving to New Zealand and the cost of managed isolation and quarantine facilities
- the retainer for the contractor
- accommodation expenses to temporarily keep labourers in a bubble.
- Note that deductions are not available to the extent that any contractors or employees were engaged in constructing a new capital asset for CCCL. That was not the case, so the full deductions were available.

Example 4 – Jetboat operator with maintenance expenses and depreciation

Jed's Jetboats Ltd (JJL), is a jet boat tourism business in Queenstown. During the last two years, JJL had a considerable decrease in customers because of the pandemic. During the COVID-19 restrictions JJL could not operate at all, but even when restrictions were eased the business struggled. JJL was still busy in the school holidays and over summer, but for the rest of the year most of the boats were in storage. Jed hoped business would pick up, but supplemented his income by taking on other jobs over winter.

JJL paid for a secure storage facility to store the unused jetboats until there were enough customers to bring them back out. JJL kept the boats regularly maintained and serviced so they would be able to immediately be used when needed. Jed did not have the mechanical skills to do the maintenance himself, so JJL paid for regular maintenance work to be undertaken. Just prior to re-using the jet boats JJL paid for additional maintenance and tests to ensure the boats were safe.

JJL can claim deductions for these costs:

- maintenance costs
- storage costs
- additional maintenance and tests before re-using the boats (to the extent that this work did not result in improvements to the boats).

The stored boats, while not used, are still available for use as soon as business picks up so deductions for depreciation loss remain available. However, when JJL makes a decision to retire or sell a boat, it will need to make a change of use calculation for depreciation purposes.

Example 5 – Web company with employee expenses

Wanda's Web Services Ltd (WWSL) is a small business that creates and runs websites for other small businesses. WWSL employs five full-time staff and they have a small office space on the outskirts of Wellington city.

WWSL's staff all worked from home during the lockdowns in the pandemic. To show appreciation to the staff, WWSL offered them vouchers for a discounted rate on mental health and wellbeing support with therapists.

Once staff were allowed back in the office, WWSL gave them all prezzy cards and meal vouchers to encourage them back. WWSL also ensured the office, while small, enabled staff to be socially distanced by changing the layout of desks and also supplied the office with hand sanitiser, masks and rapid antigen tests.

One of WWSL's clients required all visitors to be vaccinated. WWSL had one staff member, Sherry, who was critical to the work being done for that client but was not yet vaccinated. WWSL offered Sherry an inducement payment of $100 per vaccination, which Sherry ultimately accepted.

WWSL can claim deductions for these costs:

- prezzy cards and vouchers for mental health and wellbeing support and to encourage workers back into the office
- masks, hand sanitiser and rapid antigen tests to ensure a healthy workplace
- vaccination incentive payments.

FBT may be payable on the provision of some benefits to employees. If so, any FBT paid is also deductible to WWSL.

References

Legislative references

Income Tax Act 2007, ss CC 1B, DA 1, DA 2, DB 20C, DB 62, DC 1, subpart EE

Case references

Auckland Gas Co Ltd v CIR (2000) 19 NZTC 15,702 (PC)

Auckland Trotting Club v CIR [1968] NZLR 967 (CA)

Birkdale Service Station Ltd v CIR (2000) 19 NZTC 15,981 (CA)

BP Australia Ltd v FCT [1965] 3 All ER 209 (PC)

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Case L68 (1989) 11 NZTC 1,398 (TRA)

Case T43 (1998) 18 NZTC 8,287 (TRA)

Christchurch Press Co Ltd v CIR (1993) 15 NZTC 10,206 (HC)

CIR v Banks (1978) 3 NZTC 61,236 (CA)

CIR v LD Nathan & Co Ltd [1972] NZLR 209 (CA)

CIR v McKenzies New Zealand Ltd (1988) 10 NZTC 5,233 (CA)

CIR v Thomas Borthwick & Sons (Australasia) Ltd (1992) 14 NZTC 9,101 (CA)

CIR v Trustpower [2015] 3 NZLR 658 (CA)

CIR v Wattie (1998) 18 NZTC 13,991 (PC)

Commissioner of Taxation (NSW) v Ash (1938) 5 ATD 76 (HCA)

Commissioner of Taxes v Nchanga Consolidated Copper Mines [1964] AC 948 (PC)

Cox v CIR (1992) 14 NZTC 9,164 (HC)

Eggers v CIR (1988) 10 NZTC 5,153 (CA)

Europa Oil (NZ) Ltd (No 2) v CIR (1974) 1 NZTC 61,169 (CA)

Federal Coke Company Ltd v FCT 77 ATC 4255 (FCA)

FCT v Wells 71 ATC 4,188 (HCA)

Fletcher v FCT 91 ATC 4,950 (HCA)

Fullers Bay of Islands Ltd v CIR (2006) 22 NZTC 19,716 (CA)

Hallstroms Pty Ltd v FCT (1946) 72 CLR 634 (HCA)

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Trustpower v CIR [2017] 1 NZLR 155 (SC)

Other references

IS 10/06: Deductibility of business relocation costs, *Tax Information Bulletin* Vol 22, No 8 (September 2010): 20. **www.taxtechnical.ird.govt.nz/tib/volume-22---2010/tib-vol22-no8**

IS 12/03: Income Tax - Deductibility of repairs and maintenance expenditure, *Tax Information Bulletin* Vol 24, No 7 (August 2012): 68. **www.taxtechnical.ird.govt.nz/tib/volume-24---2012/tib-vol24-no7**

IS 14/04: Income tax - Deductibility of company administration costs, *Tax Information Bulletin* Vol 26, No 7 (August 2014): 5. **www.taxtechnical.ird.govt.nz/tib/volume-26---2014/tib-vol26-no7**

IS 21/04: Income Tax and GST – Deductions for businesses disrupted by the COVID-19 pandemic, *Tax Information Bulletin* Vol 33, No 9 (October 2021): 8. **www.taxtechnical.ird.govt.nz/tib/volume-33---2021/tib-vol-33-no9**

IS 22/02: GST and finance leases

All legislative references are to the Goods and Services Tax Act 1985 unless otherwise stated.

GST information rules

For taxable periods beginning on or after 1 April 2023 a reference in this document to tax invoice is to be read as including a reference to taxable supply information. A reference to a credit note or a debit note is to be read as including a reference to supply correction information.

Summary

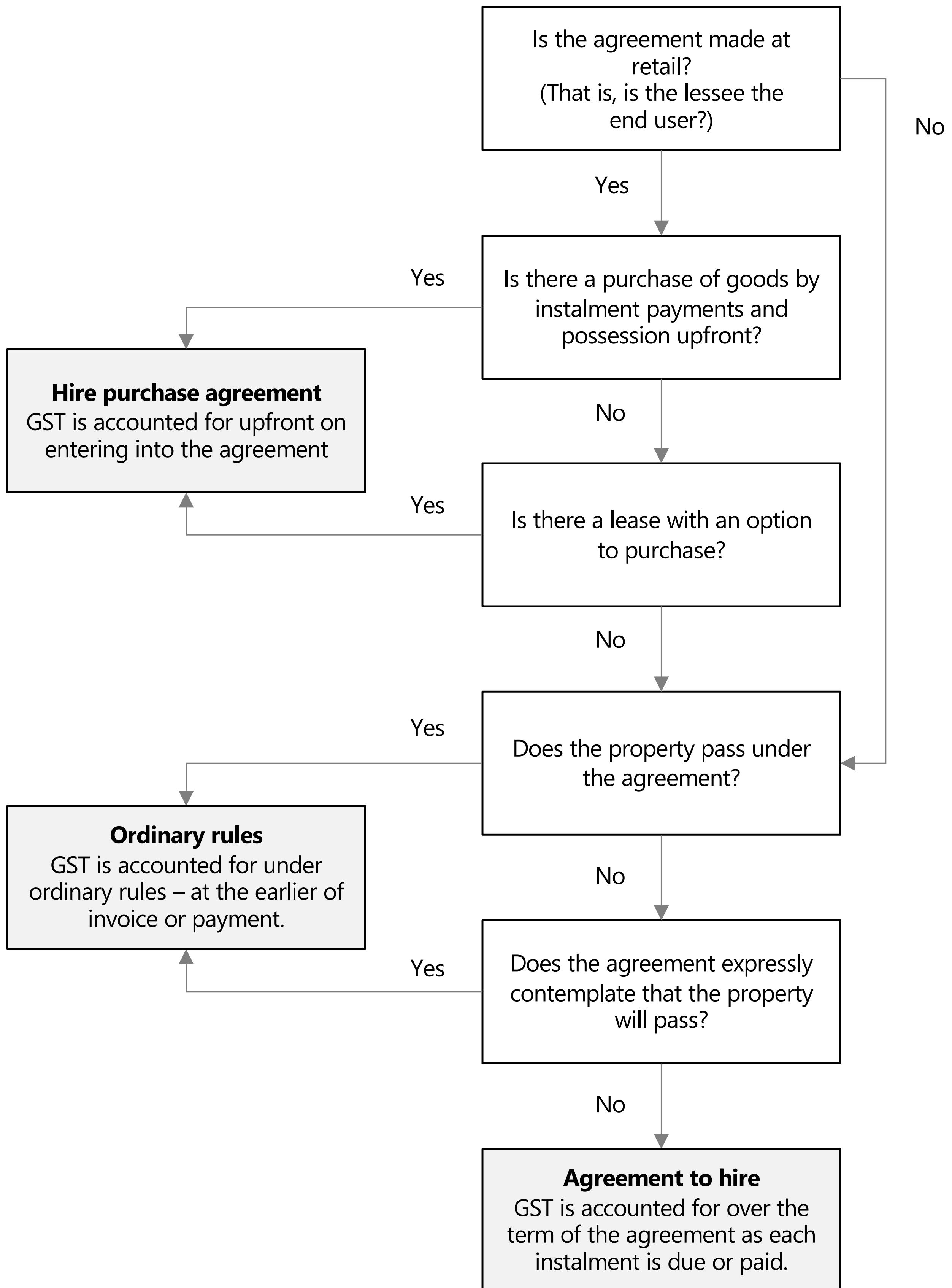
1. This interpretation statement explains how to classify finance leases for the purposes of the time of supply and value of supply rules. It also explains how to account for GST on finance leases when applying any "special" time and value of supply rules.
2. The term "finance lease" is not a defined term for GST purposes. It is a commercial term that describes a lease of an asset for a fixed term when the amounts payable by the lessee relate to the value of the leased goods and not the value of their use. The terms and conditions of a finance lease will vary from lease to lease. Accordingly, every finance lease arrangement needs to be considered on its own terms.

Classifying finance leases – time of supply

3. To apply the time of supply rules, it is necessary to correctly classify a finance lease as:
   - an **agreement to hire**, in which case the goods are treated as being successively supplied and each successive supply is treated as taking place at the earlier of when a payment becomes due or is received;
   - a **hire purchase agreement**, in which case the time of supply is the time the agreement is entered into; or
   - falling outside the previous two definitions (a **third category agreement**), so the ordinary rules will generally apply, and the time of supply is the earlier of the time the supplier issues an invoice or receives a payment for that supply.
4. In many cases a finance lease is an agreement to hire for GST purposes. However, a finance lease will not be an agreement to hire if the:
   - lessee is the end user of the goods and the lessor gives the lessee an option to purchase; or
   - property passes upfront or will definitely pass under the terms of the agreement.
5. The relevant time to classify a finance lease for GST purposes is the time at which the agreement is entered into. The same GST classification of a finance lease applies to both parties to the agreement.
6. The process for classifying finance leases for time of supply is summarised in Flowchart 1 – Classifying finance leases for time of supply.

INTERPRETATION STATEMENTS

Flowchart 1 – Classifying finance leases for time of supply



Classifying finance leases – value of supply

7. To apply the value of supply rules, it is necessary to determine whether a finance lease is a credit contract.
8. When a finance lease is a credit contract, GST is generally calculated on the "cash price" of the leased goods. The cash price is usually specified in the contract. The cash price is usually less than the total amount payable under the contract with the balance being interest or finance charges. Any interest or finance charges are financial services and exempt from GST (unless they are zero-rated under s 11A(1)(q)).
9. When a finance lease is not a credit contract, the ordinary rules apply. GST is calculated on the total amount payable under the lease (because there is no implied interest or finance component).
10. Whether a finance lease is a credit contract depends on whether it is a "credit contract" under the Credit Contracts Act 1981 (CCA).[1] However, the parties to a lease can elect to apply the definition in the Credit Contracts and Consumer Finance Act 2003 (CCCFA) to a particular arrangement if the CCCFA provides a different outcome. The lease contract and tax invoice(s) should reflect the agreed position.

Accounting for GST on finance leases

11. How to account for GST on a finance lease depends whether the lease is:
    - a hire purchase agreement, an agreement to hire or a third category agreement; and
    - a credit contract.
12. When a finance lease is a hire purchase agreement or third category agreement and a credit contract, GST is generally 3/23 of the cash price of the leased goods, payable upfront.
13. When a finance lease is a hire purchase agreement or third category agreement and not a credit contract, GST is 3/23 of the full consideration of the leased goods, payable upfront.
14. When a finance lease is an agreement to hire and a credit contract, GST is generally 3/23 of the cash price of the leased goods, spread over the payments to be made over the term of the lease. Lessors may adopt a straight-line basis to spread GST evenly over the term of the lease. Lessors must return output tax on the basis set out in the tax invoice. GST-registered lessees who acquire the goods for use in their taxable activity must, when claiming an input tax deduction, do so on the same basis adopted by the lessor, being as set out in the tax invoice.
15. When a finance lease is an agreement to hire and not a credit contract, GST is 3/23 of each lease payment made over the term of the lease.

Agency issues on selling goods

16. If a lessee sells the leased goods as agent for the lessor, the supply is deemed to be made by the lessor. The lessor must account for GST even if the lessee issues the tax invoice for the supply. The lessee is required to notify the lessor of the sale and provide sufficient information for the lessor to account for GST correctly. An exception to this treatment can apply where the lessee and lessor agree to treat the supply as two separate supplies.

Introduction

Reasons for updating the statement

17. This statement updates and replaces the Commissioner's view on how GST applies to finance leases as set out in **"GST and finance leases — classification, method of accounting and treatment of residual value clause"**, *Tax Information Bulletin* Vol 8, No 1 (July 1996): 1 (the 1996 statement).
18. The key principles for applying GST to finance leases are unchanged from the 1996 statement. The main reasons for updating this statement are due to issues that have arisen since the 1996 statement including:
    - changes to the definition of "hire purchase agreement";
    - issues concerning the treatment of options to purchase;
    - whether business-to-business leases are made "at retail";
    - uncertainty about agreements that "expressly contemplate" property passing;

[1] Although the CCA was repealed and replaced by the CCCFA, s 10(5A) defines credit contract by reference to s 3 of the CCA immediately before the repeal of that Act.

- the new definition of "credit contract" under the CCCFA; and
- agency issues on selling goods at the end of a lease.

What this statement covers

19. This interpretation statement is in four parts, covering:
    - classifying finance leases – time of supply (from [22]);
    - classifying finance leases – value of supply (from [111]);
    - accounting for GST on finance leases (from [140]); and
    - agency issues on selling goods (from [169]).

What is meant by "finance lease"

20. This interpretation statement applies to finance leases.[2] The term "finance lease" is not a defined term for GST purposes. It is a commercial term that describes a lease of an asset for a fixed term when the amounts payable by the lessee (including a deposit or residual value payment) relate to the value of the leased goods and not the value of their use.
21. Under a finance lease, the total amount payable by the lessee ensures the lessor recovers the capital cost of the leased goods and makes a commercial return on that capital. Common examples of goods leased under finance leases are motor vehicles and office equipment, but finance leases can apply to a variety of different goods.

Classifying finance leases – time of supply

22. To apply the time of supply rules, it is necessary to correctly classify a finance lease as an agreement to hire, a hire purchase agreement or as falling outside these definitions, so a third category agreement. The classification determines whether GST is chargeable upfront or over the term of the lease.
23. The overall position at the end of the agreement is generally GST neutral, so the issue is one of timing. It is important the parties to a lease agreement are clear about the nature of the agreement so there is no timing mismatch for GST purposes. For GST purposes, an agreement has only one legal classification that determines its treatment under the GST Act for both parties to that agreement. Accordingly, both parties to a lease must adopt the same timing treatment.
24. The time of supply rules are set out in s 9. The general rule under s 9(1) is that time of supply is the earlier of the time:
    - an invoice is issued by the supplier or the recipient; or
    - any payment is received by the supplier.
25. However, there are exceptions to the general rule for hire purchase agreements and agreements to hire. These exceptions are stated in s 9(3)(a)–(c):

[2] "Finance lease" is a defined term for income tax purposes. Broadly, under the Income Tax Act 2007 finance leases reflect the economic effect of the lease arrangement and deem the leased goods to have been sold by the lessor to the lessee. However, there is no equivalent express treatment of finance leases in terms of economic, rather than legal, effect in the GST Act.

9 Time of supply

…

(3) Notwithstanding anything in subsection (1) or subsection (2),—

(a) where goods are supplied under an agreement to hire, or where services are supplied under any agreement or enactment which provides for periodic payments, they shall be deemed to be successively supplied for successive parts of the period of the agreement or the enactment, and each of the successive supplies shall be deemed to take place when a payment becomes due or is received, whichever is the earlier:

…

(b) where goods and services are supplied under a hire purchase agreement, that supply shall be deemed to take place at the time the agreement is entered into:

(c) for the purposes of this subsection, the term **agreement to hire** means an agreement for the bailment of goods for hire and includes a lease of goods and a rental agreement; but does not include—

(i) an agreement under which the property in the goods passes to the bailee or which expressly contemplates that the property in the goods will pass to the bailee; or

(ii) a hire purchase agreement.

26. Section 9(3)(a) deems goods supplied under an agreement to hire to be successively supplied. It deems each successive supply to take place at the earlier of when a payment becomes due or is received. Accordingly, if a finance lease is an agreement to hire, GST is payable over the term of the lease each time a payment is due or received.
27. Section 9(3)(b) deems the time of supply to take place at the time the agreement is entered into for hire purchase agreements. Accordingly, if a finance lease is a hire purchase agreement, GST is accounted for upfront when the agreement is entered into.
28. The special timing rules in ss 9(3)(a) and (b) apply irrespective of whether a person accounts for GST on a payments basis or an invoice basis.
29. If a finance lease is a third category agreement, then (subject to the application of any other "special" time of supply rule) the ordinary rules apply. This means GST is usually accounted for upfront, at the earlier of the time the supplier issues an invoice or receives a payment for that supply.
30. It can be seen from this that correctly classifying a finance lease as an agreement to hire, a hire purchase agreement or a third category agreement has important consequences for the timing of a lessee's and lessor's GST liabilities. The important point when both parties are GST registered is that the parties classify the agreement in the same way for GST purposes. The terms of the agreement should be clear enough that both parties are able to reach the same conclusion on the nature of the agreement.
31. The rest of this section considers how to classify a finance lease for time of supply purposes. Because the definition of an agreement to hire in s 9(3)(c) specifically excludes a hire purchase agreement, the following analysis first considers when a finance lease will be a hire purchase agreement.

When finance leases are hire purchase agreements

32. A finance lease may, in some circumstances, be treated as a hire purchase agreement for GST purposes. "Hire purchase agreement" is defined in s 2(1):

> **hire purchase agreement** has the same meaning as in section YA 1 of the Income Tax Act 2007; but includes an agreement that would be a hire purchase agreement but for the exclusion in paragraph (f) of the definition of that term in that section

33. The definition refers to the meaning of "hire purchase agreement" in s YA 1 of the Income Tax Act 2007:

hire purchase agreement—

(a) means—

(i) an agreement under which goods are let or hired with an option to purchase, however the agreement describes the payments:

(ii) an agreement for the purchase of goods by instalment payments, however the agreement describes the payments, under which the person who agrees to purchase the goods is given possession of them before the total amount payable has been paid; and

(b) includes an agreement to sell goods at retail under which—

(i) the buyer grants security over the goods to the seller for some or all of the purchase price; and

(ii) the property in the goods passes to the buyer subject to the security, in which case the agreement is a hire purchase agreement made at the time the sale is made; and

(c) includes a sale and loan arrangement under which—

(i) a person lends money on the security of goods that have been bought or are to be bought at retail if some or all of the purchase price is paid out of the proceeds of the loan; and

(ii) the loan is made by the seller or by a third party, arranged by the seller, who is engaged in the business of lending money or who habitually lends money in the course of the third party's business, in which case the arrangement is a hire purchase agreement made at the time the loan is made; and

(d) does not include an agreement of a kind described in paragraph (a)(i) or (ii) under which property in the goods passes absolutely, to the person who agrees to purchase the goods, at the time of the agreement or at the time of delivery of the goods or at any time before delivery of the goods; and

(e) does not include an agreement made otherwise than at retail; and

(f) does not include an agreement to the extent to which the property that is the subject of the agreement is livestock or bloodstock.

34. Relevantly, a hire purchase agreement, under the definition in s YA 1 of the Income Tax Act 2007, is an agreement:

- under which goods are let or hired with an option to purchase (para (a)(i)); or
- for the purchase of goods by instalment payments; however, the agreement describes the payments under which the person who agrees to purchase the goods is given possession of them before the total amount payable has been paid (para (a)(ii)).

35. The definition does not include an agreement made otherwise than at retail (para (e)).

36. Other aspects of the definition are discussed from [74].

Agreements made at retail

37. The first point to consider is what "an agreement made otherwise than at retail" means. This is important because a finance lease can be a hire purchase agreement only if it is made "at retail". If the agreement is not made at retail, then it will not be a hire purchase agreement. This means that to determine the time of supply for an agreement that is not made at retail, it is necessary to consider only whether the agreement is an agreement to hire or a third category agreement.

38. The Commissioner is aware of the view that the "at retail" requirement does not apply to business-to-business transactions and applies only in the context of private consumers or individuals. The Commissioner's view is that business-to-business transactions can still be made at retail for the purposes of determining whether a lease is a hire purchase agreement. This view is based on the meaning of "at retail" set out below.

39. "At retail" and "retail" are not defined terms in the Act. The term "retail" is defined in the *Oxford English Dictionary* (Oxford University Press, online edition, last updated October 2021), as:[3]

> The action or business of selling goods in relatively small quantities for use or consumption rather than for resale.

[3] **https://www.oed.com/**

40. The dictionary definition of "retail" indicates that an agreement is made "at retail" where the purchaser will use or consume the goods (rather than resell them). In comparison, "wholesale" is defined in the *Oxford English Dictionary* as:

    With reference to the selling of goods: in large quantities and at low prices, typically in order to be sold on by retailers at a profit.

41. New Zealand case law on the meaning of "at retail" also focuses on the use and consumption of the goods rather than whether the recipient is a business or private consumer. An agreement is made at retail if it is made otherwise than at wholesale (essentially sales to persons who buy to sell again) or privately.[4]
42. A GST-registered lessee entering into a leasing arrangement will do so at retail if the leased goods are for use in the registered person's taxable activity, provided the registered person is not leasing the goods for the purpose of resale or long-term hire.[5]
43. In the Australian case *Collector of Customs v Chemark Services Pty Ltd*, the full court of the Federal Court of Australia concluded that the words "retail sale" have generally acquired a specialised meaning of a sale to an ultimate consumer and that the use of the term does not limit such consumers to ordinary members of the public.[6] The courts in both *National Westminster* and *Chemark* concluded that the size or quantity of the transaction is not determinative of whether a transaction is at retail.
44. The discernible purpose of the time of supply rule for hire purchase agreements is to account for GST upfront on agreements that are effectively sales where possession of the goods is given upfront. This is the case even though the goods are paid for over time and title does not generally pass until the goods have been paid for. This purpose does not support a distinction based on whether an agreement is between GST-registered parties.
45. Therefore, business-to-business transactions can still be made at retail for the purposes of determining whether a lease is a hire purchase agreement. The focus of "at retail" is whether the lessee is the ultimate consumer or end user of the goods. See Example 1 and Example 2.

Example 1 – Business-to-business agreement made at retail

Jack's Carpet Cleaning Ltd needs a fridge–freezer with chilled water and an icemaker for the staffroom. Jack decides to lease a fridge from Big Retail Co. The term of the lease is 36 months, and Jack's Carpet Cleaning Ltd will pay equal monthly instalments. Once the last payment has been made, ownership of the fridge will transfer to Jack's Carpet Cleaning Ltd.

The agreement is made "at retail" because Jacks' Carpet Cleaning Ltd is not on-selling or on-leasing the fridge long term; instead, it is using the fridge in its taxable activity.

Example 2 – Business-to-business agreement made otherwise than at retail

Finance Co Ltd leases a boat from Boat Manufacturer Ltd. Finance Co Ltd will on-lease the boat for its economic life to Choppy Charters Ltd.

The agreement between Finance Co Ltd and Boat Manufacturer Ltd is not made at retail because Finance Co Ltd is leasing the boat for the purpose of long-term hire to Choppy Charters Ltd. Finance Co Ltd is not the end user of the boat.

Agreements with options to purchase

46. Agreements with options to purchase are a type of hire purchase agreement where a person hires the goods and has the option, but no obligation, to purchase the goods.[7] The person has the use of the goods, but title does not pass until the option to purchase the goods is exercised.
47. While no legal obligation to buy the goods exists under this type of hire purchase agreement and no 'sale' occurs until the option is exercised, this type of agreement is treated as a 'sale' from a GST perspective and GST is accounted for upfront under s 9(3)(b).

[4] *Provident Life Assurance Co Ltd v Official Assignee* [1963] NZLR 961 (CA) at 965.

[5] *National Westminster Finance NZ Ltd v South Pacific Rent-a-Car Ltd* [1985] 1 NZLR 646 (HC) at 650; *National Westminster Finance NZ Ltd v South Pacific Rent-a-Car Ltd* [1985] 1 NZLR 655 (CA) at 656.

[6] (1993) 114 ALR 531

[7] *Helby v Matthews* [1895] AC 471 (HL).

48. An option to purchase is generally regarded as an offer to sell coupled with a contract not to revoke the offer.[8] To be effective, the option must either set out the terms of the agreement that will be reached or provide machinery for the settlement of those terms. For example, the agreement must state the purchase price or provide a mechanism to determine the purchase price. An option can exist even if it is not described as an option in the agreement. It is the effect of the transaction that matters, not the description the parties give it.[9]
49. In the context of a finance lease, an option to purchase exists if:
    - the lessee has the right to buy the goods; and
    - the lessor is obliged to sell the goods if the lessee exercises their right to buy.
50. One question that arises is whether the mere existence of an option to purchase is enough to make a hire agreement a "hire purchase agreement" for GST purposes. The Commissioner's view is that the language of the definition is clear and any option to purchase the goods is sufficient to bring a finance lease agreement within the definition of hire purchase agreement.
51. To summarise, where the lessee is the end user of the goods and the lessor gives the lessee an option to purchase the goods, the agreement is a hire purchase agreement for GST purposes and GST is accounted for at the time the agreement is entered into. See Example 3. A lease with an option to purchase where the lessee is not the end user of the goods, will be an agreement to hire, as discussed from [80].

Example 3 – Lease with an option to purchase the goods

Building Co Ltd is GST registered and needs a crane for use in its construction business. It enters into a lease agreement with Finance Co Ltd. Under the agreement, Building Co Ltd will make monthly lease payments for 15 years. At the end of the lease, Building Co Ltd has the option to purchase the crane for $1.

The agreement is a hire purchase agreement because Building Co Ltd has entered into an agreement under which it has leased goods (the crane) with an option to purchase the goods. The agreement is made at retail because Building Co Ltd is using the crane in its taxable activity.

Both Building Co Ltd and Finance Co Ltd must account for GST at the time the agreement is entered into under s 9(3)(b).

Change to the legislation

52. From 1 April 2005 to 22 November 2013 a drafting error in para (a)(i) of the definition of hire purchase agreement in s YA 1 of the Income Tax Act 2007 arguably meant a person's upfront agreement to purchase the goods was required in order for a lease with an option to purchase to be a hire purchase agreement.
53. This error was amended in 2014 and can no longer be relied on to exclude a lease with an option to purchase from being a hire purchase agreement. An exception applies for tax positions taken from 1 April 2005 to 22 November 2013 that rely on the definition as it was before the amendment.
54. Accordingly, parties to a lease with an option to purchase must consider whether the agreement is made at retail to determine whether the agreement is a hire purchase agreement.

Interrelated and side agreements

55. Sometimes the parties to a finance lease will enter into more than one agreement for the same goods at the outset of the lease. For example, the parties may enter into a lease agreement for goods and a separate option to purchase the goods. These agreements may be written or oral agreements. In these situations, it is necessary to determine the true legal nature of the arrangement.
56. Classifying a particular agreement requires a careful analysis of the documentation and, in some cases, the factual context (including such things as other written and oral arrangements between the parties that affect the terms of the documentation). However, this does not involve substituting the legal arrangements for an assessment of the overall economic consequences of the transaction.[10]

[8] *Alexander v Tse* [1988] 1 NZLR 318 (CA) at 324–325; *Murray v Scott* [1976] 1 NZLR 643 (SC) at 655–656; *Jane v Ben Hall Properties Ltd* [1979] 2 NZLR 68 (CA) at 73.

[9] *Adaras Developments Ltd v Marcona Corp* [1975] 1 NZLR 324 (HC) at 332 ("option" held to be a right of pre-emption); *Woodroffe v Box* (1954) 92 CLR 245 (HCA) (right of "first refusal" held to be an option).

[10] *Re Securitibank Ltd (No 2)* [1978] 2 NZLR 136 (CA) at 145 and 167; *Marac Life Assurance Ltd v CIR* (1986) 8 NZTC 5,086 (CA).

57. The true nature of an agreement can be ascertained only by careful consideration of the legal arrangements entered into and carried out. Consideration must be given to the whole of the contractual arrangements, and, if the transaction is embodied in a series of interrelated instruments, all the agreements must be considered together and one may be read to explain the others.[11]
58. The relevant time to determine whether an agreement (including any side agreements) is a hire purchase agreement for GST purposes is the time at which the agreement is entered into.
59. For example, if a hire agreement and an option to purchase are entered into by the same parties about the same time and for the same goods, then the documents are interrelated and should be read together as one agreement. In these circumstances, the agreement would be a hire purchase agreement (if it was made at retail). See Example 4.

Example 4 – Option granted at the outset of the lease

Bobbi the builder needs a vehicle for use in her business. She enters into a lease agreement for a vehicle with Finance Co Ltd. The lease agreement is for 5 years. On the same day, Bobbi also enters into a separate agreement in writing with Finance Co Ltd for an option to purchase the vehicle for a small fee on termination of the lease agreement.

Although the lease and the option are in two separate documents, these documents are interrelated and part of the same agreement. The option to purchase the vehicle for a small fee would not be available if it were not for the existence of the lease agreement for that vehicle.

The agreement is a hire purchase agreement. The lease agreement and the option to purchase were entered into by the same parties about the same time and for the same goods. Therefore, the agreement as a whole is one under which goods are leased with an option to purchase.

Both Bobbi the builder and Finance Co Ltd must account for GST at the time the agreement is entered into under s 9(3)(b).

Residual value clauses

60. In many cases, a finance lease will have a residual value clause. An issue that has arisen is whether a residual value clause can be an "option to purchase". Residual value clauses come in different forms.
61. In its simplest form, a residual value clause simply requires the lessee to "guarantee" to the lessor that the leased goods will have a certain value at the end of the lease. The finance lease makes it clear that ownership of the goods always remains with the lessor, and the lessee is obliged to return the goods to the lessor at the end of the lease. Such residual value clauses then usually oblige the lessor to sell the leased goods with the lessee making up any shortfall in value up to the "guaranteed" amount. Some residual value clauses provide for the lessor to pay any amount gained on sale over the guaranteed value to the lessee. If the lessee fails to return the goods at the end of the term of a finance lease, some residual value clauses require the lessee to pay the residual value to the lessor.
62. On its own, a guaranteed residual value is not legally an option to purchase the goods. There is generally no offer to sell the goods, the lessee has no right to purchase the goods and there is no mechanism by which to transfer title.
63. Difficulties may arise where the lessee does not return the goods at the end of the lease and the lease agreement requires the lessee to pay the residual value to the lessor. The parties might then agree that ownership of the leased goods will pass to the lessee for a further nominal consideration. In legal terms, this sale is a separate contract from the finance lease. GST must be returned on the value of the consideration for the sale, if any.
64. If the agreement to transfer ownership is not made until a later date, whether that is before the end of the hire period, on termination of the agreement or after the agreement ends, the transfer of ownership will be a separate agreement from the finance lease.
65. However, if the residual value clause allows the lessee to retain possession of the goods by paying the residual value and allows for ownership to transfer to the lessee, then legally this is an option irrespective of the words the parties use to describe it. The lessee has the right to buy the goods and the lessor is obliged to sell the goods if the lessee exercises their right to buy. In this case, the agreement will be a hire purchase agreement.
66. The same GST classification of a finance lease applies to both parties to the agreement. The terms of the agreement should be clear enough that both parties can reach the same conclusion on the nature of the agreement.

[11] *Marac Finance Ltd v Virtue* [1981] 1 NZLR 586 (CA).

Summary for options to purchase

67. In summary, one type of hire purchase agreement is an agreement under which goods are let or hired with an option to purchase. It does not matter whether the option is exercised. Leases with options where the lessee is the end user of the goods will be a hire purchase agreement and GST must be accounted for by both parties at the time the agreement is entered into. Whether or not a residual value clause or any side agreements indicate that an agreement contains an option to purchase will depend on the circumstances. See Example 5 to Example 9.

Example 5 – Agreement where lessee returns goods under residual value clause

Sparkle Ltd leases a car for use in its business from Finance Co Ltd. The agreement states that Sparkle Ltd does not have a right to buy the car under the agreement and that ownership of the car remains with Finance Co Ltd. The agreement has a guaranteed residual value of $25,000 and requires Sparkle Ltd to return the car to Finance Co Ltd at the end of the lease. Finance Co Ltd is required to sell the car at the end of the lease. If the net sale price is less than the residual value, Sparkle Ltd must pay the difference to Finance Co Ltd.

At the end of the lease, Sparkle Ltd returns the car to Finance Co Ltd. Finance Co Ltd sells the vehicle for $20,000 net of expenses. Sparkle Ltd is required to pay the difference of $5,000 to Finance Co Ltd.

The agreement is not a hire purchase agreement. No option exists to purchase the goods under the agreement.

Example 6 – Agreement where lessee retains goods under residual value clause

This example is a variation on Example 5. The facts are the same as in Example 5 except the residual value clause provides that if Sparkle Ltd does not return the vehicle at the end of the lease, Sparkle Ltd must pay the residual value to Finance Co Ltd.

One month before the end of the lease, Sparkle Ltd tells Finance Co Ltd that it wants to retain the car at the end of the lease and will pay the residual value. Sparkle Ltd and Finance Co Ltd agree that Finance Co Ltd will transfer ownership to Sparkle Ltd once Finance Co Ltd has received the payment of the residual value (and all other money owed under the contract).

The agreement is not a hire purchase agreement. Sparkle Ltd had no right to purchase the car under the written agreement and no other written or oral agreements were entered into at about the same time as the lease that would give Sparkle Ltd the right to buy the car.

Example 7 – Residual value clause legally an option

This example is a variation on Example 5. The facts are the same as in Example 5 except the residual value clause provides that if Sparkle Ltd does not return the vehicle at the end of the lease, Sparkle Ltd must pay the residual value to Finance Co Ltd. The agreement also provides that if Sparkle Ltd retains possession of the vehicle and pays the residual value, then property in the vehicle will pass to Sparkle Ltd.

The agreement refers to the clause as a residual value clause and does not use the term "option". However, legally, because Sparkle Ltd has a right to buy the goods and Finance Co Ltd has agreed that title will pass if Sparkle Ltd retains the goods and pays the residual value, this is an agreement with an option. Therefore, the agreement is a hire purchase agreement. Both parties must account for GST at the time the agreement is entered into.

Example 8 – Option to purchase the goods for the residual value

Matte Ltd leases goods for use in its business from Finance Co Ltd. The agreement states that Finance Co Ltd retains ownership of the goods for the term of the lease. The agreement states that Matte Ltd must return the goods to Finance Co Ltd at the end of the lease. However, Matte Ltd also has the option to purchase the goods for the residual value of $1 if Matte Ltd notifies Finance Co Ltd within 7 days of making the final payment that it wishes to exercise the option.

Matte Ltd notifies Finance Co Ltd within the required timeframe that it wishes to exercise the option and makes payment of $1.

The agreement is a hire purchase agreement. At the time the agreement is entered into, the terms of the agreement include both a lease and an option to purchase the goods. Both parties must account for GST at the time the agreement is entered into.

Example 9 – Offer to buy made at the end of the lease

Zany Ltd leases goods for use in its business from Finance Co Ltd. The agreement states that Finance Co Ltd retains ownership of the goods for the term of the lease. The agreement states that Zany Ltd must return the goods to Finance Co Ltd at the end of the lease. The agreement also states that when the lease comes to an end, Zany Ltd can make an offer to purchase the goods for any price. Finance Co Ltd has the right to accept or reject the offer.

The agreement is not a hire purchase agreement. Zany Ltd has no right to purchase the goods under the written agreement. Zany Ltd can make an offer that Finance Co Ltd may accept. However, legally, that is not an option because, while Zany Ltd has the right to offer to buy the goods, Finance Co Ltd is **not** obliged to sell the goods if Zany Ltd exercises its right to offer to buy.

Agreements to purchase goods by instalment payments

68. The other type of hire purchase agreement is an agreement for the purchase of goods by instalment payments where the purchaser is given possession before the total amount payable has been paid. It does not matter how the instalment payments are described in the agreement (for example, as rent, lease or hire payments).
69. This type of agreement is legally an agreement to buy the goods.[12] The purchaser takes possession of the goods upfront and the purchase price is paid by instalments – often with a deposit upfront and sometimes with a larger "balloon payment" at the end. The purchaser becomes the owner of the goods once all instalment payments have been made.
70. The contract may describe the instalment payments as hire, lease or rental payments. However, despite the label given to the instalment payments, the purchaser is contractually committed to buying the goods. This type of agreement is often referred to as a "conditional sale agreement" because title does not pass until all the money owing under the agreement is paid and any other obligations under the agreement are fulfilled. This is different to a hire agreement with an option to buy the goods, where there is merely an option to buy and no obligation.
71. A financing arrangement for the lease, hire or purchase of goods will be a hire purchase agreement under para (a)(ii) of the definition in s YA 1 of the Income Tax Act 2007 if the relevant requirements are met. The label given to the arrangement (for example, finance lease or hire purchase agreement) or the label given to the payments does not determine the GST treatment.
72. Examples of finance leases that are conditional sale agreements occur in *National Westminster* and *Aubit Industries Ltd v Cable Price Corp Ltd*.[13]
73. Accordingly, where an agreement to purchase goods by instalment payments has the "lessee" being given possession of the goods before the total payment is made, this will be a hire purchase agreement if the lessee is the end user. Both parties to the transaction will need to account for GST on the agreement upfront. See Example 10. If the lessee is not the end user of the goods, the agreement will be a third category agreement as discussed from [104].

Example 10 – Lease to buy agreement

Alpha Ltd enters into a lease to buy office furniture from Finance Co Ltd. The agreement provides for regular monthly lease payments for 24 months. Finance Co Ltd delivers the furniture to Alpha Ltd once the agreement has been entered into and Alpha Ltd has made the initial payment. Once the final payment is made (and all other money owing under the agreement has been paid), Finance Co Ltd will transfer ownership of the office equipment to Alpha Ltd.

The agreement is a hire purchase agreement. Alpha Ltd has possession of the furniture upfront and has agreed to make all the lease payments. When Alpha Ltd has made all the payments under the lease, it will become the owner of the furniture. Alpha Ltd has agreed to buy the goods.

Both Alpha Ltd and Finance Co Ltd are required to account for all the GST on the supply at the time the agreement is entered into.

Other aspects of the definition of a "hire purchase agreement"

74. Under s YA 1 of the Income Tax Act 2007, a hire purchase agreement also includes:
    - an agreement to sell goods at retail where the buyer grants security over the goods to the seller for some or all of the purchase price and the property in the goods passes to the buyer subject to the security (para (b)); and
    - a sale and loan arrangement under which a person lends money on the security of goods bought at retail if various conditions are met (para (c)).

[12] *Lee v Butler* [1893] 2 QB 318 (CA).

[13] *Aubit Industries Ltd (in rec and in liq) v Cable Price Corp Ltd* (1994) 5 NZBLC 103,395 (CA).

75. Absent the provisions listed above, transactions involving a sale combined with either a loan or security would be taxed as sales for GST purposes in any event. Output tax would be payable upfront as for any other sale. Accordingly, these provisions do not appear to be strictly necessary for timing purposes. It is likely that, because the definition of hire purchase agreement was taken from the Hire Purchase Act 1971 (repealed), these provisions have simply been carried through to the definition for GST purposes. The effect of these provisions means these agreements are treated as hire purchase agreements rather than sales, although with the same GST timing outcome.
76. The definition of hire purchase agreement makes it clear that a hire purchase agreement does not include an agreement where property passes absolutely to the purchaser at the time of the agreement or on or before delivery of the goods (unless the agreement is of a kind described in [74]).
77. It is a feature of hire purchase agreements that the lessee/purchaser gets the use of the goods without having to pay the full purchase price when the goods are handed over. Ownership generally remains with the lessor/vendor until any option to purchase is exercised or until the total amount payable has been paid under a purchase by instalment payments.
78. Paragraph (f) of the definition in the Income Tax Act 2007 excludes livestock and bloodstock from the definition of hire purchase agreement for income tax purposes. However, the s 2 definition in the GST Act specifically brings livestock and bloodstock back into the definition of hire purchase agreement for GST purposes.

Summary for hire purchase agreements

79. The situation for hire purchase agreements can be summarised as follows:
    - The relevant time to determine whether a finance lease is a hire purchase agreement for GST purposes is the time at which the agreement is entered into. If a finance lease is a hire purchase agreement, GST is accounted for upfront – at the time the agreement is entered into.
    - The same GST classification of a finance lease applies to both parties to the agreement. The terms of the agreement should be clear enough that both parties can reach the same conclusion on the nature of the agreement because there is only one correct classification.
    - Whether a finance lease is made at retail depends on whether the lessee is the end user of the goods. A business-to-business lease can be made at retail.
    - A lease with an option to purchase where the lessee is the end user of the goods is a hire purchase agreement. The mere existence of an option to purchase is enough to make a hire agreement a hire purchase agreement for GST purposes (if the lessee is the end user). A lease with an option to purchase where the lessee is not the end user of the goods, will be an agreement to hire, as discussed from [80].
    - If a hire agreement and a separate option to purchase are entered into by the same parties about the same time and in relation to the same goods, then the documents are interrelated and should be read together as one agreement.
    - A lease that is an agreement for the purchase of goods by instalment payments by the lessee as end user of the goods is a hire purchase agreement. If the lessee is not the end user of the goods, the agreement will be a third category agreement as discussed from [104]. This outcome arises because property in the goods passes under the agreement (or the agreement expressly contemplates that property in the goods will pass).
    - A residual value clause in a finance lease requiring the lessee to pay the guaranteed residual value amount if they do not return the goods is not legally, on its own, an option to purchase the goods. However, if there is also an agreement that ownership will pass to the lessee for nominal consideration, then this may be an option to purchase the goods.

When finance leases are agreements to hire

80. If a finance lease is not a hire purchase agreement, it might be an agreement to hire. An "agreement to hire" is defined in s 9(3)(c):

> **9 Time of supply**
>
> …
>
> (3) Notwithstanding anything in subsection (1) or subsection (2),—
>
> …
>
> (c) for the purposes of this subsection, the term agreement to hire means an agreement for the bailment of goods for hire and includes a lease of goods and a rental agreement; but does not include—
>
> (i) an agreement under which the property in the goods passes to the bailee or which expressly contemplates that the property in the goods will pass to the bailee; or
>
> (ii) a hire purchase agreement.

81. The consequence of a finance lease being treated as an agreement to hire is that GST is not accounted for upfront but is spread over time under s 9(3)(a).
82. An agreement to hire includes a lease of goods but it does not include an agreement:
    - under which the property in the goods passes to the lessee; or
    - that expressly contemplates that the property in the goods will pass to the lessee.
83. Therefore, if, under the terms of the finance lease, property either passes to the lessee or is expressly contemplated to pass to the lessee, those agreements will not be agreements to hire. This makes sense as these agreements are not true agreements to hire.

Agreements where property passes

84. An agreement to hire does not include an agreement under which property in the goods passes to the lessee. This exclusion applies to agreements where it is certain under the terms of the agreement that title will pass, regardless of whether the title passes upfront or at the end of the agreement. This type of agreement is in effect an agreement to buy the goods and not just a simple rental agreement.
85. An example of this type of agreement is an agreement to purchase goods by instalment payments. Practically, the exclusion applies to this type of agreement only if the lessee is not the end user of the goods. If the lessee is the end user of the goods, this agreement will be a hire purchase agreement and excluded from being an agreement to hire under s 9(3)(c)(ii).
86. This exclusion does not apply to an agreement where an option to purchase exists. The existence of an option does not provide any certainty that title will pass. No obligation exists to buy the goods, just an option that may or may not be exercised.
87. This exclusion also does not apply where an option to purchase is exercised and property passes at the end of the lease under the terms of the agreement. While it could be argued that this situation involves an agreement under which property passes, it is possible to know this outcome only in hindsight. In the context of the time of supply rules, the amount of GST to be accounted for must be known with certainty at the time of supply. This means that certainty about when to account for GST is required at the earlier of invoice or payment.
88. Therefore, the Commissioner's view is that an agreement under which it is possible that title will pass but where it cannot be said for certain at the time of supply that title will pass does not fall within this exclusion.
89. For completeness, this exclusion does not cover situations where title passes at the end of the agreement but the transfer of ownership was not part of the original terms of the agreement at the time it was entered into. Once again, this could not be certain at the time of supply and the subsequent agreement to buy the goods would be a separate agreement.

Agreements that expressly contemplate property will pass

90. An agreement to hire also excludes any agreement that expressly contemplates that the property in the goods will pass to the lessee. It is necessary to consider the meaning of the phrase "expressly contemplates" in order to understand the difference between the first and second limbs of s 9(3)(c)(i).

91. The Commissioner accepts that the words "an agreement which expressly contemplates that the property in the goods will pass to the bailee" can be read narrowly or more broadly:
    - The words can be read narrowly to mean an agreement that clearly intends that ownership of the goods will pass to the lessee. This could include agreements where property will pass provided instalment payments are made.
    - The words can also be read more widely to include an agreement that envisages or considers the possibility that property will pass. This could include a contingency that the parties explicitly allowed for in the terms of the agreement. On this interpretation, an agreement with an option to purchase the goods would be included in the second limb.
92. The Commissioner notes that the words of the second limb come from United Kingdom value-added tax (VAT) legislation where it seems to have been accepted as applying to hire purchase agreements with an option to purchase the goods.[14]
93. However, the Commissioner's view is that this exclusion applies to agreements only where it is certain under the terms of the agreement that title will pass, regardless of whether title passes upfront or at the end of the agreement. An example of this type of agreement is an agreement where property will pass provided instalment payments are made. This exclusion is not intended to include an agreement with an option to purchase, even where that option is exercised. An agreement with an option to purchase the goods is an agreement to hire unless the lessee is the end user of the goods, in which case it is a hire purchase agreement.
94. This is consistent with the Commissioner's view in the 1996 statement. It is supported by a report to the Finance and Expenditure Committee in July 1986 when the second limb was added to s 9(3)(c)(i).[15] The background to the amendment was that, arguably, it was not clear whether the original limb encompassed situations where the property in the goods passed at a point after the agreement was entered into, so the second limb was added to complement and clarify the original limb. The report states:

    > **Comment**
    >
    > The scheme of the Act contemplates that where property in goods passes to a purchaser, the time of supply will be at the earlier of payment or invoicing. This is achieved specifically in relation to hire purchase sales by section 9(3)(b) … whereby the time of supply is deemed to be when the agreement is entered into. The purpose of section 9(3)(c)(i) is to ensure similar treatment for other types of conditional sales where property will eventually definitely pass consequent upon the performance of certain conditions by the purchaser.
    >
    > Where there is merely an option to purchase at some determinate or indeterminate date in the future it is the Department's view that a series of successive services are performed which are taxable at the time successive payments become due or are received. If the option to purchase is exercised there will be a separate supply of goods at the time the option is exercised and tax will be chargeable on whatever consideration is agreed for that supply without regard to tax charged on previous rental payments. As this payment will no doubt be adjusted by the supplier having regards to previous rental payments there will be no need for further adjustments as required in the case of goods sold under hire purchase agreements where there is a subsequent repossession.
    >
    > If, as submitted, the definition in section 9(3)(c)(i) fails to achieve this result, it may be possible to follow the UK approach by rewording the subparagraph as follows: "An agreement under which property passes or which expressly contemplates that property in the goods will pass at some time in the future;".
    >
    > **Recommendation**
    >
    > It is recommended that the definition of "agreement to hire" in section 9(3)(c)(i) … is amended to ensure that it excludes those agreements under which property passes or will (expressly) pass.
95. The report to the Finance and Expenditure Committee makes it clear that s 9(3)(c)(i) as a whole is intended to apply to agreements under which property will definitely pass. It states that an agreement with an option to purchase will be an agreement to hire.
96. Therefore, in the context of finance lease arrangements in New Zealand and given the clear legislative purpose in the report to the Finance and Expenditure Committee, the Commissioner's view remains that expressed in [93]. This exclusion applies to agreements only where it is certain under the terms of the agreement that title will pass, regardless of whether title passes upfront or at the end of the agreement.

[14] *Rodney Crawford Hogarth t/a Hogarth Associates v Customs and Excise Commissioners* (1994) VT 13259; *General Motors Acceptance Corp (UK) plc v Customs and Excise Commissioners* (2003) VT 17990 upheld by the High Court in *Customs & Excise Commissioners v General Motors Acceptance Corp (UK) plc* [2004] EWHC 192 (Ch). Both cases seem to accept the proposition without detailed analysis.

[15] *Taxation Reform Bill 1986* (Officials' Report to the Finance and Expenditure Committee on Submissions on the Bill, July 1986).

Relevance of *HMRC v Mercedes-Benz Financial Services UK Ltd*

97. It has been suggested that the 2017 decision of the Court of Justice of the European Union (CJEU) in *Case C-164/16 – HMRC v Mercedes-Benz Financial Services UK Ltd* ECLI:EU:C:2017:734 could be relevant to how s 9(3)(c)(i) should be applied in New Zealand. The issue in that case was whether an agreement to lease a motor vehicle with an option to purchase that vehicle "expressly contemplate[s] that the property will pass at some time in the future" (cl 1(2)(b) of sch 4 of the Value Added Tax Act 1994 (UK)).

98. The words from the UK VAT legislation are similar to the words of s 9(3)(c)(i). However, the words from the UK VAT legislation need to be read in light of the words of the European Union VAT Directive.[16] The question in *Mercedes* was whether the agreement was a contract for hire that provides that "in the normal course of events" ownership is to pass and this is based on the wording of the VAT Directive (art 14(2)(b)).

99. The CJEU ruled (at [43]):

> the words "contract for hire which provides that in the normal course of events ownership is to pass at the latest upon payment of the final instalment" … must be interpreted as applying to a leasing contract with an option to purchase if it can be inferred from the financial terms of the contract that exercising the option appears to be the only economically rational choice that the lessee will be able to make at the appropriate time if the contract is performed for its full term …

100. Essentially, the CJEU distinguished between options where the lessee has a genuine decision to make in determining whether to exercise the option and options where the only economically rational choice is to exercise the option (for example, an option for $1). The CJEU concluded that contracts with options where the only economically rational choice was that the lessee would exercise the option were agreements where property would pass in the normal course of events. The argument seems to be that in a New Zealand context, contracts with, say, an option to purchase for $1 should be treated as agreements that expressly contemplate that the property in the goods will pass to the lessee.

101. While the Commissioner appreciates that argument, she considers the approach in *Mercedes* should not be applied in New Zealand. Although nothing turned on the difference between **in the normal course of events** (VAT Directive) and **which expressly contemplate** (UK VAT legislation), it is the words "in the normal course of events ownership is to pass" that the CJEU interpreted. Additionally, if the Commissioner were to follow the case, this would introduce further uncertainty through needing to determine which agreements with options should be regarded as expressly contemplating the property will pass.

102. The current approach means agreements with options made at retail are treated as "sales" rather than "leases" under the definition of hire purchase agreement, while agreements with options not at retail are treated as "leases". Adopting the *Mercedes* approach would not entirely address this inconsistency because it applies only to options not at retail. See Example 11 to Example 12.

Example 11 – Finance lease that is an agreement to hire (residual value clause)

Koa's Farms Ltd leases a tractor for use in its taxable activity from Finance Co Ltd. The lease term is 5 years, and Koa's Farms Ltd makes monthly rental payments. The lease agreement has a guaranteed residual value and states that ownership remains with Finance Co Ltd. At the end of the lease, Koa's Farms Ltd is required to return the tractor to Finance Co Ltd. If Koa's Farms Ltd does not return the tractor, Koa's Farms Ltd is required to pay the guaranteed residual value to Finance Co Ltd.

At the end of the lease, Koa's Farms Ltd decides not to return the tractor and pays the guaranteed residual value to Finance Co Ltd. At that time, Koa's Farms Ltd and Finance Co Ltd agree that ownership of the tractor will pass to Koa's Farms Ltd.

The lease is an agreement to hire. Although the agreement is made at retail, no obligation or option exists for Koa's Farms Ltd to buy the tractor and the agreement does not expressly contemplate that the tractor will pass to Koa's Farms Ltd. Both parties account for GST on the monthly rental payments over the term of the agreement.

[16] Council Directive 2006/112/EC of 28 November 2006 on the Common System of Value Added Tax (VAT Directive).

Example 12 – Finance lease that is an agreement to hire (option not at retail)

Finance Co Ltd leases a boat from Boat Manufacturer Ltd. Finance Co Ltd will on-lease the boat for its economic life to Voyage Ltd. Finance Co Ltd has the option to purchase the boat for $1 at the end of the lease term.

The lease is an agreement to hire because it is not made at retail (Finance Co Ltd is not the end user of the boat as it has leased the equipment for the purpose of long-term hire to Voyage Ltd) and the agreement does not expressly contemplate that property in the goods will pass.

Both Finance Co Ltd and Boat Manufacturer Ltd account for GST over the term of the agreement.

Example 13 – Finance lease that is not an agreement to hire or a hire purchase agreement

TopTele Ltd leases 50 televisions from Finance Co Ltd. TopTele Ltd on-leases the televisions for their economic life to various customers. The agreement between TopTele Ltd and Finance Co Ltd provides for regular monthly lease payments for a period of 24 months. Once the final payment is made (and all other money owing under the agreement has been paid), Finance Co Ltd will transfer ownership of the televisions to TopTele Ltd.

The lease is not an agreement to hire or a hire purchase agreement. It is not an agreement to hire because at the time the agreement is entered into it is clear property in the goods will pass to TopTele Ltd at the end of the lease (if the contract proceeds as intended). The lease is also not a hire purchase agreement because it is not made at retail – TopTele Ltd is not an end user and has leased the equipment for the purpose of long-term hire to customers.

Both TopTele Ltd and Finance Co Ltd are required to account for all the GST on the supply at the earlier of the time the supplier issues an invoice or receives a payment for that supply, which is likely to be when they enter into the agreement.

Summary for agreements to hire

103. The situation for agreements to hire can be summarised as follows:
    - Typically, a finance lease will be an agreement to hire where the lessor always retains ownership of the goods and the lessee returns the goods to the lessor at the end of the lease. Many finance leases provide an express statement that property in the leased goods remains with the lessor and that the lessee has no option to acquire property in the leased goods.
    - Finance leases where property either passes to the lessee or is expressly contemplated to pass to the lessee are not agreements to hire.
    - The Commissioner's view is that "an agreement which expressly contemplates that the property in the goods will pass" applies to agreements only where it is certain under the terms of the agreement that title will pass, regardless of whether title passes upfront or at the end of the agreement. It is not intended to include an agreement with an option to purchase even if it is highly likely the option will be exercised because that is the economically rational decision.
    - Finance leases with options to purchase will be agreements to hire when the lessee is not the end user of the goods. If the lessee is the end user of the goods, the finance lease is a hire purchase agreement and s 9(3)(b) applies.
    - If a finance lease is an agreement to hire, GST is accounted for over the term of the lease.

When finance leases are third category agreements

104. For convenience, we have described an agreement that falls outside the definitions of hire purchase agreement and agreement to hire as a third category agreement. Effectively, this category encompasses agreements where the property passes or which expressly contemplate that property will pass to the lessee, but which are not hire purchase agreements.
105. A finance lease is likely to be a third category agreement if:
    - the lessee is not the end user of the goods; and
    - the agreement is one where the property will definitely pass under the terms of the agreement.
106. An example of this type of agreement is an agreement to purchase goods by instalment payments where the lessee is not the end user of the goods. The third category does not include finance leases with an option to purchase where the lessee is not the end user – this is an agreement to hire, as considered from [80].

107. If a finance lease is a third category agreement, then the general time of supply rule applies (subject to any other "special" time of supply rules). GST is accounted for at the earlier of the time the supplier issues an invoice or receives a payment for that supply (s 9(1)).

Summary – time of supply for finance leases

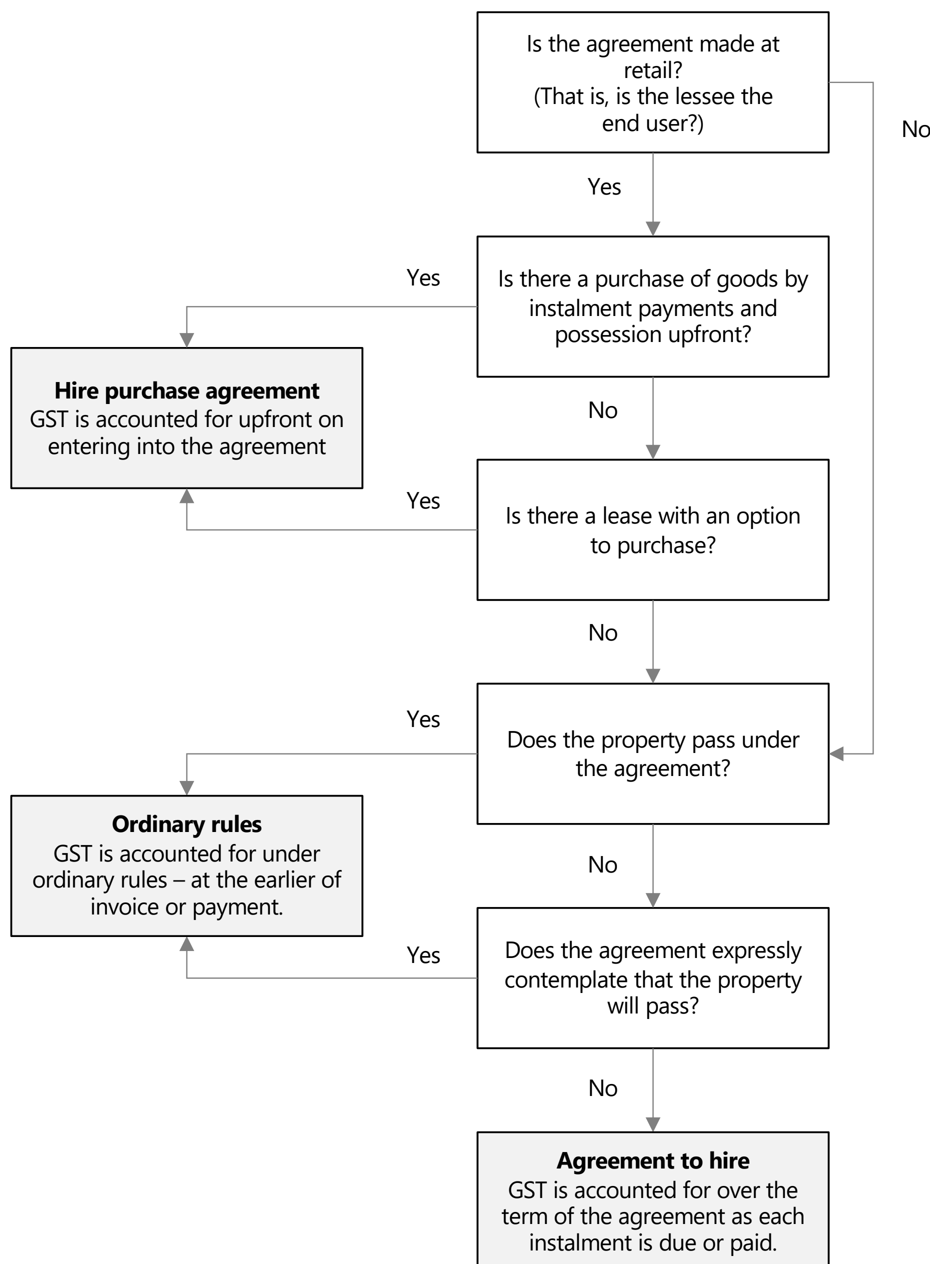
108. To apply the time of supply rules, it is necessary to correctly classify a finance lease as:

- an agreement to hire;
- a hire purchase agreement; or
- as falling outside these definitions, so a third category agreement.

109. The classification determines whether GST is chargeable upfront or over the term of the lease. For GST purposes, an agreement has only one legal classification that determines its treatment under the Act for both parties to that agreement. Accordingly, both parties to a lease must adopt the same timing treatment.

110. The process for classifying finance leases for time of supply is summarised in Flowchart 1 – Classifying finance leases for time of supply which is reproduced here for convenience.

Flowchart 1 – Classifying finance leases for time of supply



Classifying finance leases – value of supply

111. Section 10 determines the value of any supply. The general rule is that the value of a supply is the GST-exclusive consideration paid for it. However, under s 10(5) and (5A)–(5C) there is an exception to this general rule for supplies made under a credit contract:

> **10 Value of supply of goods and services**
>
> …
>
> (5) Despite subsection (2), if a supply of goods and services is made under a credit contract, the consideration in money for the supply is treated as being the higher of the cash price of the goods and services and the price the supplier would have charged the purchaser if the purchaser had paid in full at the time the credit contract was entered into.
>
> (5A) In subsection (5),—
>
> **cash price** has the same meaning as in section 5 of the Credit Contracts and Consumer Finance Act 2003
>
> **credit contract** has the same meaning as in section 3 of the Credit Contracts Act 1981 immediately before the repeal of that Act.
>
> (5B) Despite subsection (5A), a person who is a party to an arrangement that is a credit contract but is not a credit contract under section 7 of the Credit Contracts and Consumer Finance Act 2003 may elect that the arrangement be treated under this section as not being a credit contract in relation to the person.
>
> (5C) Despite subsection (5A), a person who is a party to an arrangement that is not a credit contract but is a credit contract under section 7 of the Credit Contracts and Consumer Finance Act 2003 may elect that the arrangement be treated under this section as being a credit contract in relation to the person.

112. The exception excludes any interest and finance charges from GST when a supply is made under a credit contract. Under s 10(5), GST is payable on only that part of the consideration equivalent to the “cash price” or, if higher, the price that customer would have been charged if they had paid in full upfront. The reason for the exception is that providing credit under a credit contract is a financial service and the supply of any financial services is generally exempt from GST (ss 3(1)(f) and 14(1)(a)). Interest or finance charges can also be zero-rated under s 11A(1)(q) if the requirements of that section are met.

113. Accordingly, to determine the value of a supply, it first needs to be determined whether the relevant lease is a credit contract and subject to the exception. If the finance lease is a “credit contract”, the “cash price” then needs to be determined. When a lease is not a credit contract, ordinary value of supply rules apply and the total amount payable under the lease is subject to GST.

Finance leases that are credit contracts

114. A finance lease can be a credit contract regardless of whether the finance lease is a hire purchase agreement, an agreement to hire or a third category agreement.

115. *The definition of “credit contract”* in the GST Act is interesting as it refers to a definition in a repealed Act. The Credit Contracts Act 1981 (CCA) was repealed and replaced by the Credit Contracts and Consumer Finance Act 2003 (CCCFA). Section 10(5A) in the GST Act defines credit contract by referring to the CCA, but ss 10(5B) and 10(5C) permit persons party to a credit contract under the CCA to elect that the definition of credit contract under the CCCFA applies instead.[17]

116. Therefore, we consider the default position under the definition from the CCA first, then choices available to use the CCCFA. For ease of reference, s 3 of the CCA as it was immediately before the repeal of that Act is set out in the Appendix to this item.

Credit contracts under the Credit Contracts Act 1981

117. The meaning of “credit contract” in s 3 of the CCA (immediately before the Act’s repeal) includes:

[17] These provisions are reflected in s 3(2), (3B) and (3C) of the CCA, which define financial services.

> **3 Meaning of "credit contract"**
>
> (1) ...
>
> (d) A contract under which a person sells or agrees to sell property or provides or agrees to provide services (whether or not possession of the property is given, or the services are provided, before all money payable under the contract has been paid) in consideration of a promise by another person to pay, or to procure the payment of, in the future and in respect of the sale or provision, a sum or sums of money exceeding in aggregate the cash price of the property or services; and
>
> (e) A contract under which a person bails or agrees to bail goods (whether or not with an option to purchase) in consideration of a promise by another person to pay, or to procure the payment of, in the future and in respect of the bailment or option, a sum or sums of money exceeding in aggregate the cash price of the goods;
>
> (2) In subsection (1) of this section, the term "promise" includes a conditional promise.

118. Finance leases will generally be credit contracts under the definition in the CCA. This is because the amount payable under the lease will usually exceed the cash price of the leased goods.

119. A finance lease which is a purchase of goods by instalment payments will generally be a credit contract under paragraph (d). Other lease arrangements which are used as a financing tool will generally be credit contracts under paragraph (e).

120. Two aspects of the definition in paragraph (e) should be noted. First, options are specifically referred to. Included in the definition are payments made in respect of options. Secondly, as a "promise to pay" includes a conditional promise, the Commissioner considers any payments relating to residual value clauses under a finance lease need to be included. Although a guaranteed residual value is not referred to explicitly in s 3(1)(e) of the CCA, the potential liability of a lessee to pay an amount up to the residual value at the end of a lease is a conditional promise to pay money in the future for the lease. This means when calculating whether the amount payable under the lease exceeds the cash price, the following amounts are included in the amount payable:

- the exercise price of an option; and
- any guaranteed residual value.

Credit contracts under the Credit Contracts and Consumer Finance Act 2003

121. As noted above, the parties to a credit contract arrangement can elect to apply the definition of "credit contract" in s 7 of the CCCFA to a particular arrangement instead of the definition in the CCA. The ability to elect to apply the CCCFA is available if the treatment under the CCCFA is different from the treatment under the CCA. Section 7 of the CCCFA states:

> **7 Meaning of credit contract**
>
> (1) In this Act, unless the context otherwise requires, **credit contract** means a contract under which credit is or may be provided.
>
> (2) If, because of any contract or contracts (none of which by itself constitutes a credit contract) or any arrangement, there is a transaction that is in substance or effect a credit contract, the contract, contracts, or arrangement must, for the purposes of this Act, be treated as a credit contract made at the time when the contract, or the last of those contracts, or the arrangement, was made, as the case may be.

122. For a finance lease to be a credit contract under the CCCFA, "credit" needs to be provided under the contract. Credit is defined in s 6 of the CCCFA.

> **6 Meaning of credit**
>
> In this Act, unless the context otherwise requires, credit is provided under a contract if a right is granted by a person to another person to—
>
> (a) defer payment of a debt; or
>
> (b) incur a debt and defer its payment; or
>
> (c) purchase property or services and defer payment for that purchase (in whole or in part).

123. The definition of "credit" under the CCCFA has three limbs, but essentially the contract must defer a payment of a debt. The two elements to this requirement are:
   - there must be a debt; and
   - the payment of that debt must be deferred.

124. Whether a particular arrangement is a credit contract under this definition will depend on the terms of the contract. Some finance leases may not defer the payment of debt. It may be that each payment becomes due and payable when required under the lease. The argument is that the total amount of the lease payments is not due on day one of the lease with the payments deferred over the term of that lease. The argument continues that each payment becomes due on the continuing lease or hire of the goods. Because of this, there is no deferral of a debt.

125. If a particular arrangement is a credit contract under the CCA (because total payments due exceed the cash price) but is not a "credit contract" under the CCCFA (because there is no deferral of a debt), the parties can choose to apply the definition in the CCCFA. In this case, the finance lease will not be a credit contract for GST purposes.

126. The reverse situation can also apply. If a particular arrangement is not a credit contract under the CCA but is a credit contract under the CCCFA, the parties can choose to apply the definition in the CCCFA so that the arrangement is treated as a credit contract. This situation will not occur frequently as the definition of "credit contract" in the CCCFA appears to be narrower than the definition in the CCA.

127. Accordingly, whether a finance lease is a credit contract is determined in the first instance by the definition of credit contract in the CCA. If the treatment is different under the CCCFA, the parties can choose to apply the definition in the CCCFA.

128. In some situations, taxpayers may have updated their standard lease contracts to comply with the definition of "credit contract" in the CCCFA. If it is clear from the terms of the contract that the lease is a credit contract under the CCCFA, then the Commissioner will not generally require the parties to also show whether the arrangement is a credit contract under the CCA.

Making an election

129. Where it is desired that the definition of "credit contract" in the CCCFA should apply, it is the Commissioner's view that both parties to the finance lease must treat the agreement in the same way. Arguably, the words "in relation to the person" in s 10(5B) and (5C) could be interpreted as allowing the parties to an arrangement to elect to treat the arrangement differently from each other.

130. However, only one contract exists (irrespective of whether there is a single supply or the GST Act deems there to be successive supplies) and that contract cannot have different GST treatments for the parties to the contract. The Commissioner's view of these sections is that any party to an arrangement may decide the treatment, but if the parties are of different minds, only one party can prevail – and this is likely to be the supplier or lessor. This is part of the negotiation process and, ultimately, the contract and tax invoice(s) need to reflect the agreed position.

131. The GST Act does not specify how to elect to apply the definition of "credit contract" in the CCCFA to a particular arrangement. The Commissioner accepts that parties to a finance lease can make this election by adopting the relevant treatment in the written contract and tax invoice(s), and filing their GST returns accordingly.

Determining the value of supply under s 10(5)

132. Having determined whether the finance lease is a credit contract, the value of the supply can be determined.

133. If a finance lease is not a credit contract, GST applies to the total amount payable under the lease because there are no implied finance and interest charges. No "credit" is provided, and the transaction is taxed in full at 15%. Parties to a finance lease might elect this treatment under the CCCFA as a means of simplifying the GST treatment of the finance lease.

134. If a finance lease is a credit contract, GST is payable only on that part of the consideration equivalent to the "cash price" or, if higher, the price that customer would have been charged if they had paid in full upfront (s 10(5)). Generally the cash price is the same as the price the customer would have been charged but for the credit contract. However, in some cases (for example when a supplier has both retail and wholesale customers), these amounts might be different. For more information see *Tax Information Bulletin* Vol 12, No 12, December 2000 at 22 "*Consideration for a supply under a credit contract*". "Cash price" is defined in s 5 of the CCCFA:

> **cash price**, in relation to property sold or leased, or to services provided under a contract, means—
>
> (a) the lowest price at which a person could have purchased that property or those services from the vendor, lessor, or provider on the basis of payment in full at the time the contract was made; or
>
> (b) if there is no price in accordance with paragraph (a), the fair market value of that property or those services at the time the contract was made.

135. The "cash price" is usually specified in the contract. When there is doubt that the cash price stated in the contract is the true cash price, the lowest price at which a person could have purchased the leased goods outright from the lessor at the time the lease was entered into should be used. If that price is not known, then the fair market value of the leased goods at the time the lease was entered should be used.
136. Once the cash price has been determined, GST is payable only on that part of the consideration equivalent to the "cash price" or, if higher, the price that customer would have been charged if they had paid in full upfront. The difference between the cash price (or higher amount) and the total consideration payable under the finance lease is consideration for providing credit under a credit contract that is a financial service and exempt from GST (ss 3(1)(f) and 14(1)(a)) or zero-rated (s 11A(1)(q)).

Summary

137. Generally, finance leases will be credit contracts under the CCA. This is because the amount payable under the lease will exceed the cash price of the leased goods. In these cases, GST is chargeable on only the cash price component of the total consideration payable over the term of the lease (or if higher, the price that customer would have been charged if they had paid in full upfront).
138. However, the parties to a finance lease can elect to apply the definition in the CCCFA. This election may mean the finance lease is treated as not being a credit contract. If the finance lease is not a credit contract, GST is chargeable on the total amount payable under the lease (because there is no implied interest or finance component).
139. Where the definition of "credit contract" in the CCCFA is sought to be applied, the Commissioner's view is that both parties to the finance lease must treat the arrangement in the same way. The contract and tax invoice(s) should reflect the agreed position. See Example 14.

Example 14 – Finance lease that is a credit contract under Credit Contracts Act 1981

Standout Painter Ltd decides to get a car on finance from Dealer Ltd to use in Standout Painter Ltd's taxable activity. Finance Co Ltd provides finance. Both parties are GST registered. The cash price of the car is $46,000, including GST of $6,000. The term of the lease is 5 years with 60 equal monthly payments to be made. The lease has a residual value of $1. The total interest charges for the term of the lease are $10,000.

The lease is a credit contract under the CCA because the amount payable under the lease is more than the cash price of the car. Both Finance Co Ltd and Standout Painter Ltd are happy with this position and do not consider the position under the CCCFA. The contract states the cash price (which is also the price Standout Painter Ltd would have paid if Standout Painter Ltd had paid in full upfront and not entered into a finance lease). To avoid subsequent debate, Finance Co Ltd puts a clause in the contract that states the lease is a credit contract for GST purposes.

GST is chargeable on only the cash price component of the total amount payable over the term of the lease.

Accounting for GST on finance leases

140. Having classified finance leases for time of supply purposes and determined whether they are credit contracts for value of supply purposes, it is then necessary to determine how to account for GST on finance leases. As would be expected, how to account for GST on a finance lease depends on whether the lease is:
    - a hire purchase agreement, an agreement to hire or a third category agreement (for time of supply purposes); and
    - a credit contract (for value of supply purposes).
141. Once a finance lease has been classified for both time and value of supply purposes, any special rules can be applied to determine when and how much GST to return or claim. We discuss the accounting treatment and special rules for each type of finance lease. Hire purchase agreements and third category agreements are considered first as they are treated similarly.

Hire purchase agreements

142. A finance lease will be a hire purchase agreement, if the lessee is the end user of the goods and:
    - the lessor gives the lessee an option to purchase (see [46] – [67]); or
    - the agreement is a purchase of goods by instalment payments (see [68] – [73]).
143. When a finance lease is a hire purchase agreement, the time of supply is deemed to be the time the agreement is entered into (s 9(3)(b)).
144. If the lease is a hire purchase agreement and a credit contract, GST is chargeable on only the cash price component of the total consideration payable over the term of the lease (or if higher, the price that customer would have been charged if they had paid in full upfront). The difference between the total consideration payable under the finance lease and the cash price is treated as a financial service and exempt from GST (s 10(5)), unless it can be zero-rated (s 11A(1)(q)). Accordingly, GST is generally 3/23 of the cash price of the leased goods, accounted for at the time the agreement is entered into.
145. If the lease is a hire purchase agreement and not a credit contract, then GST is chargeable on the full consideration of the leased goods (because there is no implied interest or finance component) (s 10(2)). The consideration includes an amount that is payable if an option to purchase is exercised. Accordingly, GST is 3/23 of the full consideration of the leased goods, accounted for at the time the agreement is entered into. This is illustrated in Example 15.

Option not exercised

146. If the agreement is a finance lease with an option to purchase and that option is not exercised, an adjustment may need to be made to the consideration and a credit note issued. When this happens, the nature of the supply has been fundamentally varied or altered so any credit note should be issued under s 25(1)(aa) (or s 19N from 1 April 2023).
147. The GST Act treats a hire purchase agreement effectively as a sale by requiring the supplier to account for GST at the time the hire purchase agreement is entered into. It expects that the option will be exercised and ownership of the goods will transfer to the lessee. If the option is not exercised, ownership of the goods remains with the lessor and the lessee has merely rented the goods. This is illustrated in Example 16.

Example 15 – Hire purchase agreement and credit contract – option exercised

Unearth Ltd is a GST-registered company that needs some specialised plant to use in its taxable activity. Unearth Ltd leases the machinery from Finance Co Ltd with an option to purchase. The cash price is $80,500 inclusive of GST of $10,500. The term of the lease is 36 months. Total lease payments are $56,000, including finance charges of $10,000. The payment to buy the machine at the end of the lease is $34,500. At the end of the lease, Unearth Ltd exercises the option to purchase for $34,500.

The agreement is a hire purchase agreement and a credit contract. Finance Ltd must return output tax of $10,500 at the time the agreement is entered into. Unearth Ltd can claim an input tax credit of $10,500 at the time the agreement is entered into. No further GST is payable when the option is exercised. GST has been accounted for correctly on the cash price as required.

Example 16 – Hire purchase agreement and credit contract – option not exercised

This is a variation on Example 15. The facts are the same as in Example 15, except at the end of the lease, Unearth Ltd decides not to exercise the option to purchase and returns the machine to Finance Ltd.

Finance Ltd issues a credit note showing that the correct amount of GST to pay on the lease is $6,000 (that is, the cash price for leasing the machine of $46,000 x 3/23).

Third category agreements

148. A finance lease will generally be a third category agreement if the lessee is not the end user of the goods and the goods will eventually definitely pass to the lessee under the terms of the agreement.
149. When a finance lease is a third category agreement the GST outcome is similar to that for a hire purchase agreement. However, the time of supply is the earlier of the time the supplier issues an invoice or receives a payment for that supply (s 9(1)).
150. Accordingly, if the agreement is a credit contract, GST is 3/23 of the cash price of the leased goods, accounted for at the earlier of the time the supplier issues an invoice or receives a payment for that supply. If the agreement is not a credit contract, GST is 3/23 of the full consideration of the leased goods, accounted for at the earlier of the time the supplier issues an invoice or receives a payment for that supply.

Agreement to hire and a credit contract

151. In many cases, a finance lease is an agreement to hire for GST purposes. When a finance lease is an agreement to hire, the goods are treated as being successively supplied. Each successive supply is treated as taking place at the earlier of when a payment becomes due or is received.

152. When a finance lease is also a credit contract, s 10(5) deems GST to be payable on only that part of the consideration that is equivalent to the cash price. GST applies to only the non-interest and finance charge elements of the consideration; that is, the principal component.

153. The combined effect of the "special" time and value of supply rules is that the GST payable under a finance lease that is an agreement to hire and a credit contract is 3/23 of the GST-inclusive cash price of the leased goods, spread over the payments to be made over the term of the lease.

154. To determine how much GST to account for on each payment, it is necessary to determine the principal component of each payment. That is the amount being paid for the supply of the use of the goods rather than for the exempt supply of financial services. The amount of principal and interest or finance charges included in each payment is usually determined using the actuarial method (or an allowable spreading method for income tax purposes). Generally, the amounts of principal and interest will vary for each payment with the principal increasing and the interest decreasing over the term of the finance lease. The principal is a GST-exclusive amount, so GST is 15% of the principal component of each payment. Using an actuarial method means a different amount of GST will apply to each lease payment as illustrated in Example 17.

Example 17 – GST calculated on an actuarial basis

On 1 March 2021, Finance Co Ltd leases a photocopier to Mikaere's Business Ltd for use in its office. The term of the lease is 3 years. The cash price of the photocopier is $5,750, including GST of $750. The finance charges amount to $1,000. Lease payments are due quarterly in advance. The finance company determines the amount of principal and interest in each payment actuarially. It calculates GST on the principal component of each payment. The payments schedule looks like this:

Due date	Rental ($)	Principal ($)	Interest ($)	GST ($)	Total due ($)
1/03/2021	500.00	500.00	0.00	75.00	575.00
1/06/2021	500.00	342.50	157.50	51.38	551.38
1/09/2021	500.00	354.49	145.51	53.17	553.17
…	…	…	…	…	…
1/12/2023	500.00	483.13	16.87	72.47	572.47
	6,000.00	5,000.00	1,000.00	750.00	6,750.00

155. Because the amount of GST varies from payment to payment, there may be administrative difficulties for parties to finance leases. For example, it may be difficult to set up automatic payment facilities as the payment amount would not be the same. The use of an actuarial basis may also result in lessees incorrectly claiming input tax deductions based on 3/23 of each payment, rather than 15% of the principal component of each payment.

156. To avoid these problems the Commissioner in practice accepts GST being returned on a straight-line basis as an alternative to using an actuarial method (or allowable spreading method for income tax purposes). Under the straight-line method, the GST payable under a finance lease is spread evenly over the rental payments. The same amount of GST must be returned and is available to be claimed as an input tax deduction on each rental payment. This is illustrated in Example 18.

Example 18 – GST calculated on a straight-line basis

Using the facts from Example 17 but accounting for GST on a straight-line basis, the payments schedule looks like this:

Due date	Rental ($)	Principal ($)	Interest ($)	GST ($)	Total due ($)
1/03/2021	500.00	500.00	0.00	62.50	562.50
1/06/2021	500.00	342.50	157.50	62.50	562.50
1/09/2021	500.00	354.49	145.51	62.50	562.50
…	…	…	…	…	…
1/12/2023	500.00	483.13	16.87	62.50	562.50
	6,000.00	5,000.00	1,000.00	750.00	6,750.00

Tax invoices

157. For a finance lease that is an agreement to hire and a credit contract, GST is accounted for over the term of the lease on an actuarial or straight-line basis. Under s 24(3)(g) (or s19E from 1 April 2023), the tax invoice(s) for a finance lease must indicate what part of each payment made under the lease is attributable to GST. Lessors must return GST on the basis set out in the tax invoice. If GST-registered lessees who acquire leased goods for use in their taxable activity are claiming an input tax deduction, they must do so on the basis set out in the tax invoice.

Residual value clauses

158. The nature of a residual value clause is considered from [60]. The residual value payments made at the end of a finance lease affect the total amount of GST payable under the finance lease. If the lessee retains the leased goods and pays the residual value (including GST), the full amount of GST payable on the finance lease (as determined by reference to the "cash price" at the start of the lease) is returned. However, this is not the position when the lessee returns the leased goods.

159. If the leased goods are returned and sold (or valued), certain adjustments to the consideration paid by the lessee are usually required under the residual value clause of the finance lease. For GST purposes, these adjustments may require the lessor to issue a credit note to reflect the fact consideration for the supply of the leased goods has been altered under s 25(1)(b) (or s 19N from 1 April 2023).

160. This treatment applies to all payments made under residual value clauses, regardless of whether a finance lease terminates at the end of its term or earlier by agreement between the parties or due to the lessee's default. See Example 19.

Example 19 – Residual value – GST calculated on a straight-line basis

Krazy Kakes Ltd leases a vehicle from Finance Co Ltd for use in its taxable activity. Both parties are GST registered. The cash price of the vehicle is $46,000, including GST of $6,000. The lease is for a three-year term, with 36 equal monthly rental payments. The finance charges total $10,000. The lease provides the following:

- The lessor remains the owner of the vehicle.
- At the end of the lease, the lessee must return the vehicle and pay the residual value of $13,800 (including GST of $1,800) less the net sale proceeds of the vehicle. If the vehicle sells for more than the residual value, the lessor must pay the excess to the lessee.
- If the lessee does not return the vehicle to the lessor, the lessee must pay the full residual value.

Finance Co Ltd issues a tax invoice for the lease setting out the lease payments and the GST charged on each payment. The tax invoice indicates that GST is to be returned over the term of the lease on a straight-line basis.

The following table summarises the financial terms of the lease.

	GST-exclusive amount ($)	GST ($)	GST-inclusive amount ($)
Cash price	40,000	6,000	46,000
Finance charges	10,000	-	10,000
Total	**50,000**	**6,000**	**56,000**
Less residual value	12,000	1,800	13,800
Total monthly rental payments	**38,000**	**4,200**	**42,200**
Divide by 36 months			
Monthly payments	**1,055.55**	**116.66**	**1,172.21**

The lease is an agreement to hire and a credit contract. It is not a hire purchase agreement because although Krazy Kakes Ltd is the end user of the vehicle, it does not include an option to purchase. It is a credit contract because the consideration payable over the term of the lease exceeds the cash price of $46,000.

The GST treatment at the end of the lease is explained in the following three scenarios.

Scenario 1 – Krazy Kakes Ltd returns the vehicle – shortfall on sale

Krazy Kakes Ltd leases the vehicle for the full three-year term and returns the vehicle to Finance Co Ltd at the end of the lease. Finance Co Ltd sells the vehicle at auction for $11,500 (including GST). After deducting the auction expenses (excluding GST), the net sale proceeds are $10,350. The terms of the lease require Krazy Kakes Ltd to pay to Finance Co Ltd the shortfall between the residual value and the net sale proceeds (that is, $3,450):

	GST-exclusive amount ($)	GST ($)	GST-inclusive amount ($)
Finance Co Ltd sale at auction	10,000	1,500	11,500
Less auction expenses	1,000	150	1,150
Net sale proceeds	9,000	1,350	10,350
Residual value	12,000	1,800	13,800
Shortfall to Finance Co Ltd	**3,000**	**450**	**3,450**

The GST treatment is as follows:

- Finance Co Ltd issues a credit note to Krazy Kakes Ltd, stating that the correct amount of GST still to pay on the lease is $450 (3/23 of $3,450).
- Krazy Kakes Ltd pays a further $3,450 to Finance Co Ltd.
- Krazy Kakes Ltd claims a $450 input tax deduction.
- Finance Co Ltd returns $450 output tax on the lease.
- Finance Co Ltd issues a tax invoice on the sale of the vehicle.
- Finance Co Ltd returns $1,500 output tax on the sale of the vehicle (3/23 of $11,500).

Therefore, the lessee has an input tax deduction of $450. Finance Co Ltd pays output tax of $1,950. The overall result is a further $1,500 output tax (3/23 of sale proceeds).

Scenario 2 – Krazy Kakes Ltd returns the vehicle – surplus on sale

Krazy Kakes Ltd leases the vehicle for the full three-year term and returns it to Finance Co Ltd at the end of the lease. Finance Co Ltd sells the vehicle through a private sale for $17,250 (including GST). After deducting the sale expenses (excluding GST) the net sale proceeds are $16,100. There is no shortfall between the residual value and the net sale proceeds, so Krazy Kakes Ltd is not required to pay anything further to Finance Co Ltd. The terms of the lease require Finance Co Ltd to pay to Krazy Kakes Ltd the difference between the net sale proceeds and the residual value:

	GST-exclusive amount ($)	GST ($)	GST-inclusive amount ($)
Finance Co Ltd private sale	15,000	2,250	17,250
Less auction expenses	1,000	150	1,150
Net sale proceeds	14,000	2,100	16,100
Residual value	12,000	1,800	13,800
Surplus to Finance Co Ltd	**2,000**	**300**	**2,300**

The GST treatment is as follows:

- Krazy Kakes Ltd pays nothing further to Finance Co Ltd.
- Finance Co Ltd issues a tax invoice on the sale of the vehicle.
- Finance Co Ltd returns $2,250 output tax on the sale of the vehicle (3/23 of $17,250).
- Finance Co Ltd pays $2,300 to Krazy Kakes Ltd (the excess of the net sale proceeds over the residual value). This reflects a reduction to the consideration agreed for the lease.
- Finance Co Ltd issues a credit note stating that the correct amount of GST to pay on the lease is $3,900 ($4,200 less 3/23 of $2,300).
- Krazy Kakes Ltd returns output tax of $300.
- Finance Co Ltd claims an input tax deduction of $300.

Therefore, Krazy Kakes Ltd returns $300 output tax. Finance Co Ltd pays output tax of $2,250 and claims an input tax deduction of $300. The overall result is a further $2,250 output tax (that is, 3/23 of the proceeds of sale).

Scenario 3 – Krazy Kakes Ltd keeps the vehicle and pays the residual value

Krazy Kakes Ltd leases the vehicle for the full three-year term and decides to keep the vehicle at the end of the lease. The terms of the lease require Krazy Kakes Ltd to pay to Finance Co Ltd the full residual value.

The GST treatment is as follows:

- Krazy Kakes Ltd pays a further $13,800 to Finance Co Ltd (by virtue of its obligation to pay the residual value).
- Krazy Kakes Ltd claims an input tax deduction of $1,800 (with reference to the tax invoice issued by the lessor at the time of entering into the lease).
- Finance Co Ltd returns $1,800 output tax on the lease.

Therefore, Krazy Kakes Ltd claims a further $1,800 input tax. Finance Co Ltd pays a further $1,800 output tax.

On termination of the lease, Krazy Kakes Ltd negotiates with Finance Co Ltd to buy the vehicle. Finance Co Ltd agrees to transfer title to the vehicle for a further $115 administration charge (including GST of $15). Accordingly:

- Finance Co Ltd returns $15 output tax on the sale; and
- Krazy Kakes Ltd claims an input tax deduction of $15.

Not a credit contract

161. When a finance lease is an agreement to hire and not a credit contract, GST is chargeable on the full consideration of the leased goods (because there is no implied interest or finance component) (s 10(2)). Accordingly, GST is 3/23 of the full amount of each lease payment, accounted for each time a payment is due or received (whichever is earlier).

Summary

162. Hire purchase agreements and third category agreements are treated in a similar way. If they are credit contracts, GST is generally 3/23 of the cash price of the leased goods, payable upfront. If they are not credit contracts, GST is 3/23 of the full consideration of the leased goods, payable upfront. If an option to purchase is not exercised, an adjustment may need to be made to the consideration and a credit note issued.
163. When a finance lease is an agreement to hire and a credit contract, GST is accounted for over the term of the lease each time a payment is due or received (whichever is earlier) generally by reference to the cash price. The interest and finance components of the lease payments are exempt from GST (unless zero-rated under s 11A(1)(q)).
164. To determine the cash price of each payment the lessor calculates the principal and interest components of each payment on an actuarial basis. GST is 15% of the principal component of each payment. This method generally results in a different amount of GST for each payment.
165. To ease compliance, the Commissioner accepts a straight-line method to spread GST evenly over the term of the lease. This approach does not require any reference to the principal component of each payment but simply spreads the GST on the cash price evenly over the lease payments.
166. An exception to this approach arises where the finance lease is a residual value lease. In this case, GST applies in full to the difference between the cash price and the residual value and is spread evenly over the rental payments. GST on any payment(s) made under the residual value clause is accounted for at the end of the lease. This approach accounts for any potential adjustments to the consideration because of the residual value clause. It is also consistent with the approach to agreements to hire under s 9(3)(a) of accounting for GST on the actual payments made.
167. Lessors must return output tax on the basis set out in the tax invoice. GST-registered lessees who acquire the goods for use in their taxable activity can claim input tax deductions only on the same basis as the lessor, being as set out in the tax invoice.
168. When a finance lease is an agreement to hire and not a credit contract, GST is 3/23 of each lease payment made over the term of the lease.

Agency issues on selling goods

169. Issues have arisen about the GST consequences of supplies when a lessee sells the goods as agent for a lessor at the end of finance leases. This situation can be further complicated where residual value clauses exist.

170. The law relating to issues of GST and agency is set out in "IS 21/01: GST and agency", *Tax Information Bulletin* Vol 33, No 2 (March 2021): 21. The following analysis reproduces parts of and is consistent with that analysis.

General rule

171. Section 60 is the main provision in the Act that deals with agency. The general rule is that where a person acts as an agent in making a supply on behalf of a principal, the supply is deemed to be made by the principal and not by the agent (s 60(1)). Consequently, the principal, not the agent, must account for GST on that supply. The principal is responsible for complying with its GST obligations, including issuing a tax invoice and any related credit or debit notes.

172. However, where the supply is a taxable supply, the proviso to s 60(1) allows a GST-registered agent to issue a tax invoice for the supply (or a credit or debit note if required) as if the agent had made the taxable supply. If the agent is not GST registered, it cannot issue a tax invoice. Agents who issue tax invoices, credit notes or debit notes in these situations must comply with the record-keeping requirements in the Act. Where an agent issues a tax invoice or a credit or debit note (under s 60(1) or s 60(2)), the agent must maintain sufficient records to enable the name, address and registration number (if any) of the principal to be ascertained (s 60(3)). The principal must account for the GST on the tax invoice, credit note or debit note.

173. The time of supply rules in s 9 apply to principals and agents. Therefore, a principal must account for GST when the time of supply is triggered. In some cases, the principal might not be aware that an agent has made a sale on the principal's behalf, triggering the time of supply. Agents and principals must have appropriate systems in place so the principal is notified of the sale and can account for GST correctly.

174. The agent is usually required to notify the principal of the price at which goods are sold. Similarly, the agent is usually required to reveal the identity of the principal's customers.

175. In summary, if a lessee sells the leased goods as agent for the lessor, the supply is deemed to be made by the lessor. The lessor must account for GST even if the lessee issues the tax invoice for the supply. The lessee is required to notify the lessor of the sale and provide sufficient information for them to account for GST correctly. See Example 20.

Alternative approach if treated as separate supplies

176. An alternative to the general rule is provided under the Act (s 60(1B)). Where an agent makes a supply to a third party on behalf of a principal, the principal and the agent can agree to treat the supply as two separate supplies:
   - a supply of goods and services from the principal to the agent; and
   - a supply of those goods and services from the agent to the third party.

> **60 Agents and auctioneers**
>
> …
>
> (1B) Despite subsection (1), when a principal and their agent agree, and record their agreement in a document, either in relation to a particular supply or for a type of supply, that this subsection applies to a supply of goods or services, the supply is treated for the purposes of the Act as 2 separate supplies, being—
>
> (a) a supply of goods and services from the principal to the agent; and
>
> (b) a supply of those goods and services from the agent to the recipient, treating the agent as if they were the principal for the purpose of the supply.

177. Section 60(1B) was introduced because some accounting systems automatically issue invoices when goods and services are supplied. For example, the principal's accounting system might issue a tax invoice when goods and services are provided to the agent and the agent's accounting system might also issue a tax invoice when goods and services are provided to the third party.

178. The principal and the agent can agree that the supply is to be treated as two separate supplies. The agreement must be recorded in a document. The agreement may relate to a particular supply or a type of supply. Two separate invoices can

then be issued without contravening the Act. The principal then returns output tax on the tax invoice issued to the agent. Likewise, the agent returns output tax on the tax invoice issued to the third party and can claim input tax being the output tax charged to them by the principal. This is illustrated in Example 21.

Example 20 – Lessee sells goods and entitled to sale proceeds over guaranteed residual value

Finance Co Ltd leases a vehicle to Showy Showers Ltd. Finance Co Ltd retains ownership of the vehicle throughout the term of the agreement. Under the agreement, there is a guaranteed residual value of $10 and Showy Showers Ltd is entitled to keep any sales proceeds over the guaranteed residual value. Showy Showers Ltd retains possession of the vehicle at the end of the lease and sells it on behalf of Finance Co Ltd in accordance with the finance lease. The vehicle sells for $5,000 to a third party.

Showy Showers Ltd sold the vehicle as agent for Finance Co Ltd. Either Showy Showers Ltd or Finance Co Ltd must issue a tax invoice for the sale to the third party. However, Finance Co Ltd must account for the output tax on the sale proceeds of $5,000.

Showy Showers Ltd is entitled to receive $4,990 of the sale proceeds. This is treated as a reduction to the consideration agreed for the lease. Finance Co Ltd issues a credit note for $4,990 and can claim an input tax deduction for GST on $4,990. Showy Showers Ltd is required to return output tax on $4,990.

Example 21 – Parties treat as two supplies

This is a variation on Example 20. The facts are the same as in Example 20 except Finance Co Ltd agrees with Showy Showers Ltd (and sends Showy Showers Ltd an email to that effect) that the sale of the vehicle to the third party should be treated as two supplies. Therefore, Finance Co Ltd issues a tax invoice for the sale price of $5,000 to Showy Showers Ltd, and Showy Showers Ltd issues a tax invoice for $5,000 to the third party. Finance Co Ltd returns GST output tax on the invoice to Showy Showers Ltd, while Showy Showers Ltd returns GST output tax on the invoice to the third party, but can claim and input tax deduction on the invoice from Finance Co Ltd.

Finance Co Ltd and Showy Showers Ltd must account for the return of the $4,990 sale proceeds to Showy Showers Ltd in the same manner as Example 20.

Appendix

Credit Contracts Act 1981 (repealed)

3 Meaning of "credit contract"

(1) In this Act, the term "credit contract" means -

(a) A contract under which a person provides or agrees to provide money or money's worth in consideration of a promise by another person to pay, or to procure the payment of, in the future and in respect of the provision, a sum or sums of money exceeding in aggregate the amount of the first-mentioned money or money's worth; or

(b) A contract under which a person forbears or agrees to forbear from requiring payment of money owing to him in consideration of a promise by another person to pay, or to procure the payment of, in the future and in respect of the forbearance, a sum or sums of money exceeding in aggregate the amount of the first-mentioned money;

and, without limiting the generality of paragraphs (a) and (b) of this subsection, includes -

(c) A contract under which a person lends or agrees to lend money in consideration of a promise by another person to pay, or to procure the payment of, in the future and in respect of the loan, a sum or sums of money exceeding in aggregate the amount of the loan; and

(d) A contract under which a person sells or agrees to sell property or provides or agrees to provide services (whether or not possession of the property is given, or the services are provided, before all money payable under the contract has been paid) in consideration of a promise by another person to pay, or to procure the payment of, in the future and in respect of the sale or provision, a sum or sums of money exceeding in aggregate the cash price of the property or services; and

(e A contract under which a person bails or agrees to bail goods (whether or not with an option to purchase)

in consideration of a promise by another person to pay, or to procure the payment of, in the future and in respect of the bailment or option, a sum or sums of money exceeding in aggregate the cash price of the goods; and

(f) A contract under which a person releases or assigns or agrees to release or assign (whether absolutely or by way of mortgage), with recourse upon himself, a right to receive money in the future in consideration of a promise by another person to pay a lesser sum of money either immediately or at a time earlier than the maturity of the released or assigned right;

but, subject to subsection (4) of this section and to section 4 of this Act, does not include -

(g) A contract of indemnity against loss or a policy within the meaning of section 41 of the Life Insurance Act 1908; or

(h) A lease of, or an agreement to lease, any real property (whether with or without an option to purchase); or

(i) A contract for the sale of property, or the provision of services, to a person if the total amount payable under the contract by the person (other than any amount payable solely as a result of a default in payment by him) is the agreed price of the property or services and is to be paid within 2 months from the date the contract is made.

(2) In subsection (1) of this section, the term "promise" includes a conditional promise.

(3) For the purposes of determining whether a contract is a credit contract within the meaning of this section,

(a) Incidental services provided pursuant to the contract, and legal services relating to the contract, shall not be included as money's worth provided, or agreed to be provided, under the contract; and

(b) The following amounts shall not be included as part of the sum or sums of money promised to be paid in the future:

(i) Any reasonable amount payable for incidental services to the promisor, or for incidental services to any property sold or bailed under the contract or over which security is taken by or pursuant to the contract:

(ii) Any reasonable amount payable as a result of a default under the contract by the promisor:

(iii) Any reasonable amount payable as a result of damage to property while in the possession of the promisor:

(iv) Any reasonable amount payable for surveys, inspections, or valuations of property required for the purposes of the contract:

(v) Any reasonable amount payable for legal services relating to the contract (other than for the collection of money):

(vi) Any amount required to be paid by virtue of any enactment:

(vii) In the case of a contract of bailment where the bailee has the right to cancel the bailment, any amounts that cease to be payable under the contract upon the bailee exercising that right:

(viii) Any amount of a kind specified in regulations made under section 47 (1) (a) of this Act.

(4) Where, by virtue of any contract or contracts (none of which by itself constitutes a credit contract) or any arrangement, there is a transaction that is in substance or effect a credit contract, the contract, contracts, or arrangement shall for the purposes of this Act be deemed to be a credit contract made at the time when the contract, or the last of those contracts, or the arrangement, was made, as the case may be.

References

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Credit Contracts Act 1981 (repealed), s 3 ("credit contract")

Credit Contracts and Consumer Finance Act 2003, ss 5 ("cash price"), 6 ("credit"), 7 ("credit contract")

Goods and Services Tax Act 1985, ss 2(1) ("hire purchase agreement"), 3(1)(f), 9, 10(2), (5), (5A) ("cash price", "credit contract"), (5B) and (5C), 14(1)(a), 19E to 19Q, 24, 25(1)(aa) and (b), 60.

Hire Purchase Act 1971(repealed)

Income Tax Act 2007, s YA 1 ("hire purchase agreement")

Value Added Tax Act 1994 (UK), cl 1 of sch 4

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QUESTION WE'VE BEEN ASKED

This section of the *TIB* sets out the answers to some day-to-day questions people have asked. They are published here as they may be of general interest to readers.

QB 22/02: Donations - what is required to establish and maintain a "public fund" under s LD 3(2)(d) of the Income Tax Act 2007?

Key provisions

Income Tax Act 2007, s LD 3(2)(d)

Tax Administration Act 1994, s 41A

Question

What is required to establish and maintain a "public fund" under s LD 3(2)(d) of the Income Tax Act 2007?

Answer

In the Commissioner's view, to establish and maintain a "public fund" under s LD 3(2)(d) requires or involves the following:

- **The fund must:**
  - **originate in a public initiative or with a founder or founders who intend that the public will contribute to the fund and participate in its administration;**
  - **over time, attract public financial participation (however if the fund originates in a public initiative, it is sufficient that public contributions are sought); and**
  - **have public participation in its administration.**
- **A fund originates in a public initiative if it is established by:**
  - **a group of individuals who together represent a sector of the public and have the requisite degree of responsibility to the community; or**
  - **the Crown or local government, or generally if established by an entity controlled by the Crown or local government.**
- **If a fund does not originate in a public initiative, the intention of the founder or founders can be ascertained by examining:**
  - **any documents establishing the fund;**
  - **the nature of any advertising campaigns carried out on behalf of the fund or the nature of any other publicity received by the fund (for example, articles in print and online media, social media presence, and radio and television interviews);**
  - **the number and amounts of donations the fund receives from members of the public unrelated to the founder or founders; and**
  - **the level of participation in the administration of the fund by people with a requisite degree of responsibility to the community.**
- **For the above purposes, "the public" may comprise a section of the community, provided membership of that section is not conditional on the approval of some or all of the members of that section.**
- **The fund must comprise a stock of separately identifiable money or other assets.**
- **A fund should be established and maintained through a combination of book entries and a document setting out terms for the establishment, operation and winding up of the fund (either as part of the rules of the founder or in a stand-alone document such as a resolution). In most cases the fund should also have its own bank account.**
- **Maintaining the public fund requires maintaining the stock of money or other assets consistent with any book entries. Movements of the money or other assets in the public fund should be tracked and reported on in financial accounts.**

The financial accounts and supporting workpapers should be sufficient to show both the sources of donations made to the fund and the application of funds. Financial accounts prepared to meet the requirements of another enactment (such as the Charities Act 2005 or Local Government Act 2002) may not contain all of the required information.

- **The fund's money may be used to acquire goods and services that are used for the required purpose or to make grants for the required purpose. In addition, the fund's money may be used:**
  - **for purposes other than the required purpose, but only if those other purposes are subordinate or incidental to the required purpose and are not independent purposes; and**
  - **by the founder (or founders) to meet or reimburse costs it or they incur in administering the fund (or, where the founder is a s LD 3(2)(a) donee organisation, to meet or reimburse costs incurred in furthering the founder's purposes if consistent with the purposes of the public fund).**
- **The public fund must be maintained for the required purpose throughout its lifetime, including on the disposal of the public fund's money or other assets if wound up.**

Key terms

Charitable or other public benefit gift includes a gift of money of $5 or more that is paid to a fund, if the fund is a "public fund" as described in s LD 3(2)(d) and the fund is named on the list the Commissioner publishes under s 41A(14) to (16) of the Tax Administration Act 1994. A charitable or other public benefit gift does not include a subscription that confers rights arising from membership in the public fund or in any other society, institution, association, organisation, trust or fund; a testamentary gift; a gift made by forgiving some or all of a debt; or a gift to a public fund that is not registered as a charitable entity under the Charities Act 2005 if, in the Commissioner's opinion, the public fund is eligible to be registered as a charitable entity under that Act.

Donee organisation means an entity or fund described in s LD 3(2) or listed in schedule 32 of the Income Tax Act 2007.

New Zealand does not include Niue, the Cook Islands, Tokelau or the Ross Dependency of Antarctica.

Required purpose means the provision of money for a s LD 3(2)(d) public fund's specified purposes within New Zealand.

Specified purposes means charitable, benevolent, philanthropic and/or cultural purposes.

All legislative references are to the Income Tax Act 2007 (the Act), unless otherwise stated.

References to a founder include multiple founders.

Explanation

Introduction

1. This item is about **donee organisation** status under the Income Tax Act 2007. Taxpayers who make gifts of money to an entity or fund with donee organisation status under the Act can generally get tax advantages. Subject to limits, the tax advantage for an individual is a refundable tax credit of one-third of their gifts of $5 or more to donee organisations each year under ss LD 1 and LD 2. Companies and Māori authorities making such gifts can get a deduction for the gift under s DB 41 or s DV 12.
2. Donee organisation status can apply to an entity or a fund. For example, a society, institution, association, organisation or trust that is not carried on for the private pecuniary profit of an individual (a **non-profit entity**) can be a donee organisation under s LD 3(2)(a) if the entity applies its funds "wholly or mainly" to charitable, benevolent, philanthropic or cultural purposes (**specified purposes**) within New Zealand.[1] A fund established and maintained by a non-profit entity exclusively for the purpose of providing money for any one or more specified purposes within New Zealand can be a donee organisation under s LD 3(2)(c).[2]
3. Since 1 April 2020, to qualify as a donee organisation under s LD 3(2)(a), (ab), (b), (c), or (d) the entity must be on the list the Commissioner publishes. Further, if the Commissioner considers that an entity under s LD 3(2)(a), (b), (c) or (d) is eligible to be registered as a charitable entity under the Charities Act 2005 but it is not so registered, the entity is not a donee organisation. Registration under the Charities Act 2005 is dealt with by the Department of Internal Affairs' Charities Services.

[1] For more details on qualifying under s LD 3(2)(a), see *Interpretation Statement IS 18/05: Income tax – donee organisations – meaning of wholly or mainly applying funds to specified purposes within New Zealand* (Inland Revenue, September 2018) (**IS 18/05**).

[2] For more details on qualifying under s LD 3(2)(c), see *Question We've Been Asked QB 19/10: Donations – what is required to establish and maintain a fund under s LD 3(2)(c) of the Income Tax Act 2007?* (Inland Revenue, June 2019) (**QB 19/10**).

4. A public fund can have donee organisation status under s LD 3(2)(d), provided the fund is established and maintained exclusively for the purpose of providing money for one or more specified purposes within New Zealand (the **required purpose**). However, a public fund cannot of itself be registered under the Charities Act 2005 because a fund, being a stock of money or other assets, cannot of itself be a society, trust or institution. However, a public fund established as a trust will be registrable under the Charities Act 2005.
5. It follows that a founder who establishes and maintains a public fund:
   - legally as part of an entity with an existing Charities Act 2005 registration may rely on that registration. If a registered charity considers it has established a "public fund" it may apply to Inland Revenue for inclusion of the fund on IR's donee list using the process outlined from [62] to [64].
   - legally as part of an entity that is not registered under the Charities Act 2005 should approach the Department of Internal Affairs' Charities Services to determine whether the entity is registrable. If the Department of Internal Affairs' Charities Services determines that the entity is not registrable under the Charities Act 2005, the non-registrable entity may apply to Inland Revenue using the process outlined from [62] to [64] for inclusion of the fund on IR's donee list. For exceptions from the requirement to approach the Department of Internal Affairs' Charities Services before applying to IR, see from [70] to [71].
   - as an individual or group of individuals, should approach the Department of Internal Affairs' Charities Services to determine whether the founder can form an entity that is registrable under the Charities Act 2005. If following consultation with the Department of Internal Affairs' Charities Services it is decided not to form a registrable entity, the individual founder(s) may apply to Inland Revenue using the process outlined from [62] to [64] for inclusion of the fund on IR's donee list.
   - as a new entity that is itself registrable under the Charities Act 2005 (ie, a trust) should apply to the Department of Internal Affairs' Charities Services for registration under the Charities Act 2005. If the new entity's application is accepted it will be added automatically to the Commissioner's donee list (see [61]). If the new entity's application is declined (eg, because the entity's purposes include benevolent, philanthropic or cultural purposes that are not ancillary to a charitable purpose) the new entity may apply to the Commissioner for inclusion on the donee list using the process outlined from [62] to [64].
6. An example of a public fund could be a fund established by a local body such as a Council that receives donations from the public and that is established for a specified purpose such as the promotion of the arts or a cultural festival. Obtaining donee status under s LD 3(2)(d) may be an option where a fund's situation is such that qualification for donee organisation status under s LD 3(2)(a) or (c) is not possible. A fund held on trust could qualify for donee organisation status under s LD 3(2)(a), (c) or (d), although, under paras (c) and (d), the fund must be established and maintained "exclusively" for specified purposes within New Zealand. Under s LD 3(2)(a) and (c), the fund must be, or must be established and maintained by, a non-profit entity, while under s LD 3(2)(d) this is not necessarily the case, but the fund must be a "public fund".
7. This item concerns the donee organisation status of a fund under only s LD 3(2)(d) (the **key provision**). The key provision applies to:

   > (d) a public fund established and maintained exclusively for the purpose of providing money for any 1 or more of the purposes within New Zealand set out in paragraph (a).

8. The key provision refers to certain purposes within New Zealand set out in s LD 3(2)(a). These purposes are "charitable, benevolent, philanthropic, or cultural purposes" (that is, specified purposes).
9. This item considers the:
   - meaning of the following terms and phrases used in the key provision:
     - public (see [11] to [14]);
     - fund (see [15] to [20]); and
     - public fund (see [21] to [55]); and
   - practical implications of the above terms, including:
     - how a person can establish a fund that qualifies as a "public fund" (see [56] to [71]);
     - what the person must do to maintain such a fund (see [72] to [85]); and
     - who may maintain such a fund (see [86] to [88]).

10. This item does not consider:
    - the meaning of "established", "maintained" and "exclusively" (see QB 19/10 for the meaning of these terms);
    - the meaning of "charitable, benevolent, philanthropic, or cultural purposes"; and
    - whether, if the person seeking to establish a "public fund" is an entity, the establishment of a "public fund" is permitted under the governing documents or terms applicable to the entity.

Analysis

"Public"

11. The meaning of the term "public" in the *Concise Oxford English Dictionary* (12th ed, Oxford University Press, New York, 2011) is:

> **public** ▶ adj. **1** of, concerning, or open to the people as a whole. ▪ involved in the affairs of the community, especially in government or entertainment: a *public figure*. **2** done, perceived, or existing in open view. **3** of or provided by the state rather than an independent commercial company.

12. In that definition, the meanings "of, concerning, or open to the people as a whole" and "done, perceived, or existing in open view" have the most relevance to the meaning of the term "public" in the phrase "public fund". The third meaning "of or provided by the state" has some relevance (as discussed from [53]).
13. In *Re Income Tax Acts (No 1)* (1930) VLR 211, the Supreme Court of Victoria considered whether accommodation that admitted only freemasons and their spouses was a "public benevolent asylum". Macfarlan J held that, generally, if admission to membership of a body or inclusion in a class depends on the consent of some or all of the other members of the body or class (for example, a committee), the body or class is not a section of "the public" in the relevant sense of the term. Macfarlan J stated that he preferred to express the definition in the negative (by identifying what was not a section of the public). However, he also stated that a group of people will, roughly speaking, constitute a section of the public if inclusion in the group depends on only the possession of natural attributes or attributes that any member of the community may acquire. MacFarlan J held that the accommodation did not meet the definition.
14. Therefore, it is considered that a group of people who contribute to and participate in the administration of a fund will usually be considered a section of the public, if the right to membership of the group depends only on natural attributes or on attributes that any member of the community may acquire. A group of people will not generally be considered a section of the public if inclusion in the group depends on the consent of all or some of the other members of the group.

"Fund"

15. The ordinary meaning of "fund" suggested by the *Concise Oxford English Dictionary* is "a sum of money saved or made available for a particular purpose".
16. The United Kingdom Court of Appeal decision in *Allchin v Coulthard* [1942] 2 All ER 39 is a commonly cited authority on the meaning of the term. In *Allchin v Coulthard*, Lord Greene considered fund had two meanings (at 44):

> The word "fund" may mean actual cash resources of a particular kind (e.g., money in a drawer or at a bank) or it may be a mere accountancy expression used to describe a particular category which a person uses in making up his accounts.
>
> …
>
> A fund in the second sense is merely an accountancy category. It has a real existence in that sense, but not in the sense that a real payment can be made out of it as distinct from being debited to it.

17. In *Rapid Metal Developments (NZ) Ltd v Rusher* (1987) 2 PRNZ 85, McGechan J in the New Zealand High Court considered (at 93) dictionary definitions of fund, including the following definition in the *Shorter Oxford English Dictionary* (vol 1, 1972):

> 3. Sources of supply; a permanent stock that can be drawn upon 4(a) sing. A stock or sum of money, esp. one set aside for a particular purpose (b) Pecuniary resources.

18. McGechan J considered that in *Allchin v Coulthard* Lord Greene's second meaning of fund as an accountancy category extended the dictionary definition. McGechan J also considered that the applicable meaning, including whether Lord Greene's extended meaning applied, depended on the context. McGechan J stated (at 93):

> The meaning of "fund" is not necessarily restricted to such dictionary sense of actual stock or sum of money set apart. It can be "a mere accountancy expression used to determine a particular category which a person uses in making up his accounts" *Allchin v Coulthard* [1942] 2 KB 228, 234, per Lord Greene MR.
>
> …
>
> In short, to constitute an [sic] "fund" it is not necessary to set aside actual coin. An accountancy device will suffice. … The word "fund" can vary in meaning according to context.

19. McGechan J considered that, under any meaning, the essential features of a fund are purpose and retention (at 94):

> The underlying feature of a "fund" so exemplified is that it is an aggregation of money or an accounting device directing money to a particular purpose, and that such money is still so held or still so allocated for that purpose. On this common usage approach, the essential features are purpose and retention.

20. In the Commissioner's view, the relevant meaning is one that recognises that there is a specific fund which is a source from which a real payment can be made to fulfil its specified purpose, rather than an accounting entry or a concept of accountancy. Accordingly, a meaning of "fund" based on the ordinary usage and the dictionary meaning rather than on Lord Greene's extended meaning of the term, is preferred. That is, a s LD 3(2)(d) fund must be an actual stock of money or other assets set aside for the required purpose. This includes, for example, a fund represented by a credit balance in a bank account.

"Public fund"

21. No New Zealand case law discusses the meaning of "public fund" under the key provision or any of its predecessors.
22. Two Australian cases discuss the meaning of public fund in relation to an Australian provision, s 78 of the Income Tax Assessment Act 1936: *Bray v FC of T* 78 ATC 4,179 (HCA) (discussed in [25] to [30]) and *Case X13* 90 ATC 165 (AAT) (discussed in [31] to [34]).
23. Section 78 of the Australian Act has since been repealed and replaced with new "donee gift recipient" provisions. However, it had allowed a deduction for donations to "public funds" established for specific purposes. The context in which the phrase public fund was used (in s 78) was, therefore, very similar to the context in which it is used in the key provision, and the legislative purpose of s 78 was also very similar to the purpose of the key provision. Therefore, the Commissioner considers *Bray* and *Case X13* are relevant to the interpretation of the phrase "public fund" in the key provision.
24. We discuss the two Australian cases and their conclusions on the meaning of "public fund" next.

Bray v FC of T

25. In *Bray*, a solicitor established a trust fund to which he made substantial donations and treated them as deductible. Although the terms of the trust allowed the trust fund to receive donations from the public, at all material times the solicitor was the sole contributor to the fund.
26. By a 4 : 1 majority, the Full High Court held that the fund was not at any relevant time a public fund. This was on the basis that no public elements existed in the establishment or maintenance of the fund under the deed of trust. There was no public initiative in the fund's establishment, and no public participation in its maintenance.
27. Jacobs J concluded that the principal characteristic of a public fund was that public contributions are sought from the public or a significant section of the public. In the case of a fund that does not originate in a public initiative, the founder of the fund must genuinely intend that the public will contribute. If contributions are received from the public this will be strong evidence that the fund is a public fund (provided its funds are used for the required purpose) (at 4,187):

> A consideration of these circumstances leads me to conclude that **the principal distinguishing characteristic of a public fund is that contributions thereto are sought from the public or a significant section of the public.** …
>
> But what of the initial establishment of a public fund where the establishment is by an individual or a number of individuals? At that stage there is no contribution by a member of the public and perhaps no invitation to the public to contribute. In my opinion it is not sufficient that the public under the terms of its establishment may contribute to the fund. **That being so, it appears to me that it must be the intention of the promoters or of the founder or founders (if any) that the public will contribute so that in the case of a fund established by an initial gift from an individual or a few individuals what is born of the contribution from an individual or from individuals will blossom into a fund to which the public in fact subscribe. A fund is a public fund when the purpose of its establishment is the raising of funds from the public or a significant section of the public so that the objects**

> **will benefit to an extent greater than the benefit which a founder (if any) confers by his own contribution.** The question is one of fact in each case and the conclusion would not be lightly reached that promoters or founders did not have the requisite intention or purpose. The fact that members of the public unassociated with the promoters or founders did in fact contribute in response to an invitation or request extended to them would no doubt be very strong evidence that the promoters or founders had extended the invitation to the public with the purpose intention and expectation that the result would follow.

[Emphasis added]

28. Similarly, Barwick J considered that for a fund to be a public fund, it must either originate in a public initiative or attract public financial participation to a substantial degree. In his view, the critical facts of the case were that the fund was set up on the sole initiative of the appellant and, though the deed setting it up allowed for contributions from members of the public, the appellant was in fact the only contributor to the fund and did not make "any effective endeavour" to obtain subscriptions from the public. Barwick J did not rule out that there may be other circumstances that must be present to warrant the conclusion that a fund is of a public nature. On the facts, there had been no public initiative in the fund's establishment and no public participation in its maintenance (at 4,181):

> **But at least, in order for a fund to be a public fund, it must, in my opinion, either originate in a public initiative or attract public financial participation to a substantial degree. Given one of these conditions, there may yet be other circumstances which must be present to warrant the conclusion that the fund is of a public nature.** In any case, a fund cannot obtain its public character from the nature of the purposes for which the fund may be used. The Act requires both that the fund should be a public fund and that it be devoted to the specified purposes.
>
> …
>
> **My conclusion is that the fund established under the deed of trust in this case was not at any relevant time a public fund. Beyond the possibility of public contributions it had no public element.** In reaching that conclusion I have not placed any reliance on the manner in which the funds of the trust were dealt with by the trustees; nor have I found it necessary to impugn the bona fides of the appellant. I have done so because **there are, in fact, no public elements whatsoever in the establishment or maintenance of the fund under the deed of trust. There was no public initiative in its establishment and no public participation in its maintenance.**

[Emphasis added]

29. Mason J considered the fund must be open for subscription by the public and the public must contribute to the fund. He considered participation by the public in the administration of the fund would also advance its public character, provided some level of public contribution to the fund occurred (at 4,182):

> That the fund is open for subscription by the public is unquestionably an essential, though not in my opinion a sufficient, manifestation of its public character. It must also appear that the public participates in the fund by making contributions to it. No doubt the public character of the fund will be advanced by the participation of the public in its formation and in its administration but I cannot think that this is enough in itself without participation by the public in the making of contributions to the fund so as to constitute it as a public fund.

30. Therefore, in Mason J's view the assessment involved weighing up the relevant factors (public contribution and public administration), with at least some public contributions to the fund being a requirement.

Case X13

31. In *Case X13*, the taxpayer and others established a foundation to help pupils of a state school in a disadvantaged area. The foundation paid out money to the school that could not be collected from their parents for school fees and the costs of hobbies and excursions for certain children.
32. The taxpayer claimed deductions under s 78(1)(a) of the Income Tax Assessment Act 1936–1987 for the donations he had made to the foundation. He argued that the foundation was a public fund established and maintained for the relief of persons in Australia who are in necessitous circumstances for which gifts would be deductible under s 78(1)(a)(iii).
33. The Administrative Appeals Tribunal referred to the judgment of Barwick CJ in *Bray* (at 4,181) who said a public fund must either originate in a public initiative or attract public financial participation to a substantial degree (and that there may be other circumstances that must be present to warrant the conclusion that the fund is of a public nature).
34. The tribunal held that in the taxpayer's case the foundation was a private initiative. Although there had been a "public appeal" (by way of advertisements in a newspaper and newsletter), only a minimal amount had been raised, so it could not be said that a substantial degree of public financial participation had occurred; nor had the public participated in the foundation's administration.

Summary – what a public fund is

35. In summary, the case law establishes that a fund is a public fund where:
    - the fund originates in a public initiative or with a founder who intends that the public will contribute to the fund and participate in its administration;
    - over time, the fund attracts public financial participation (however if the fund originates in a public initiative, it is sufficient that public contributions are sought); and
    - the public participates in the administration of the fund.
36. The following three aspects of the above requirements are discussed next:
    - What is a public initiative?
    - How is the founder's intention ascertained?
    - What is meant by public participation in the administration of the fund?

What a public initiative is

37. The Australian case law above refers to funds that "originate in a public initiative". However, the case law does not expand on what is meant by a "public initiative".
38. The *Concise Oxford English Dictionary* defines "initiative" as:

    > n. **1** the ability to initiate or begin something. … **2** a fresh strategy intended to resolve or improve something.
39. A "public initiative" will exist where members of "the public" or a section of it (see [11] to [14]) together decide to establish a public fund.
40. A public initiative may include, for example, a fund established by a club or association (for example, a Rotary or Lions club) if the committee of the club or association controlling the fund is made up of people with a degree of responsibility to the community in general as distinct from having obligations as members of the club or association (see further from [86]). A "public initiative" may similarly include a fund established by a non-profit organisation if the committee of the non-profit organisation meets the above criteria.
41. A public initiative may also include an event (or series of events) such as a telethon, concert, or concert tour where members of the public through a committee of people with a degree of responsibility to the community (again, see from [86]) together organise the event to attract public contributions to a public fund to be used exclusively for specified purposes. Only amounts in addition to any set ticket price paid voluntarily qualify for the donations deduction. (For further information on donations collected at or in respect of fundraising events, see *Question We've Been Asked QB 16/05: Income Tax – donee organisations and gifts* (Inland Revenue, June 2016).)
42. A "public initiative" may also include a fund established by the Crown or local government or (in appropriate cases) by an entity controlled by the Crown or local government (see further from [53]).

How the founder's intention is ascertained

43. In *Bray*, the court considered how the intention of the founder should be ascertained.
44. Jacobs J stated (at 4,187) that the receipt of public contributions would be strong evidence of an intention on the part of the founder that the public should contribute to the fund. Jacobs J also stated (at 4,188) that the nature of any advertising should be considered; that is, whether the advertising was genuinely designed to attract donations. On the facts, he considered the form of advertisement chosen (at 4,188) "appear[ed] to have been designed to discourage rather than to encourage contribution".
45. Barwick CJ (at 4,181) and Mason J (at 4,182) considered the critical facts were that at all material times the taxpayer was the only contributor to the fund. Although the taxpayer claimed to have attempted to obtain public contributions, the contributions obtained were of a minimal nature (Barwick CJ at 4,181). Only Aickin J (dissenting) considered that the intention of the founder should be ascertained solely from the documents establishing the fund.
46. Based on the comments in *Bray*, the Commissioner considers that although the documents establishing the fund are an important starting point, the intention of the founder may be ascertained also from:
    - the extent and nature of any advertising carried out by or on behalf of the fund;
    - any media publicity it attracts (for example, articles in print and online media, social media presence, and radio and television interviews);

- the number and amounts of donations received by the fund from members of the public unrelated to the founder of the fund; and
- the level of public participation in the administration of the fund.

Public participation in the administration of the fund

47. “The public” must participate in the administration (maintenance) of the fund. This requirement is supported by the judgments of Mason J (at 4,182; see [29]) and Barwick CJ (at 4,181; see [28]).
48. Jacobs J did not comment on who must administer a fund. He had already concluded that a private founder must intend that the public will contribute to the fund and that the receipt of public contributions would be strong evidence of such an intention. On the facts there had not been any public contributions, and there was no other evidence sufficient to convince Jacobs J that the founder had intended that the public would contribute to the fund. The fund was not a “public fund”, regardless of any other factors such as who administered it. Stephen J concurred with Jacobs J.
49. However in considering a second issue (whether the fund had been established for the purposes required by s 78), Jacobs J stated (at 4,189) that at all times the other trustees intended to do, and in fact did, what the founder thought fit to do. Jacobs J therefore implicitly agreed with Barwick CJ and Mason J that on the facts, the founder was the sole person administering the fund. It is not clear what Jacobs J would have concluded as regards the need to establish public participation in the administration of the fund as a relevant factor, but his conclusion on the facts regarding the fund in question suggests a focus on control needing to be other than in the hands of an individual (private). It is acknowledged that Aickin J dissented and that Stephen J did not feel it necessary to conclude on the second issue. However, the Commissioner considers that on balance, the requirement for public participation in the administration of the fund is supported by the *Bray* case given its consideration by Barwick CJ and Mason J.
50. The Commissioner considers public participation in the fund’s administration is best achieved by way of a committee or a similar group or body. This may be an existing committee already established for similar or related purposes or a new committee specifically established to maintain the public fund.
51. Best practice suggests the majority of the committee members should be people with a sufficient degree of responsibility to the community (see from [86]). Committee members should not hold positions outside the committee that could lead to actual or perceived conflicts of interest (such as their decisions being influenced by the founder or subsequent major donors) unless such conflicts can be adequately managed. A person acting in their own interest is not administering the fund for the public.
52. The Commissioner considers that funds maintained by the Crown or local government or (in appropriate cases) entities controlled by them are considered “administered” (maintained) by the public (see from [53]).

Governmental funds

53. Some “public funds” are established and maintained (or only maintained) by the Crown or local government or by entities controlled by the Crown or local government.
54. The Commissioner considers that public funds established and maintained (or only maintained) by the Crown or local government or (in appropriate cases) entities controlled by them (**governmental funds**) meet the requirement that the founder intends the public will contribute to the fund, provided that public contributions have been sought.
55. Governmental funds are also considered to meet the requirement that the public participates in the administration of the fund. This is on the basis that employees of central and local government and controlled entities would have the requisite degree of responsibility to the public. Most controlled entities would qualify.

What the above definition of public fund means in practice

Establishing a fund

56. A person looking to establish and maintain a public fund that qualifies as a donee organisation under the key provision must be able to show that the fund meets the requirements of an actual stock of money or other assets set aside on a firm and permanent basis for the required purpose. The establishment and maintenance of the fund also needs to be within the purposes and powers of the founder, if relevant in the context, for example, if the public fund is established by a non-profit entity. (This is not relevant if the founder is an individual.)
57. As a general matter, establishing a fund does not necessarily require written documentation. However, it is unlikely the Commissioner would be satisfied that a fund meets the requirements of the key provision in the absence of written documentation.

58. As noted above, the Commissioner also considers a fund (it being a public fund) must be an actual stock of money (such as a bank account) or other assets set aside rather than just book entries that support the establishment of the fund. As the onus is on the founder to show that the fund meets the requirements of the key provision, in practice a public fund must have a founding document setting out terms for the establishment, operation and winding up of the fund. This could be in the form of changes to the founding entity's own founding or governing documents (if the founding person is an entity) or a separate document or documents detailing the terms of the establishment, operation and winding up of the fund. The documents would help satisfy the Commissioner that the fund's establishment and intended operation meet the key provision's requirements (see Examples 1–4 in [89]). This practice may also give greater confidence to the fund's potential donors and reduce the possibility that they will have to demonstrate their donation is eligible for tax benefits.
59. Since 1 April 2020, the Commissioner must be satisfied that the fund meets the requirements of the key provision for it to be included on the list of donee organisations the Commissioner publishes under s 41A of the Tax Administration Act 1994. Since that date, the fund's name must be on this list for it to qualify as a donee organisation. The onus is on the fund to satisfy the requirements of the key provision to obtain and maintain its listing.
60. Also, since 1 April 2020, a donee organisation (including a fund under s LD 3(2)(d)), must now be registered as a charitable entity under the Charities Act 2005 if, in the Commissioner's opinion, it is eligible to register. Entities registrable under the Charities Act 2005 will generally be entities that are societies, institutions, or trusts that are established and maintained, or derive income in trust, exclusively for charitable purposes.

Process for having a fund added to the donee list

61. Charities will automatically be considered for donee status upon registration by the Department of Internal Affairs' Charities Services (where they have indicated they intend to receive donations). These charities should not make a separate application to the Commissioner for donee status.
62. Entities (including funds) that do not have charitable purposes, or for any other reason are not eligible to register with the Department of Internal Affairs' Charities Services, may seek donee status by applying to, and receiving approval by, the Commissioner (for example if they have benevolent, philanthropic or cultural purposes). There is no prescribed form of application. Instead, those entities seeking to obtain donee status approval from the Commissioner should either send their request through myIR or write to the Commissioner seeking approval to be placed on the Commissioner's list of Approved Donee Organisations.
63. The written application to Inland Revenue should be sent through myIR or by mail to Inland Revenue, PO Box 1147, Palmerston North Central, Palmerston North 4440 and should include the following information:
    - the fund's IRD number – if the fund has no IRD number then an application for an IRD number needs to be made. This can be made online;
    - a copy of the fund's founding documents;
    - a copy of the letter from the Department of Internal Affairs' Charities Services declining an application to be a registered charity (unless the fund is established by and legally as part of a local authority);
    - details of how the fund has been, or will be, operated, including:
        - how its funds will be applied; and
        - confirmation its funds will not be applied for purposes outside New Zealand.
64. It is often helpful to include further information if it illustrates the objects, activities and achievements of the fund, such as website references, reports, newsletters, media articles or testimonials.

Donee organisation status and income tax exemption

65. The criteria for exemption from income tax differ from the criteria for donee organisation status.
66. Local authorities are exempt from income tax on most income. Entities registered as charities with the Department of Internal Affairs' Charities Services (registered charities) (subject to some limitations) are also exempt from income tax.[3]
67. A public fund will not be able to register as a charity if it (being a stock of money or other assets) fails to meet the "entity" criteria under the Charities Act 2005 (which allows a society, institution, or the trustee(s) of a trust to register). Alternatively public funds may not meet the "purposes" criteria under the Charities Act 2005. The Act requires the entity

[3] For example, section CW 42(4) requires business income of a registered charity to be apportioned between the New Zealand purposes and overseas purposes of the charity. Only the part apportioned to the New Zealand purposes is exempt income.

to be established and maintained exclusively for charitable purposes and not carried on for the private pecuniary profit of any individual (ancillary purposes need not be charitable). As discussed above, donee organisations may have charitable, benevolent, philanthropic or cultural purposes.

68. Public funds established and maintained otherwise than by local authorities or registered charities are unlikely to be exempt from income tax or from resident withholding tax.

69. Unless a fund has been established as a new entity (eg, a trust), any taxable income (eg, bank interest) is derived by the founder and should be returned in the founder's income tax return.

Local Authority "Mayoral" disaster relief funds

70. Local authorities are not registrable under the Charities Act 2005. If a local authority that receives donations from the public for disaster relief considers it has established a "public fund" and would like its donors to receive donations tax credits, it will need to take steps to ensure the fund is listed on IR's donee list. As a local authority is not registrable under the Charities Act 2005 and a "fund" is not, of itself, registrable under the Charities Act 2005, the appropriate route will usually be for the local authority to apply to Inland Revenue for donee organisation status for the resulting fund using the process outlined at [62] to [64].

71. However, if the local authority decides to settle a trust for disaster relief, and considers it has established a "public fund", it will be required to take the steps outlined at [5]. The Department of Internal Affairs' Charities Services has a fast-track process that may be used where a charitable entity wishes to register and there is a need for this to occur quickly (such as in a disaster relief situation). Assessment of the entity's application will be given priority.

Maintaining a public fund

72. Once established, the public fund must be maintained for the required purpose. The onus is on the founder (or person who maintains the fund) to show that this is the case.

73. Donations must meet the definition of a "charitable or other public benefit gift" to qualify. The concept of a "gift" requires that no material benefit is given in exchange for a payment. This differs from the comparative materiality test used in accounting practice.[4] Therefore for reporting entities, not all "non-exchange transactions" recorded in the entity's financial statements will qualify for a donations tax credit or deduction. To be sufficient, the entity's records must show the payment is a "gift" for tax purposes.

74. Adequate record keeping on an ongoing basis must show any changes in the composition of the fund and how the fund's money or other assets have been used for the required purpose. As the money or other assets of the fund at its establishment may change, maintaining the fund requires maintaining the stock of money or other assets comprising the fund, consistent with book entries showing movements of the fund's money and other assets. Movements in the fund should be specifically reported on in financial accounts by showing the balance of the fund brought forward from the prior year, donations and other additions to the fund, expenditure and transfers out of the fund, any other gains or losses, and the closing fund balance.

75. Some entities that maintain public funds will have reporting obligations under other enactments, such as the Charities Act 2005 or the Local Government Act 2002. The records kept for tax purposes may include accounting entries in the financial accounts of the founder prepared for the purposes of that other enactment. However, just as the requirement to maintain records for tax purposes does not replace those other reporting obligations, those other reporting obligations do not replace the requirement to maintain records for tax purposes (although there may be a significant amount of overlap in the financial information reported and tax records maintained).

76. The fund, and in particular the fund's money, should be kept separate from the founder's other money and assets. The Commissioner considers this is best achieved by the fund maintaining a separate bank account. This will make it easier to show an actual stock of money exists and that the purposes of the fund have been maintained (by seeing how the money in the account has been used).

77. Where an authority maintains multiple governmental funds (see [53] to [55]), the Commissioner considers separation of money is best achieved by maintaining at least one "Funds" bank account (separate from the authority's general bank account). In the absence of this, the authority must maintain records that are sufficiently detailed to allow the entries in the ledger account for a fund to be matched to corresponding entries on the authority's general bank account statements.

78. Donors should clearly indicate they are intending to make a donation to the fund, to avoid any doubt about whether the donation is to the fund or the founder (if the circumstances are such that doubt could arise).

79. As to the uses of the money in the fund, the fund must be used for, or used to provide money for, the required purpose. A

[4] See *Question We've Been Asked QB 16/05: Income Tax – donee organisations and gifts* (Inland Revenue, June 2016), at [33].

fund's purposes are ascertained by considering its founding documents and the uses made of the money or other assets of the fund. Once those purposes have been ascertained, it is a question of law as to whether or not those purposes are exclusively charitable, benevolent, philanthropic or cultural. The fund may provide money to a non-profit entity that founded or maintains the fund, provided this is exclusively for the advancement of specified purposes within New Zealand and consistent with the fund's purposes.

80. The Commissioner is also aware the following questions have been raised about the use of the fund's money:
    - Can the founder use the fund's money to meet or reimburse costs they incur specifically relating to administering the fund?
    - Can the founder make a charge against the fund's money to reimburse them for a reasonable share of their administration costs, where such costs include the costs of administering the fund?
    - Can the fund's money be used to meet any other costs incurred by the founder?
    - Would the founder exclude the fund from its own assets for financial reporting purposes?

81. The Commissioner considers that the fund's money can be used to meet or reimburse reasonable costs specifically relating to administering the fund, including the costs of record keeping.

82. The Commissioner also considers that the fund's money can be used to meet a charge for a share of administration costs incurred by the founder apportioned to the fund on a reasonable basis where those costs include the direct costs of administering the fund. For example, a reasonable apportionment of employee salaries based on time spent administering the fund could be charged to the fund. Other direct costs would include bank charges, stationery costs, and accounting and audit fees relating expressly to the fund. No apportionment of costs may be made where the founder would have incurred the costs had the public fund not been established.

83. In all cases, the Commissioner considers the above uses of the fund's money would not jeopardise the fund's donee organisation status. In the Commissioner's view, the use of the fund's money for such administration costs advances or is subordinate or incidental to advancing the required purpose.

84. Use of the fund's money to meet any other costs by the founder may advance the required purpose if the founder is a s LD 3(2)(a) donee organisation, but only if the fund's terms permit this. The costs must advance purposes that are exclusively specified purposes within New Zealand and consistent with the fund's purposes. Care would be needed if the founder's purposes included purposes other than specified purposes within New Zealand. This is because using the fund's money to contribute to the founder's costs could mean the fund's money advances a purpose or purposes other than the required purpose. This would be contrary to the key provision's requirement for the fund to be "exclusively" for the required purpose, and the donee organisation status of the fund would be jeopardised. For more information on when money is considered to be applied to specified purposes within New Zealand (including apportionment issues) see IS 18/05 at [245] to [280] and the examples at [280]. If the founder is not a s LD 3(2)(a) donee organisation, the fund's money may not be used to meet any other costs incurred by the founder.

85. Finally, as noted at [75], a founder may have a statutory obligation to prepare general purpose financial statements under an enactment such as the Charities Act 2005 or the Local Government Act 2002. In that case the applicable accounting standards will determine how the fund is accounted for in the financial statements. However, the Commissioner would not expect the public fund's assets to be included in the assets of the founder, for example, for the purpose of the founder establishing it is able to provide security for its own or a related party's borrowing.

People who may maintain a public fund

86. As noted at [47], it is a requirement that "the public" must participate in the administration of a "public fund". The Commissioner considers this is best achieved by way of a committee or similar group or body. The committee may be a pre-existing committee already established for similar or related purposes or a new committee specifically established to maintain the public fund. Best practice suggests the majority of committee members should be people who have a sufficient degree of responsibility to the public (respected community members).[5]

[5] For further information on what is expected of officers of charities registered with Charities Services see **https://www.charities.govt.nz/assets/Uploads/Resources/Congratulations-you-are-the-officer-of-a-registered-charity-A4.pdf**. See also **https://www.charities.govt.nz/im-a-registered-charity/officer-information/disqualified-officers/**.

87. People who have traditionally been regarded as respected community members include church authorities, clergy, school principals, kaumātua and iwi leaders, professional people including solicitors, doctors and accountants, mayors, councillors, local government chief executives, members of parliament, judges and appointees of the court.
88. As noted at [51], committee members should not hold positions outside the committee that could lead to actual or perceived conflicts of interest (such as their decisions being influenced by the founder or by subsequent major donors to the fund), unless such conflicts can be adequately managed.

Examples

89. Examples 1–4 explain the application of the law. They indicate the matters that need to be considered when establishing and maintaining a public fund.

Example 1: Private founder establishes a fund administered by a community organisation

A taxpayer (the founder) owns land near the centre of a small town. Forty years ago, the founder received a sum of money from the local council to establish and maintain a park and gardens on the land to which the public would be granted access. The park and gardens were duly established and have been well maintained and are well used by the public. However, over time, the sum of money has been used up. The founder approaches the council for further funding but the request is declined.

The founder decides to raise money directly from the public for the maintenance of the park and gardens. The founder approaches a local community club to identify people who might be interested to act as administrators of the fund on a voluntary basis. The founder is able to assemble a group of community members who are interested to participate and form a committee. The committee comprises, in the majority, people who are respected community members, who include a member of the clergy, a school principal, kaumātua and iwi leaders, professional people including solicitors, doctors, and accountants, councillors, a member of parliament, and a judge. The founder sets up a bank account in the name of the "X Park and Gardens Maintenance Fund" and grants signing authority on the account to the committee members.

The committee resolves to:

- set up a ledger account in the name of the "X Park and Gardens Maintenance Fund";
- draft a founding constitution that establishes themselves as an association making clear how decisions are made and setting out the association's objectives and how the funds will be held and applied;
- ensure the fund is added to the Commissioner's list of donee organisations;
- place a weekly advertisement in local newspapers on an ongoing basis and a series of advertisements in the national newspaper most commonly read in the area seeking donations to the fund;
- approach journalists from the above newspapers and national television networks to gain publicity for the fund in the print, online and television media;
- create a social media presence for the fund and set up a page for the fund on an online gifting platform; and
- place billboards in the local community and surrounding towns to raise awareness of the fund.

These things are duly done by representatives on the committee's behalf. The committee further resolves that it will:

- apply donations received from the public exclusively to the maintenance of the X Park and Gardens and ongoing administration costs directly related to the fund;
- place any funds not immediately required for the maintenance of the X Park and Gardens on term deposit with a reputable financial institution; and
- if the X Park and Gardens are closed to the public at a time when funds remain in the X Park and Gardens fund, apply those funds exclusively to charitable, benevolent, philanthropic and/or cultural purposes within New Zealand.

The founder agrees to contribute an initial amount to cover the costs of the advertising outlined above and other initial costs of administering the fund plus a further amount equal to 10% of total public contributions raised.

A significant amount is raised for the continued maintenance of the park and gardens by way of donations from members of the public, and the founder duly contributes an amount equal to 10% of the donations received by the fund.

The committee ensures the funds are used exclusively to maintain the park and gardens. Funds raised that are not required are placed on term deposit with a trading bank, and the interest is added to the fund's capital.

The fund is a "public fund" under s LD 3(2)(d). This is because, although established on the private initiative of the founder, the public makes significant contributions to the fund and the fund is administered by a committee of people with the requisite degree of responsibility to the public. Further, the fund is established and maintained for charitable, benevolent, philanthropic or cultural purposes within New Zealand, and is on the Commissioner's list of donee organisations. It follows that gifts to the fund qualify for donations tax credits under s LD 3.

Example 2: Private founder establishes a fund for specified purposes

A taxpayer establishes a trust fund and makes donations of money to the fund. The trust deed provides that the trust is established and maintained exclusively for the purpose of providing money for charitable purposes within New Zealand. The deed also states that the trust will solicit and accept donations from the public. The taxpayer and three of the taxpayer's associates are appointed as trustees. The trust applies for and is granted charitable status by the Department of Internal Affairs' Charities Services.

The fund places two advertisements on an online forum with a limited audience. It receives public donations of less than $100, and the taxpayer is the only other contributor to the fund.

The trust is not considered to be a "public fund". There was no public initiative in its establishment, no significant public contributions were received by the fund, and there was no public participation in the fund's administration. Moreover, based on the fund's actions, there did not appear to be any real intention to attract public contributions to the fund or that the public would participate in its administration.

Example 3: Local council establishes and maintains a fund

A local council establishes a fund that promotes events organised by other (non–council-controlled) charitable, benevolent, philanthropic and/or cultural organisations. These events include a lantern festival, a Pasifika festival and the local City Art Gallery's open day. The fund's purposes are limited exclusively to charitable, benevolent, philanthropic and/or cultural purposes within New Zealand.

The council maintains a separate ledger account for the fund and sufficient records to enable debits and credits in the ledger account to be identified in the council's bank account statements. The council resolutions establishing the fund record that the fund is open to contributions from the public and record its purposes as outlined above. The resolutions also record that should the fund no longer be required, any remaining money in the fund will be applied to charitable, benevolent, philanthropic and/or cultural purposes within New Zealand.

A local authority is not registrable under the Charities Act 2005. The fund applies directly to the Commissioner using the process outlined at [62] to [64] and is granted donee organisation status on the basis that it has been established and will be maintained exclusively for one or more charitable, benevolent, philanthropic or cultural purposes within New Zealand, will seek and receive contributions from the public, and will be administered by the public.

The council actively seeks contributions to the fund from the public. Over time, the council receives a significant number of donations to the fund from members of the public, which in aggregate amount to a significant sum of money.

Council employees administer the fund and ensure contributions to the fund are used exclusively for the fund's stated purposes. The only costs paid for by the fund or recovered from the fund by the council relate directly to the fund. No costs are apportioned to the fund where those costs would still have been incurred by the council had the fund not been established.

The fund is a "public fund" under s LD 3(2)(d). This is because the fund originates in a public initiative, and the public both contributes to and participates in the administration of the fund. Further, the fund is established and maintained exclusively for charitable, benevolent, philanthropic or cultural purposes within New Zealand, and has been added to the Commissioner's list of donee organisations. It follows that gifts to the fund qualify for donations tax credits under s LD 3.

Example 4: Local council establishes and maintains a "mayoral" disaster relief fund

A severe storm causes widespread flooding in a largely rural district of the South Island. There is extensive damage to farmland and to the low-lying areas of a provincial town. The local council receives donations from members of the public to assist with flood relief efforts.

The council establishes a separate ledger account for the fund to which the monies received are debited. A council resolution records that the fund has been established and consists of contributions from the public towards flood relief in the area. The resolution also records that if all of the monies received are not required for flood relief, they will be applied to charitable, benevolent, philanthropic and/or cultural purposes within New Zealand.

A local authority is not registrable under the Charities Act 2005. Therefore the fund applies directly to the Commissioner using the process outlined at [62] to [64] and is granted donee organisation status on the basis that it has been established and will be maintained exclusively for one or more charitable, benevolent, philanthropic or cultural purposes within New Zealand, receives contributions from the public, and is administered by the public.

Council employees administer the fund and ensure contributions to the fund are used exclusively for flood relief purposes. The only costs paid for by the fund or recovered from the fund by the council relate directly to the fund. The council does not apportion any costs to the fund that would still have been incurred by the council if the fund had not been established.

The fund is a "public fund" under s LD 3(2)(d). This is because the fund originates in a public initiative, and the public both contributes to and participates in the administration of the fund. Further, the fund is established and maintained exclusively for charitable, benevolent, philanthropic or cultural purposes within New Zealand, and has been added to the Commissioner's list of donee organisations. It follows that gifts to the fund qualify for donations tax credits under s LD 3.

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Charities Act 2005

Income Tax Act 2007, ss CW 41, DB 41, DV 12, LD 1 to LD 3, schedule 32

Tax Administration Act 1994, ss 32E, 41A

Income Tax Assessment Act 1936, s 78 (Cth)

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Rapid Metal Developments (NZ) Ltd v Rusher (1987) 2 PRNZ 85 (HC)

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TECHNICAL DECISION SUMMARIES

Technical decision summaries (TDS) are summaries of technical decisions made by the Tax Counsel Office. As this is a summary of the original technical decision, it may not contain all the facts or assumptions relevant to that decision. A TDS is made available for information only and is not advice, guidance or a "Commissioner's official opinion" (as defined in s 3(1) of the Tax Administration Act 1994). **You cannot rely on this document as setting out the Commissioner's position more generally or in relation to your own circumstances or tax affairs**. It is not binding and provides you with no protection (including from underpaid tax, penalty or interest).

TDS 22/06: GST input tax deductions, income tax deductions, understated income, shortfall penalties

Technical decision summary - Adjudication

Decision date | Te Rā o te Whakatau: 5 November 2021

Issue date | Te Rā Tuku: 14 April 2022

Subjects | Ngā kaupapa

GST: Input tax deductions; Income tax: Deductions, understated income; TAA: Shortfall penalties.

Abbreviations | Whakapotonga kupu

The abbreviations used in this document include:

CCS	Customer and Compliance Services, Inland Revenue
Commissioner or CIR	Commissioner of Inland Revenue
GST	Goods and services tax
GSTA	Goods and Services Tax Act 1985
ITA	Income Tax Act 2007
TAA	Tax Administration Act 1994
TCO	Tax Counsel Office, Inland Revenue

Taxation laws | Ngā ture tāke

The legislation considered in this document is:

- Goods and Services Tax Act 1985 (**GSTA**);
- Income Tax Act 2007 (**ITA**); and
- Tax Administration Act 1994 (**TAA**).

Facts | Ngā meka

1. The Taxpayer is a company that provides business advisory and consultancy services. The Taxpayer argued that it and its sole director and shareholder (the Director) were also directors of Company A which is part of a company group. Company A was placed into voluntary liquidation during the income tax period under dispute.
2. The Director filed the Taxpayer's two 6-monthly GST returns and an income tax return that were subject to the dispute.
3. Following an analysis of the information requested from the Taxpayer, Customer and Compliance Services, Inland Revenue (**CCS**) considered that the Taxpayer may have claimed input tax deductions and income tax deductions it was not entitled to and may have understated its income in its income tax return.

Issues | Ngā take

4. The main issues considered were:
   - whether the Taxpayer was entitled to the input tax deductions it claimed in its GST returns;
   - whether the Taxpayer was entitled to the deductions it claimed in its income tax return;
   - whether the Taxpayer included all of its income in its income tax return;
   - whether the Taxpayer was liable for the following shortfall penalties:
     - gross carelessness;
     - not taking reasonable care; or
     - unacceptable tax position.
5. A preliminary issue on the onus and standard of proof was also considered.

Decisions | Ngā whakatau

6. The Tax Counsel Office (**TCO**) decided that:
   - the Taxpayer was not entitled to claim the input tax deductions in dispute in its GST returns;
   - the Taxpayer was not entitled to claim the deductions in dispute in its income tax return, except for an amount of interest paid on loans;
   - the Taxpayer understated the income amount in its income tax return;
   - the Taxpayer met the requirements for all the proposed shortfall penalties. In such cases, the highest penalty is imposed. The Taxpayer was liable to pay a shortfall penalty for gross carelessness.

Reasons for decisions | Ngā take mō ngā whakatau

Preliminary issue | Take tōmua: Onus and standard of proof

7. The onus of proof in civil proceedings[1] is on the taxpayer, except for shortfall penalties for evasion or similar act, or obstruction.[2] The taxpayer must prove that an assessment is wrong, why it is wrong, and by how much it is wrong.[3]
8. The standard of proof in civil proceedings is the balance of probabilities.[4] This standard is met if it is proved that a matter is "more likely than not".[5] Whether the Taxpayer has discharged the onus of proof is considered in the other issues.

Issue 1 | Take tuatahi: Input tax deductions

9. In Issue 1, all legislative references are to the GSTA unless stated otherwise.
10. The Taxpayer claimed input tax deductions for goods and services it acquired, including insurance, motor vehicle expenses, lunches, valuation and purchase of assets. No further explanation of these items was provided by either party.
11. CCS argued that due to the lack of documentation, particularly tax invoices, the Taxpayer did not discharge its onus to show that the Commissioner's assessments were wrong.
12. The calculation of GST payable by a registered person is set out in s 20. Briefly, the input tax that a registered person has paid for acquiring goods and services for making taxable supplies can be offset against the GST output tax payable on taxable supplies made by the person in the same period.
13. To deduct input tax on a supply, the following requirements must be met:
    - Goods or services must have been acquired. It is not enough that a payment to a registered person is identified, it must have sufficient connection to the supply of goods and services.[6]

[1] Challenge proceedings (ie, the proceedings that would follow if this dispute proceeds to the TRA or a court) are civil proceedings.

[2] Section 149A(2) of the TAA.

[3] *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 (CA); *Beckham v CIR* (2008) 23 NZTC 22,066 (CA).

[4] Section 149A(1) of the TAA; *Yew v CIR* (1984) 6 NZTC 61,710 (CA); *Birkdale Service Station Ltd v CIR* (1999) 19 NZTC 15,493 (HC); *Case X16* (2005) 22 NZTC 12,216; *Case Y3* (2007) 23 NZTC 13,028.

[5] *Miller v Minister of Pensions* [1947] 2 All ER 372, 374.

[6] *CIR v New Zealand Refining Co Ltd* (1997) 18 NZTC 13,187 at 13,193.

- The goods or services acquired must have been used for, or available for use in, making taxable supplies (s 20(3C)).[7]
- The taxpayer must have held the relevant tax invoices when the input tax deductions were claimed (s 20(2)(a)).
- The tax invoice must generally satisfy the requirements for a "tax invoice" (ss 24(3) or 24(4)). The requirement for a tax invoice is an evidential requirement of the GSTA to ensure real supplies are being made which are within the GST base.[8]
- It is not enough that the taxpayer merely shows there was a supply made to them. It must go further and provide sufficient particulars of the supply, generally in a tax invoice.[9]
- In some circumstances, an input tax deduction can be claimed without a tax invoice. These include where:
  - A tax invoice is not required for supplies made for a consideration of $50 or less (s 24(5)).
  - The Commissioner has provided a waiver under s 24(6).
  - There is a supply of second-hand goods to which s 24(7) applies and sufficient records are maintained as required.
- Even if the above requirements for an input tax deduction are satisfied, the Commissioner may determine that no such deduction is available if sufficient records are not kept in accordance with s 75.

14. In this dispute, the Taxpayer provided several documents as evidence. None of the documents that related to the relevant GST periods were tax invoices or show the amount of GST on individual supplies. It is not enough that the documents show that payments were made – the Taxpayer must show that any payments it made had a sufficient connection to its taxable supply. Further, there was no suggestion of a waiver being granted by the Commissioner under s 24(6). Therefore, the Taxpayer did not satisfy the onus of proof to show that it acquired the services for which it claimed input tax deductions, and so was not entitled to the input tax deductions claimed.

Issue 2 | Take tuarua: Income tax deductions

15. In Issue 2, all legislative references are to the ITA unless stated otherwise.
16. CCS considered that some of the expenditure deducted by the Taxpayer in its income tax return was not incurred by the Taxpayer but by either Company A or by the Director. Further, CCS argued that the Taxpayer had not provided sufficient documentation to support deductions for guarantee payments, loans written off (bad debts), interest paid or other miscellaneous expenses.
17. The Taxpayer argued that it incurred certain expenses for these reasons:
    - The Taxpayer took over the operation conducted by the Director as a sole trader, including the liabilities, obligations and income streams of the operation.
    - The Taxpayer was providing director services for Company A. As a result of Company A's liquidation, the Taxpayer (as Company A's director) was required to meet some of the company's liabilities under legislation.
18. Section DA 1, referred to as the general permission, contains the general rule allowing deductions. A taxpayer can deduct expenditure or loss under s DA 1(1)(a) if the taxpayer shows the following:
    - They have incurred the expenditure or loss. "Incurred" means a taxpayer must have either paid for or become "definitively committed to the expenditure"[10] and the expenditure must constitute an existing obligation.[11]
    - There is sufficient nexus or connection between the expenditure or loss and the derivation of income by the taxpayer. This is established by determining the true character of the payment.[12]
19. However, even if a person is allowed a deduction under s DA 1, the deduction may be denied under s DA 2 if one or more of the general limitations apply:
    - The private limitation denies a deduction for expenditure or loss to the extent it is of a private or domestic nature.[13]
    - The capital limitation denies a deduction for expenditure or loss to the extent it is of a capital nature.[14]

[7] *Case Z12* (2009) 24 NZTC 14,142; *CIR v Trustees in the Mangaheia Trust* (2009) 24 NZTC 23,711.

[8] *Case Z12* at [27].

[9] *Case 1/2012* (2012) 25 NZTC 1,013 at [147].

[10] *FC of T v James Flood* (1953) 88 CLR 492. See also *New Zealand Flax Investments Ltd v FC of T* (1938) 61 CLR 179 at 207.

[11] *A M Bisley & Co Ltd & Ors v CIR* (1985) 7 NZTC 5,082.

[12] *CIR v Banks* [1978] 2 NZLR 472 (CA), *Buckley & Young Ltd v CIR* [1978] 2 NZLR 485 (CA).

[13] *CIR v Haenga* (1985) 7 NZTC 5,187 (CA), *Reid v CIR* (1990) 12 NZTC 7,153 (HC).

[14] The approach to distinguish between capital and revenue expenditure follows the tests set out in *BP Australia Ltd v FCT* [1965] 3 All ER 209, which has been adopted in subsequent New Zealand cases, see for example *CIR v Wattie* (1998) 18 NZTC 13,991 (PC) and *Poverty Bay Electric Board v CIR* (1999) 19 NZTC 15,001 (CA).

20. TCO concluded that the Taxpayer had not shown, on the balance of probabilities, that it had incurred a large amount of the expenditure subject to the dispute, and therefore a deduction was not allowable, because:
    - There was no evidence that the Taxpayer had assumed the legal obligations of Company A as a director, and in any case a non-natural person cannot be a director of a company.
    - The Taxpayer had not provided any documentation to support the argument that it had assumed the liabilities that the Taxpayer purportedly took over from the Director.
    - The tax invoices provided by the Taxpayer showed the expenditure was incurred by Company A or by the Director in their personal capacity.
    - The Taxpayer had not provided documentation to show that all of the miscellaneous expenditure claimed was business related.
21. Having determined that the general permission was not satisfied for the expenditure claimed, it was not necessary for TCO to consider whether the general limitations applied.
22. For bad debts, a taxpayer is allowed a deduction, under s DB 31, for a bad debt to the extent that it is written off in the income year. A debt is bad when a reasonably prudent commercial person would conclude there is no reasonable likelihood that the debt will be paid.[15] Writing off a debt as bad requires more than a mere recognition by the taxpayer that it is unlikely to be paid. Appropriate bookkeeping entries are required.[16]
23. While the Taxpayer's financial statements showed a difference in its loan balances between two income years, there were no notes to suggest that the difference reflected an amount being repaid or written off. Nor did the Taxpayer provide any evidence to show that the loan was written off in the relevant income tax year. Therefore, it was concluded that the deduction for bad debts was not allowed.
24. Turning to the interest paid, a company is allowed a deduction, under s DB 7, for interest incurred. This supplements the general permission and, among other things, overrides the capital limitation (s DB 7(8)). The only requirement is that the taxpayer shows that it has incurred the interest. The purpose of the underlying loan, or the use of the loaned monies, is not relevant for a deduction under s DB 7.
25. TCO concluded that the bank statements provided by the Taxpayer did show that it obtained loans and paid interest on those loans. The Taxpayer had therefore incurred some interest. It was concluded that the Taxpayer was allowed a deduction for the amount of interest shown on the bank statements it provided.

Issue 3 | Take tuatoru: Understated income

26. In Issue 3, all legislative references are to the ITA unless otherwise stated.
27. CCS considered that the Taxpayer had understated its income in its income tax return. This was based on deposits shown in the Taxpayer's bank accounts and the difference between the sales returned in the tax return and corresponding GST returns. CCS argued the Taxpayer had not provided sufficient evidence to prove these amounts were not income.
28. When a taxpayer provides insufficient evidence of their return of income, the Commissioner can use the information in her possession to reach a reasonable conclusion about the income of a taxpayer.[17]
29. Where the Commissioner determines from the information available to her that a taxpayer has an amount of income, the onus is on the taxpayer to prove that the amount is not income.[18] The taxpayer is required to do more than simply provide a credible possible alternative explanation for the amounts.[19] The taxpayer must prove on the balance of probabilities that the Commissioner's proposed assessments of income are wrong and by how much they are wrong.[20]
30. Further, an amount is business income if it is derived from the current operations of a business or arises in the ordinary course of the business.[21] The unexplained bank deposits in this case may have been business income.[22]

[15] *Budget Rent A Car Ltd v CIR* (1995) 17 NZTC 12,263.

[16] *Case N69* (1991) 13 NZTC 3,541 at 3,547, *Case P53* (1992) 14 NZTC 4,370 at 4,377, *Case W3* (2003) 21 NZTC 11,014. See also Public Ruling BR Pub 18/07: *Income Tax and Goods and Services Tax – writing off debts* as published in *Tax Information Bulletin* Vol 30, No 9 (October 2018) at 3.

[17] *Case 2/2017* [2017] NZTRA 02, (2017) 28 NZTC 4,001 at [9].

[18] *Yew v CIR* (1984) 6 NZTC 61,710 (CA); *Case Y3* (2007) 23 NZTC 13,028; *Case X16* (2005) 22 NZTC 12,216.

[19] *Case S30* (1995) 17 NZTC 7,207 at 7,211; *Case E69* (1982) 5 NZTC 59,378.

[20] *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 at 61,283.

[21] See section CB 1; definition of "business" in s YA 1; *CIR v City Motor Service Ltd* [1969] NZLR 1,010 at 1,017; *FCT v The Myer Emporium Ltd* 87 ATC 4,363; and *FCT v Montgomery* 99 ATC 4,749.

[22] See for example, *Case F42* (1983) 6 NZTC 59,773 and *Case L40* (1989) 11 NZTC 1,249.

31. In this dispute, the Taxpayer did not provide an explanation about its income and CCS was entitled to make a reasonable assessment of the Taxpayer's income based on the information it had about the Taxpayer's business. TCO concluded that the Taxpayer had not satisfied the onus of proof that the income amount proposed by CCS was wrong and considered that the basis for CCS's assessment was a reasonable one.

Issue 4 | Take tuawhā: Shortfall penalties

32. In Issue 4, all legislative references are to the TAA unless stated otherwise.
33. In this dispute, the Taxpayer took tax positions in its GST returns and income tax return. The tax shortfalls for each period in dispute are the difference between the tax effect of the Taxpayer's tax position and the tax effect of the correct tax position.
34. CCS submitted that the Taxpayer was liable for a gross carelessness shortfall penalty or, alternatively, a shortfall penalty for not taking reasonable care for the tax positions taken in the GST and income tax returns. As a further alternative, CCS submitted that, if the Taxpayer was not liable to pay a penalty for not taking reasonable care for the income tax shortfall, the Taxpayer was liable to pay an unacceptable tax position shortfall penalty.

Shortfall penalty for gross carelessness

35. Section 141C imposes a shortfall penalty for gross carelessness on a taxpayer if the following requirements are satisfied:[23]
    - The taxpayer has taken a tax position.
    - Taking the tax position has resulted in a tax shortfall.
    - The taxpayer has been grossly careless in taking the taxpayer's tax position. Gross carelessness means doing or not doing something in a way that, in all of the circumstances, suggests or implies a complete or high level of disregard for the consequences (s 141C(3)):
      - Gross carelessness is characterised by conduct which creates a high risk of a tax shortfall occurring where that risk and its consequences would have been foreseen by a reasonable person in the circumstances.[24]
      - The test for gross carelessness is not whether the taxpayer actually foresaw the probability that their act or omission would cause a tax shortfall but whether a reasonable person would have foreseen that probability.[25] Whether the taxpayer has acted intentionally is not a consideration.[26]
      - A person who takes reasonable care is not grossly careless. Taking reasonable care includes exercising reasonable diligence to determine the correctness of a return, keeping adequate records, and generally making a reasonable attempt to comply with tax law.[27]
      - A taxpayer who adequately informs and follows the advice of a qualified tax agent takes reasonable care and is not careless.[28]
36. The following factors may be relevant in determining whether a reasonable person would have foreseen that their conduct created a high risk of a tax shortfall occurring:[29]
    - the significance of the transaction leading to the tax shortfall;
    - the taxpayer's level of experience in the relevant tax laws;
    - previous warnings given by Inland Revenue or advisors in relation to the risk of the tax shortfall.
37. The penalty payable for gross carelessness is 40% of the resulting tax shortfall.
38. Section 141C(4) provides that a taxpayer who takes an acceptable tax position is not grossly careless in taking their tax position. A tax position is an acceptable tax position if it is "about as likely as not to be correct". This is determined objectively.[30]

[23] The shortfall penalty for gross carelessness is considered in the Interpretation Statement IS0060: *Shortfall Penalty for Gross Carelessness* as published in *Tax Information Bulletin* Vol 16, No 8 (September 2004).

[24] *Case W4* (2003) 21 NZTC 11,034 at [44].

[25] *Case 9/2014* (2014) 26 NZTC 2,019 at [88].

[26] *Case W4* at [60].

[27] *Case W4* at [60].

[28] *Re Carlaw and FCT* 95 ATC 2166 (AAT); *Re Sparks and FCT* [2000] AATA 28 and see also *Pech v Tilgals* [1994] ATC 4206.

[29] *Case W4*.

[30] See definition of "acceptable tax position" and "unacceptable tax position" in s 3(1) and s 141B.

39. A tax position will be "about as likely as not to be correct" and, therefore, an acceptable tax position, if:
    - The tax position is close to or around 50% likely to be correct.[31]
    - The merits of the arguments supporting the tax position are substantial.[32]
    - On balance, the tax position is one that, while wrong, could be argued on rational grounds to be right.[33]
    - There is room for a real and rational difference of opinion.[34]
    - The taxpayer's tax position is one about which "reasonable minds could differ".[35]
40. It was considered that the Taxpayer's tax positions were not about as likely as not to be correct and, therefore, were not acceptable tax positions. The Taxpayer claimed input tax and income tax deductions without holding the relevant tax invoices or keeping sufficient records to establish that it had incurred the expenses. Also, the Taxpayer did not prove it had included all of its income in its income tax return. The Taxpayer had not provided any information to show CCS's proposed adjustments were wrong or the extent they were wrong. There is, therefore, no room for a real and rational difference of opinion between the Taxpayer's tax position and the correct tax position.
41. TCO considered that the Taxpayer did not take acceptable tax positions in this dispute and the tests for gross carelessness had been met for these reasons:
    - The Taxpayer filed GST and income tax returns that resulted in tax shortfalls.
    - The Taxpayer did not keep adequate records as required by the GSTA and the TAA. It was considered that a reasonable person would foresee the probability that their omission to keep records to substantiate deductions claimed would cause tax shortfalls.
    - Not keeping the required records suggests a complete or high level of disregard for the consequences. It was also considered that the Director, who filed the returns on behalf of the Taxpayer, had a background that indicated they ought to have a good understanding of the record keeping requirements.
42. The Taxpayer was, therefore, liable to pay a shortfall penalty for gross carelessness.

Shortfall penalty for not taking reasonable care

43. Section 141A imposes a shortfall penalty on a taxpayer for not taking reasonable care if the following requirements are satisfied:[36]
    - The taxpayer has taken a tax position.
    - The taxpayer's tax position has led to a tax shortfall.
    - The taxpayer has not taken reasonable care in taking the taxpayer's tax position.
44. A taxpayer will be treated as having taken reasonable care in these two situations:
    - If the taxpayer has relied on the action or advice of a tax advisor engaged by the taxpayer.[37]
    - If the taxpayer has taken an acceptable tax position.[38]
45. Case law has also developed the following principles about "reasonable care":
    - The test of "reasonable care" is whether a reasonable person in the taxpayer's circumstances would have foreseen a tax shortfall as a reasonable probability.[39]
    - Reasonable care includes exercising reasonable diligence to determine the correctness of a return, keeping adequate records to properly substantiate a return and generally making a reasonable attempt to comply with tax law.[40]

[31] *Case U47* (2000) 19 NZTC 9,410.

[32] *Ben Nevis Forestry Ventures Ltd v CIR* [2008] NZSC 115.

[33] *Ben Nevis* and *Walstern v FCT* [2003] FCA 1,428.

[34] *Walstern.*

[35] *Walstern* and *Case X25* (2006) 22 NZTC 12,303.

[36] The shortfall penalty for not taking reasonable care is considered in Interpretation Statement IS0053: *Shortfall penalty for not taking reasonable care* published in *Tax Information Bulletin* Vol 17, No 9 (November 2005).

[37] Section 141A(2B).

[38] Section 141A(3).

[39] *Case W4* at [59].

[40] *Case W4* at [60]-[61].

- What is considered "reasonable" may vary depending on a number of factors, including:[41]
  - the experience of the taxpayer;
  - the type of tax involved;
  - the size and nature of the business;
  - the complexity of the law;
  - the particular transaction;
  - the difficulty and expense of taking appropriate precautions.

46. A taxpayer is vicariously responsible for any tax position taken by its officers or employees.
47. The penalty payable for not taking reasonable care is 20% of the tax shortfall.
48. In this dispute, the Taxpayer was vicariously responsible for the tax positions taken by the Director. It was concluded that the Director did not keep sufficient records to substantiate the deductions claimed and did not take reasonable care in taking the Taxpayer's tax positions. The Taxpayer was, therefore, liable for the shortfall penalty for not taking reasonable care shortfall penalty.

Shortfall penalty for an unacceptable tax position

49. Section 141B imposes a shortfall penalty for an unacceptable tax position on a taxpayer if the following requirements are satisfied:[42]
    - The taxpayer has taken a tax position.
    - The taxpayer's tax position results in a tax shortfall exceeding the threshold in s 141B(2) of being more than both:
      - $50,000, and
      - 1% of the taxpayer's total tax figure for the relevant return period.
    - The tax position is an unacceptable tax position. A tax position will be an unacceptable tax position if:
      - the tax position, viewed objectively, fails to meet the standard of being about as likely as not to be correct, and
      - none of the exceptions in s 141B(1B) to (1D) apply.
50. The shortfall penalty is 20% of the tax shortfall.
51. In this dispute, TCO concluded that the Taxpayer was liable for a shortfall penalty for taking an unacceptable tax position for these reasons:
    - The Taxpayer took a tax position that resulted in tax shortfalls.
    - It was already concluded that the Taxpayer's tax position did not meet the standard of being about as likely as not to be correct due to the Taxpayer's lack of documentation (see para 40 above).
    - None of the exceptions in s 141(1B) to (1D) applied.
    - The tax shortfall exceeded the threshold amounts in s 141B(2).

Shortfall penalties conclusion

52. As the requirements of all three proposed shortfall penalties were satisfied, the highest gross carelessness shortfall penalty was applied to the tax shortfalls arising in each period in dispute. The shortfall penalties for not taking reasonable care and for an unacceptable tax position were not applied (s 149(2) and (3)).

[41] *Case W3* (2003) 21 NZTC 11,014.

[42] The shortfall penalty for taking an unacceptable tax position is considered in the Interpetation Statement IS0055: *Shortfall Penalty – Unacceptable intepretation and unacceptable tax positions* as published in *Tax Information Bulletin* Vol 17, No 9 (November 2005).

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