KPMG Centre
18 Viaduct Harbour Ave
PO Box 1584
Auckland 1140
New Zealand
T: +64 9 367 5800

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The Chair
Finance and Expenditure Committee
Parliament Buildings
Wellington

9 November 2021

Dear Madam Chair

KPMG submission - Taxation (Annual Rates for 2021-22, GST, and Remedial Matters) Bill

We welcome the opportunity to make a submission on the Taxation (Annual Rates for 2021-22, GST, and Remedial Matters) Bill (referred to hereafter as "the Bill") and Supplementary Order Paper No 64 ("the SOP").

We have split our submission into general comments on key matters raised in the Bill and SOP and our more detailed submissions on specific measures.

Given the wide range of matters covered, of both a policy and remedial nature, in the Bill and SOP, we have not had an opportunity to consider every amendment. Therefore, where we have not commented on a particular amendment, this does not necessarily signal our support (or lack of support) for the change.

Why we are active participants in the policy and legislative process

We were recently asked why we participate in the generic tax policy process (the "GTPP"), which includes providing feedback on this particular piece of tax legislation. Implicit in that question is that our interests would appear to be better served by poor quality legislation and policy as we could charge our clients more. We thought our response may be useful for the record, for the Committee.

Over a number of years, KPMG has spent many hours engaged in the GTPP. We provide submissions on Government discussion documents and Taxation Bills, engage with Officials and Members of Parliament and present to Select Committees. We respond to many requests for feedback from Inland Revenue on proposed policies, operational guidance and interpretations.

Fundamentally, we consider that good tax law is key to the functioning of our economy. Good tax law includes the policy, the legislation and its application by taxpayers, Inland Revenue and the Courts.

We engage in the GTPP because we can offer:

- A potentially different perspective to that of Officials and Government and can challenge some of the thinking around a particular policy or policy issue; and

- Practical experience of how tax law applies and therefore how a change may actually apply and be implemented.

We believe our involvement, and that of other advisors and professional bodies such as Chartered Accountants Australia New Zealand and the New Zealand Law Society, produces better tax law and policy.

Our perspective and experience is based on involvement with the tax system and with business. We see how both operate. That informs our approach. We recognise that not all of our submissions are accepted. However, even so, that they are considered does help improve the outcome.

We therefore have no interest in poor tax policy or law. It creates uncertainty which is inimical to business interests. It is frustrating for our clients. We bear that frustration when we are unable to provide clear and certain answers. Practically, our clients do not like to pay for non or unclear advice. It also creates risk for us. Accordingly, when we disagree with a policy, we still make submissions to make the outcome as clear and workable as possible. Hopefully that is apparent from some of our submissions on the Bill.

While we may gain a practical benefit from being part of the process, this is necessary to understand any changes to provide guidance to our clients. Engagement with the GTPP helps with self-education and therefore with our ability to help clients meet their obligations. That is a key part of how we aim to fuel New Zealand's prosperity.

Interest limitation

The SOP contains new interest limitation rules for residential rental properties. The Commentary to the SOP notes that:

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

We note that the supporting Regulatory Impact analysis notes that the tax system is not the primary driver of housing affordability. It raises the very pertinent question: is limiting interest deductions an efficient and effective way of addressing these concerns?

In our submission on the Government discussion document, *"Design of the interest limitation rules and additional bright-line rules"*, we were not convinced that interest limitation would address the Government's housing affordability objective. And, importantly, not without significant adverse impacts on the tax system's efficiency, coherence and simplicity.

That remains our view, perhaps even more so now that we have had an opportunity to view the SOP and the complex drafting therein. **Clearly these are not simple rules, however, much of the target audience that will be expected to comply with them will be "mum and dad" investors.**

We have attached a copy of our original submission, for the Committee's information. We have not attempted to replicate all those points here. However, in summary:

- We do not support the interest limitation proposals. We consider these changes are bad tax policy and recommend that the part of the SOP containing these changes should be withdrawn.
- If our principal submission is not supported, we strongly recommend that the application date of the new rules should be deferred from 1 October 2021 to 1 April 2022. This would result in the rules having prospective effect, rather than taxpayers having to apply a pending law change. As an alternative, the application date could be split so that the rule for acquisitions prior to 27 March 2021 would only apply from 1 April 2022. This would allow affected taxpayers to properly consider the new rules and apply them prospectively. The rules would apply from 1 October 2021 for any acquisitions after the announcement date.

- We strongly advocate for simplicity in the rules' design. Our specific submissions focus on some of these design issues.

GST policy changes and remedial amendments

We generally support the proposed changes in the Bill to the GST Act. Our main submissions are on the changes relating to tax invoice/taxable supply information requirements. We also comment on the GST grouping proposals.

As a general submission, we think it is timely for a rewrite and re-ordering of the GST Act to be considered (similar to the Income Tax rewrite of the early 2000s). The GST Act has undergone a significant number of amendments and changes since its introduction in 1985. The current GST proposals, particularly those in respect of tax invoice/taxable supply information, add further impetus to this given the sheer number of changes and amendments that the Bill introduces.

Other Policy items

We are broadly supportive of the following "Other Policy" matters in the Bill, subject to any detailed submissions:

- Changes to improve the workability of the Fair Dividend Rate foreign currency hedges rules.
- Clarifying that cryptocurrency assets will generally be excluded from the financial arrangements rules.
- Allowing taxpayers to use tax pooling to satisfy an additional tax liability relating to a range of tax types (including income tax, PAYE, GST, FBT and withholding taxes) arising from a voluntary disclosure, when there is no pre-existing assessment. One feature of this change is that the voluntary disclosure would need to be made within a "reasonable time frame". This period is to be set in either Inland Revenue guidance or by Order in Council. As the time to identify and address errors could vary depending on the particular tax type and circumstances of the taxpayer, we suggest caution in mandating a "one size fits all" timeframe.

We also support the new pooled alternative rate option for FBT, introduced in the SOP. This is a solution to a problem that should never have been created in the first place. When the FBT single rate was raised to 63.93% (to accompany the new 39% top marginal tax rate), thought should have been given to how the FBT rules are applied in practice. This is an example of when the GTPP is useful in making sure good law, which is consistent with Government policy, is passed.

Remedial items

We support the following amendments:

- Ensuring that the main home exclusion from the bright-line test is still applicable where construction of the property takes longer than 12 months.
- Clarifying the application of the 12-month buffer for the main home exclusion from the bright-line test (specifically to ensure that multiple non-consecutive periods of non-main home use of less than 12 months each are not a disqualifying event).
- Amending the definition of "residential income", for the purposes of the rental loss ring fencing rules, to include foreign exchange gains and losses relating to foreign currency denominated residential mortgages. However, should the interest limitation rules proceed, we consider that a principal purpose for rental loss ring fencing would be removed and these rules should be repealed.

— Amending the de minimis concession for unclassified benefits so that benefits provided by an associated person are only counted under the de minimis test where the employer and associate are members of the same wholly-owned group.

— Allowing the Approved Issuer Levy ("AIL") to be paid where the borrower and lender are only associated through a securitisation trust and allowing taxpayers to elect into the securitisation regime from the commencement of a securitisation arrangement.

— Clarifying the definition of "end investor" to ensure that a non-resident custodial institution which operates in New Zealand through a fixed establishment (such as a branch) can still apply the new investment income reporting rules as intended. This is necessary to ensure other non-NZ branches of the non-resident can still be treated as an end investor for NZ reporting and withholding tax purposes.

— Treating the same notional single person as holding the shareholding in a spun-out company, to address shareholding continuity problems. As these rules are complex, however, we recommend Officials be asked to confirm with examples how the rules are intended to apply in practice. The Commentary also notes that the Bill does not address all problems caused by corporate spin outs, due to their complexity and the limited timeframe to consider them. We agree that a wider review of these rules is needed and encourage the Committee to instruct Officials to consider this as a matter of priority.

— Clarifying the application of the related party debt remission rule. In particular, we strongly support the extension of the rule to remissions of debt owed by a New Zealand branch of a non-resident to a member of the non-resident's wholly-owned group.

— Reducing the Employer Superannuation Contribution Tax ("ESCT") rate for contributions to past employees from 39% (following the 1 April 2021 personal tax rate change) to 33% (the rate prior to that change). We agree that the 39% rate's application will significantly over-tax most employees. The Bill proposes that this remedial amendment will only have effect from 1 April 2022, meaning contributions made to past employees during the 2021-22 tax year will be overtaxed. There should be the ability for a ESCT refund to be sought for the 2021-22 year.

— Confirming that the filing of an "ancillary tax" return (such as for RWT, NRWT, AIL) can be treated as an assessment, for refunding overpaid tax.

— Allowing entries in imputation accounts (and other memorandum accounts) resulting from a transfer of tax from a previous period to be made on the date of the transfer request, rather than the effective date for the transfer (subject to certain conditions).

— Allowing extension to, and more specific targeting of, COVID-19 related use-of-money interest relief by Order in Council.

— Allowing investment income payers eligible for six-monthly remittance of RWT, NRWT and AIL to also report these amounts to Inland Revenue six-monthly.

— Removing tax return filing requirements for non-active estates.

— Applying the time bar provisions to KiwiSaver and ACC deductions.

Further information

We would appreciate the opportunity to discuss our submission with the Committee. Please contact us – Darshana on 09 367 5940 or Rachel on 09 363 3535 – if you require any further information on our submission.

Yours sincerely

D. Elwela

R.K. Piper

Darshana Elwela
Partner

Rachel Piper
Partner

Detailed submissions on the Bill and SOP

Interest limitation

Issue 1: New concepts and terminology

The SOP, in implementing interest limitation introduces a number of new tax concepts, such as "disallowed residential property", "excepted residential land", "grandparented transitional loan, and "transitional residential interest". It also contains a number of complex formulas.

Keeping in mind that the target audience of the changes is not going to be taxpayers experienced in applying complex tax legislation, it is highly unlikely that they will be able to apply the legislation as currently drafted.

Submission

We recommend that some of the terminology be reconsidered to make it more "user friendly" (consistent with the plain language drafting approach for the Income Tax Act 2007).

However, even with drafting simplification, the onus will be on Inland Revenue to publish clear, practical comprehensive guidance to enable taxpayers to comply. We recommend the Committee instruct Officials to ensure that this is the case.

Issue 2: Definition of "disallowed residential property"

The SOP proposes to exclude residential land outside New Zealand from the scope of the interest limitation rules.

Submission

We agree that land outside New Zealand should not be included.

Comment

The overall purpose of the rules is to benefit New Zealand's housing supply. Investment in land outside of New Zealand does not affect domestic housing supply and therefore should not be included.

Issue 3: Application of interest limitation to companies

The interest limitation rules will apply to certain companies, removing their current automatic interest deduction. This includes most closely-held companies, a "residential land company" or a "residential wholly-owned group member".

Submission

Consideration should be given to allowing flexibility in determining whether a company meets the definition of a "residential land company" or a "residential land wholly-owned group member".

Comment

The test as currently drafted in the SOP will require daily monitoring of the 50% residential land threshold to determine whether a company is a "residential land company" or a "residential land wholly-owned group member". This will result in compliance costs for taxpayers from having to monitor this boundary. There is also a risk that, because the definition applies if the

50% threshold is exceeded at any time, the definition may apply even if for most of the year the company held no residential property assets.

An option that allows taxpayers to test the residential land percentage on an averaged quarterly basis, as is available in the thin capitalisation rules, would be preferable in this regard.

Issue 4: Interest incurred for a land business

The SOP proposes an exemption from the interest limitation rules for interest incurred in relation to residential land held by a person in the business of developing, dividing or dealing in land or erecting buildings.

Submission

We support proposed new section DH 4(2) to exempt from the interest limitation rules, interest incurred for land held by property developers, subdividers, dealers and builders for a land-related business as described in section CB 7. The need for this carveout, and the one in new section DH 4(3) discussed below, is illustrative of the additional complexity created by the interest limitation change.

Issue 5: Interest incurred for property development activities

The SOP also proposes an exemption from the interest limitation rules for interest incurred in relation to residential land held by a person undertaking a scheme involving developing, dividing or dealing in the land or erecting buildings.

Submission

We also support proposed new section DH 4(3) to exempt interest incurred in relation to residential land that is part of an undertaking or scheme involving developing, subdividing or building to create "new build land".

Issue 6: Exclusions from the exemption for new build land

Extensive renovations and rebuilding will not meet the new build definition, as currently defined.

Submission

The proposed definition of "new build land" should be expanded to include extensive renovation of a residential property that is uninhabitable.

Comment

The objective of the new build exemption is to ensure that the interest limitation rules do not adversely impact on housing supply. In the June Government discussion document, *"Design of the interest limitation rule and additional bright-line rules"*, feedback was sought on whether renovating an uninhabitable dwelling so that it becomes habitable should be considered a "new build". The proposed new build definition in the SOP does not include this however.

Extensive renovation of an unhabitable residential property to make it habitable should be included on the basis that this work will contribute to overall housing supply, which is the stated policy driver for this change. We therefore recommend the scope of the definition of "new build land" be extended to include this activity.

Issue 7: conversions of land

The SOP proposes that conversion of certain non-residential buildings into self-contained residences will qualify as "new build land".

Submission

The SOP (in section DH 7(d)) specifically refers to "land that was a hotel or motel" being converted. However, we understand the policy intention is that the scope should be wider – e.g. it is intended to include office and other commercial property that is converted to residential living. We recommend that this be legislatively clarified in section DH 7, for the avoidance of doubt.

Issue 8: Implications of interest limitation for the loss ring-fencing rules

The loss ring-fencing rules for residential property will continue to apply under the interest limitation rules.

Submission

The loss ring fencing restrictions should be repealed.

Comment

If the interest limitation rules as proposed are enacted, it would seem that residential rental properties are very likely to produce taxable profits, with losses only at the margins (e.g. due to significant repairs and maintenance expenditure). This is particularly so given that depreciation deductions are no longer available for residential investment properties. Therefore, net rental losses can be expected to be ad hoc, if at all. On this basis, we believe that the rationale for loss ring fencing rules is no longer valid and these rules should be repealed. Particularly as the interface between the proposed interest limitation rules and rental loss ring fencing is complex and is likely to result in potential unintended consequences.

Issue 9: Interest on foreign currency residential mortgages

Foreign currency denominated residential loans will be within scope of the interest limitation rules as they cannot qualify as a "grandparented transitional loan" (under proposed section DH 5(5)).

Submission

The proposal to deny a deduction for interest for a residential loan denominated in a foreign currency, even if it meets the other requirements for the transitional phasing out of interest, should not proceed.

Comment

The policy rationale for this rule is not clear. Denying taxpayers an interest deduction during the transitional phase of the interest limitation rules for foreign currency denominated residential loan is unprincipled. There is no difference between NZD denominated loans and foreign currency denominated loans. Other parts of the Income Tax Act assume economic equivalence between the net result of a foreign currency denominated loan and NZD borrowings. The proposed approach also ignores that all loans are subject to the financial arrangement rules.

Issue 10: Grandparented transitional loans that cannot be traced

Notional loan principal can be calculated where it is not possible to trace how much of the loan relates to "disallowed residential property" (under proposed section DH 7).

Submission

Proposed section DH 7 should also apply where it is difficult and not practical to trace the use of the loans.

Comment

Extending proposed section DH 7 in this manner will avoid complexity, reduce compliance costs and avoid disputes as to whether tracing is possible.

Issue 11: High watermark

The SOP proposes rules to simplify interest deductibility for variable balance loans. The "high watermark" proposal applies to variable loan balances on 26 March 2021 and caps interest deductions, during the phase out period, to interest on the amounts calculated as at that date (with adjustments for subsequent drawdowns and repayments).

While we support the high watermark proposal, this will require complex calculations, including apportionments for any private expenditure and to exclude any business interest expenditure (which remains fully deductible). Example 44 of the Commentary illustrates this complexity.

Submission

Consideration should be given to further simplifying the operation of the high watermark rule, particularly as any interest deductibility will only apply for the transitional 5 year period (and on a reducing basis at that).

Issue 12: Refinancing

Submission

We support allowing a taxpayer to refinance a grandparented transitional loan on or after 27 March 2021, such that the interest on the refinanced loan will follow the treatment of the initial loan. We note the Commentary to the SOP states that this proposal is yet to be included in the SOP drafting, which is problematic particularly as taxpayers are being asked to apply these rules presently.

Issue 13: Income from loans denominated in a foreign currency

Income arising from a foreign currency denominated loan used for disallowed residential property will be treated as exempt income (under proposed section CW 62C).

Submission

We support the proposal to exempt income arising from a foreign currency denominated residential loan, particularly if our submission above to allow foreign currency denominated loans to be treated as grandparent transitional loans is not accepted.

Issue 14: Disposal of disallowed residential property also subject to interest limitation

As a general principle, the SOP proposes that previously denied interest is available on disposal of disallowed residential property (as it is included in the cost of the property). We support this approach, as one of the options in the Government discussion was an unprincipled complete disallowance.

The SOP proposes non-deductibility for previously denied interest deductions if disposal of property is on capital account (under proposed section DH 11).

Submission

We recommend that a deduction be allowed on the disposal of "disallowed residential property" held on capital account to the extent that the disallowed interest exceeds the non-taxed gain on disposal of the property.

Comment

Our recommendation would effectively recognise that the interest cost incurred relates to both the capital gain amount and the taxable income that has already been returned during the period of ownership. Not allowing any interest deduction where the property is held on capital account will result in economic over-taxation, where the interest incurred exceeds the non-taxed gain.

Issue 15: interest limitation anti-avoidance rules

New section GB 53B and 53C are proposed as anti-avoidance rules.

Submission

While we understand the need to address situations where the interest limitation rules may be subject to circumvention, there needs to be clear guidance on how these rules may be applied in practice by Inland Revenue (as they also incorporate a tax avoidance purpose or intent test).

Issue 16: 5 year "new build" bright-line test period

The Bill proposes that the criteria for applying the reduced 5 year new build bright-line test will be narrower than the new build exemption from the interest limitation rules (under proposed section CB 6A(2)(b)(i)).

Submission

We support a 5 year bright-line period for new builds. However, we recommend that consideration should be given to applying this to subsequent purchasers to align with the new build exemption from the interest limitation rules.

Comment

We recognise the rationale for wanting to limit the benefit of the shorter bright-line period to early owners only. However, consideration should be given to whether its application to subsequent purchasers as well may better support the Government's objective of encouraging new housing supply. In addition, alignment of the various new build exemptions will reduce complexity.

Issue 17: Application of rollover relief

The SOP proposes new rollover relief provisions for the purposes of the interest limitation rules and extends these for bright-line test purposes. We support the availability of rollover relief. Our comments below are specifically in relation to the bright-line test.

Submission 1

Rollover relief should apply broadly, to all transfers to associated persons, including the taxpayer in their different capacities.

Comment

The premise for these changes, as stated in the Commentary, is that rollover relief is appropriate in situations where there is a disposal for legal purposes or tax purposes, but no disposal in economic substance. Based on this rationale, the scope of the rules as proposed is too limited.

In our view, extensive rollover relief for associated persons transfers needs to be considered, particularly given the extension of the bright-line period to 10 years.

There are many situations where family arrangements or restructures occur which trigger or reset the bright-line rules or result in other unintended tax consequences. This includes the increasingly common situation where parents may help their children buy a property which is initially acquired in the parents' name and is transferred to the child/children at a later date.

As another example, transfers into a family trust by a principal settlor who is also a beneficiary will receive rollover relief. But as currently drafted the rules do not capture transfers out of a family trust to a beneficiary. There is no justification for distinguishing between these two situations. If Officials are willing to accept that a transfer into a trust is not a disposal of land in economic substance, despite the fact that persons within four degrees of blood relationship may then benefit from ownership of the property, then likewise it should be acceptable that a trust could transfer the property out to such a person. This could be overlaid with an anti-avoidance rule to prevent using a transfer into a trust as an intermediate step to ultimately change ownership from one individual to another individual (i.e. it is limited to valid trust transactions that do not have the purpose or effect of defeating the bright-line rules).

We therefore recommend that consideration be given to a carve out from the bright-line rules for family-related restructures. An alternative approach would be to allow for rollover relief in defined circumstances, such as for transfers between associated persons.

Rollover relief should also extend to wholly-owned corporate group transfers, e.g. restructures, where there is 100% economic ownership (outside of amalgamations which already have relief or those under the consolidation rules).

We consider that the rule relating to look through companies ("LTCs") should also be extended to explicitly apply to a deemed disposal and acquisition under section HB 4(6) due to cessation of LTC status. This is consistent with the fact that there is no disposal of the land in economic substance in this scenario (i.e. the same person, or group of persons, has continuous economic ownership of the land) and there is in fact no legal disposal of the land. If the land is currently intended to operate in this manner then we recommend that this is clarified in the legislation.

Submission 2

We generally support the proposed amendments to extend rollover relief and ensure that transfers to effect a change in co-ownership do not re-set the bright-line period. However, we consider that each of these rules as proposed requires amending to ensure the correct policy outcomes.

Comment

In our view, the proposed amendment should go wider to ensure that the bright-line period is also not reset in relation to an interest in land that is not alienated by virtue of a change in co-investment proportions.

This issue is discussed in Inland Revenue's *Draft PUB00411* statement at Examples 3 & 4. In both of those examples, part of an interest in land (not all of the interest) is disposed of which triggers income under the bright-line test for that part of the land. However, as the law is currently drafted, the Commissioner's view is that the bright-line period starts again for all parties involved for all "parts" of the land they hold.

When part of the land is disposed of in the scenario of a change in tenants in common, the vendor now owns a different proprietary interest in the land. However, this is not a new interest that has only just been acquired. It is the original interest, albeit in a smaller percentage. The original piece of land was brought based on the tax rules in place at the time and these are the rules that should continue to apply to that piece of land, regardless of the fact that part of it may be disposed of before all ownership ceases.

This difference in treatment for when part of an interest in land is disposed of for the different aspects of the rules (i.e. income from disposal under section CB 6A versus the start of the bright-line period versus which bright-line period applies) is not justifiable from a policy perspective given that there has been no change in legal or equitable ownership to that part of the land.

Section CB 23B is explicit recognition of the intention of the bright-line rules (and other land sale rules) to apply to an amount derived from the disposal of land if the land is part of the land to which the relevant section applies. We consider that Parliament intended this section to apply to the interpretation of the whole of section CB 6A so that where different parts of the land are acquired / disposed of separately, the rules at the time the remaining land was acquired continue to apply.

Consistent with Inland Revenue's analysis and logic in relation to the interaction of the disposal rules and bright-line start date rules[1], it is anomalous to suggest that Parliament specifically legislated for the bright-line rules to apply to a disposal of part of an interest in land, but nevertheless intended the bright-line period to re-start for the entire piece of the land. The clock not being re-set is consistent with the fact that there is not a (re)acquisition of part of the land in these situations. Further, the applicable bright-line period for the part of the land disposed of should also be based on when an estate or interest in that part of the land was first acquired.

We recommend that section CB 23B be amended to clarify this treatment.

Submission 3

There should be no requirement that the consideration for the transfer is less than or equal to the total cost of the residential land to the transferor for rollover relief to apply.

Comment

The Bill requires that for rollover relief to be available, the consideration on transfer must be less than or equal to the cost to the transferor.

We appreciate that in a rollover scenario that no uplift in the cost base should occur. However, the restriction doesn't make sense given that the operation of sections FC 9B(5)(a), FC 9C(3)(a), FC 9D(2)(a) and FC 9E(2)(a) will achieve this outcome in any event. The tax rules should not dictate the ability to transact commercially. In practice, the transferor may wish the transfer to be at market value for commercial or other reasons. And this is what will generally be reflected for accounting purposes. Further, this treatment is inconsistent with other deeming provisions in the Income Tax Act such as sections FC 1(1)(e) and FC 2[2] which deem transfers to occur at market value for tax purposes.

[1] See para 112 of *PUB00411* where Inland Revenue argues consistency should apply between the two treatments. Consistency across all aspects of the rules and scenarios will get to the right policy outcomes.
[2] Which will apply to gifting of land to a trust.

GST tax invoice/Taxable Supply Information ("TSI")

Submission 1

The requirement under section 19E(2)(b) for a supplier to keep "recipient details" may lead to a significant increase in compliance costs for some retailers. In many cases, it may not be possible to comply with.

Recommendation

For those suppliers who primarily deal with non-GST registered customers, the legislation should provide an option for the supplier to treat all their customers as non-registered. This would allow the retailers to switch off the issue of tax invoice / TSI, which means they would not be required to keep recipient details. The customer should be treated as GST registered only if a request for TSI is received.

Comment

Many retailers use a Point of Sale ("POS") system that automatically generates a tax invoice (i.e. TSI) at the time a transaction is completed. For example, the tax invoice is printed in the same document as the receipt, issued to the customer when a transaction is completed. This system is adopted by many retailers who have customers purchasing goods / services for business use from time to time. Having a GST compliant POS system that automatically generates tax invoices for each completed transaction is a convenient way of dealing with GST registered customers. However, such a POS system does not distinguish between GST registered customers v non-registered customers.

Under the proposed section 19E(2)(b), if TSI is issued for a supply, the supplier must keep recipient details. The meaning of "recipient details" is defined under proposed section 2(1) to include not only the recipient's name, but also, certain private information such as the telephone number, email address, physical location, or billing address of the recipient. This new record keeping requirement would apply to retailers who issues tax invoices to all of their customers (as a result of adopting a GST compliant POS system). Many of these retailers primarily deal with non-GST registered customers. It would not be practicable to collect the recipient details from all their customers.

The only way for a retailer to comply with the new record keeping requirements under section 19E(2)(b) is to switch off the issue of tax invoice / TSI. However, this could potentially expose them to the risk of not complying with the mandatory tax invoice requirements in the event the customer is GST registered.

To address this risk, the new rules should be amended to allow retailers to treat all their customers as non-GST registered. The customer should be treated as being GST registered only if a request for TSI is received. In that case, the retailer would be required to issue TSI, and obtain recipient details.

Submission 2

Under the proposed section 19F(2)(d), a **recipient** of a taxable supply is required to keep a record of the supply showing "time, or the anticipated time of supply". This is inconsistent with the record keeping requirements for a **supplier** under section 19E(2) which requires a record showing the time of supply only, <u>if that time is determined **other than** under section 9(1).</u> This inconsistency could mean that, in the event of an audit or dispute, the recipient's record of time of supply may not be easily verified against the supplier's records.

Recommendation

The requirement for a **supplier** to keep a record of the time of supply for a transaction should be same as the requirement imposed on the **recipient.**

Comment

Under section 19E(2)(e), a supplier is required to keep a record of the "time of supply" if that time is determined <u>other than</u> under section 9(1) (i.e., which deems a supply to occur at the earlier of any payment or an invoice issued). The proposed section 19E(d) and 19E(e) appear to deal with events which could trigger time of supply under section 9(1), by requiring the supplier to keep a record of the date when TSI is issued, and date of payment. However, in many cases, TSI may not be the invoice for the supply, and thus may not trigger the time of supply under section 9(1). This is because the scope of TSI is much wider than the invoice. Any document containing the requirement TSI would be TSI (e.g., purchase order confirmation), but an invoice must be a document that notifies the obligation to pay.

If there are more than one TSI issued by the supplier (e.g., both the purchase order confirmation and the invoice are TSI), then section 19E(d) would require the date of issue for both TSI to be kept. It does not require the supplier to determine which date triggered the time of supply. This is inconsistent with the record keeping requirement for a recipient under section 19F(2)(d), which clearly requires the recipient to determine and keep a record of the time of supply.

Submission 3

The requirement for a GST registered recipient to keep a record of "time of supply, or anticipated time of supply" under section 19F(2)(d) could be onerous because the proposed rules do not require the supplier to confirm the time of supply in the TSI. In cases where the time of supply is <u>**not**</u> triggered by the TSI, the recipient would have to use other information provided by the supplier to determine the time of supply. This may impose significant compliance costs on the recipient.

Recommendation

Section 19K(8) should be amended to require the supplier to confirm the time of supply for the transaction, in situations where the issue of TSI does not trigger the time of supply.

Comment

In many situations, the time of supply for a transaction is triggered by an event other than the issue of an invoice. For example, for related party transactions, the time of supply could be triggered by the date when the goods are made available, or when services are performed. In this case, the recipient of the supply may not easily determine the time of supply as the supplier is not required to confirm time of supply in the TSI. To request such information from the supplier may be an onerous task especially for large volumes of transactions.

Submission 4

Section 19K(5) allows a supplier to agree with the recipient to issue the TSI on a "later date" (being a date later than the time of supply). It does not address the situations where TSI is typically issued <u>**before**</u> the time of supply is triggered.

Recommendation

We suggest the reference to the "later date" should be changed to an "<u>**alternative date**</u>".

Comment

Under the proposed section 19K(5), a registered supplier must provide the TSI on the date the supply is triggered, except when the supplier and the recipient agree to a **later** date. For progressive supplies, the time of supply could be triggered by a payment due date (i.e., section 9(3)(a)). Commercially it would not be desirable to issue the taxable supply information on the same day as when the payment is due. In this case, the supplier and the recipient should be able to agree to issue the TSI on an ***earlier*** date, not a later date.

Submission 5

The current credit note / debit note provisions and the proposed rules regarding supply correction information do not adequately deal with Customs GST invoices.

Recommendation

We submit the proposed section 19N also extends to corrections required for invoices issued for Customs GST. This will allow importers to correct the GST claimed in the GST return when the correction information is received from the freight forwarder / broker.

Comment

The current credit note / debit note provisions and the proposed section 19N relating to supply correction information do not deal with customs GST claims, which frequently rely on freight forwarder or customs broker's invoices. Often freight forwarders and Customs brokers pay Customs GST on behalf of their client, which is the importer. The Customs GST is then recharged to the importer. Under the current rules, the importer can claim the Customs GST recharged by relying on the invoice / statement provided by the freight forwarder / Customs broker. In situations where the details of the import GST in the freight forwarders' invoices are incorrect, this would result in an incorrect amount of import GST being claimed. We think Customs GST invoices from a freight forwarder / broker should be treated the same way as a tax invoice for a taxable supply. When an error occurs in the invoice resulting in an incorrect amount of GST claimed by the importer, the freight forwarder / broker should be allowed to use the supply correction information to correct the error, similar to the credit note provisions.

Submission 6

The reference to "taxable supply information" in section 19H(2)(b) appears to be a drafting error.

Recommendation

This subsection should instead refer to "**supply information**".

Comment

That section requires the person receiving secondhand goods to keep the record of "the date on which the taxable supply information for the supply is issued". Given this section concerns a supply which is not taxable, the reference to taxable supply seems to be a drafting error

Submission 7

Section 19L(1)(a) requires the taxable supply information issued for a supply made by a member of a GST group to include the 'GST trade name and registration number of the representative member for the GST group'. This section does not currently allow that only the GST trade name and registration number of the member providing the supply is included in the taxable supply information.

Recommendation

Section 19L(1)(a) should be amended to allow that only the GST trade name and registration number of member making the supply is included in the taxable supply information issued in respect of the supply made by the member of a GST group.

Comment

Under current law, members of a GST group are allowed to issue tax invoices under their own name and registration number. This is in line with commercial practice and even for members of a GST group, it is common for each member to process their own invoicing and have their systems set-up to generate tax invoices under their own name and registration number. This is especially the case where new members are added to an existing GST group as a result of mergers and acquisitions.

Requiring the GST trade name and registration number of the representative member to be included in the taxable supply information issued by all members of a GST group will impose additional costs to businesses in updating their systems to allow for this, with no obvious benefit to improving the integrity of the GST system.

We note that as group elections are made with Inland Revenue, the representative member of a GST group should be readily identifiable by Inland Revenue. It should be able to undertake verification activity accordingly (i.e. the representative member information is not required.)

Submission 8

Currently section 60 allows agents to issue and receive tax invoices on behalf of a principal and for the current tax invoice requirements to still be met even if the invoice is issued or received in the name of the agent.

The IRD have released an Interpretation Statement (IS 21/01) that sets out in some details the position on when a person will be acting as agent. In some instances a person will be acting as a payment or collection agent where they will not satisfy the legal requirements to be an agent as set out in IS 21/01 where it would be still be practical for that agent to issue or receive tax invoices/TSI in their own name.

Recommendation

Section 60 be amended to allow for payment or collection agents who may not be legal agents as set out in IS 21/01 to issue or receive TSI in their own name on behalf of a principal

Submission 9

Section 19L(1) refers to 'a member supply made by a member of a GST group under section 55'. However, 'member supply' as defined in the new definition added to section 2 only includes supplies made by a 'supplier group' (being supplies made by members of a group under section 55B). As such, a member of a GST group under section 55, cannot, by definition, make a 'member supply'.

Recommendation

Section 19L(1) should be amended to refer to **'a taxable supply'** as opposed to a 'member supply'.

GST groups

We generally support the proposed amendments to the GST group rules.

In particular, we welcome the proposals to treat the GST group as a single company and the representative member treated as carrying on all activities for the GST group, as well as to align the GST group's joint and several liability to that for consolidated groups in the Income Tax Act 2007.

Submission

We suggest that section 55 be re-written to enable a better logic flow and enhanced readability.

We also suggest a wider re-write of the whole Goods and Services Tax Act 1985 ("the GST Act") be considered.

Comment

Whilst we appreciate that the proposed amendments intend to clarify the consequences of the GST group registration at the outset of section 55, the subsections contained in the proposed section 55 appear disconnected and the whole section does not appear easily readable due to the proposed new and re-ordered insertions. We therefore suggest that the section be re-written.

Fair Dividend Rate Foreign Currency Hedges

The Bill contains a number of technical amendments to improve the workability of the Fair Dividend Rate Foreign Currency Hedges ("FDR and FX" hedging) rules. These are based on a review of these rules by Officials' last year and we broadly support these amendments. Our specific submissions are aimed at further improving the operability of these rules.

Given the wide range of matters covered in the Bill and the recently introduced SOP, in the time available, we have not had time to consider in detail the legislative drafting of the FDR and FX hedging amendments. We bring this to the Committee's attention as a number of the issues the Bill aims to fix are drafting errors with the original legislation.

Issue 1: Flexibility of approach to FDR and FX hedging needed

While we agree with the intention of the proposed technical amendments, they illustrate the complexity of applying the FDR and FX hedging rules in practice.

To us, this raises a practical question about how best to encourage uptake of the rules. While we understand the original rationale was to ensure that the FDR and FX hedge rules would not be subject to abuse, the approach of legislating compliance with specific formulas has significantly limited their uptake in our view (not to mention creating the issues which these amendments are now aiming to fix). This barrier still remains.

In consultation on these amendments last year, Officials raised the option of a Commissioner determination making power, whereby taxpayers looking to apply the FDR and FX hedges rules could agree how the rules would apply to their individual fact circumstances. This is important as different funds' systems will operate differently. Therefore, a one-size-fits all solution will be suboptimal.

A determination making power would allow Inland Revenue to understand how a particular fund's system operates and how the FDR and FX hedges rules would apply in practice for that taxpayer. This should alleviate any concerns around potential abuse of the rules. In effect, this can be viewed as a form of pre-audit assurance over taxpayers' systems and processes.

We expect that such a determination would require that the methodology is consistent with the objective of the FDR and FX hedging rules (to provide the same tax treatment for hedges of FDR assets as the FDR assets themselves) and that it does not allow so-called "speculative hedges" (hedges entered into where an investor's intention on acquisition of the hedge instrument is to make a profit on the hedge) to benefit from this treatment. We would also expect that a determination could take into account a fund's stated investment policies and objectives to confirm that the commercial purpose is consistent with the intent of the rules.

Submission

Therefore, we recommend the inclusion of a determination making power for Inland Revenue to approve a FDR and FX hedging methodology that is effective for a particular taxpayer's specific circumstances and arrangements. This should operate in parallel to the current rules and options, giving taxpayers greater choice.

Issue 2: Multiple methodologies/formulas in section EM 5

The technical amendments to sections EM 5(6) to (10) are designed to ensure that when non-eligible assets are also fully hedged, that there should be no further adjustment of the FDR hedge portion (that is, the proportion of hedges that hedge assets that should be eligible for FDR treatment). We support this change.

However, the complexity of the required remedial amendments – the need for two additional steps, with calculations under each, to be legislated – illustrates the need for taxpayers to be able to agree a practical FDR and FX hedging methodology with Inland Revenue, which is the focus of our submission above.

Further, the inclusion of both the hedge-by-hedge and (existing) whole of portfolio-based hedging options for calculating FDR hedge portions in section EM 5 can lead to confusion. This is because these FDR and FX hedging methodologies are described in section EM 5 as the first and second formulas, notwithstanding each method also having multiple calculations. This confusion will be exacerbated further by the modifications to the hedge-by-hedge option to introduce the additional steps.

Submission

We therefore recommend that section EM 5 be modified to separate out the existing hedge-by-hedge and whole of portfolio-based hedging options. For example, by moving the latter to, say, new section EM 5AB (similar to how the new portfolio method is being inserted as section EM 5B). At a minimum, if the current drafting approach is maintained there needs to be clearer sign posting of the different methods.

Issue 3: De minimis threshold for non-eligible assets

An amendment is proposed to introduce a de minimis threshold for certain types of non-eligible assets – foreign currency cash holdings equal to or less than 5% of the total value of eligible assets. This has the effect of ensuring these cash balances do not reduce the portion of a hedge that can be subject to FDR treatment.

We support this change. However, it is unclear how this de minimis is intended to be applied in practice. That is, whether at all times during the hedging period the de minimis must be met or whether there is scope for temporary breaches. In relation to the latter, there may be times when the de minimis may be breached due to "liquidity" events – such as transactions being settled or significant investor movements, which may require cash balances above the threshold limit to be held temporarily. Some funds may also have mandates which require, in certainty extraordinary circumstances, for assets to be liquidated and held in cash (these cash balances may not be in NZD).

Submission

While we welcome this change, we consider that further flexibility is needed in relation to the application of the de minimis threshold for non-eligible assets to ensure the rules can be applied in practice. This could be achieved by allowing limited breaches for defined events (such as those listed above and circumstances beyond a fund's control, similar to under the PIE eligibility concessions). Alternatively, the de minimis should be allowed to be applied on a "weighted average assets" basis over the relevant calculation period. (That is not our preferred option, however, as this may be difficult for funds to monitor in real time).

Issue 4: New portfolio method for calculating FDR hedge portions

The Bill introduces a new portfolio calculation option for calculating FDR hedge portions, alongside the current options (described above in our submission 2).

This is a modification of the existing whole of portfolio-based hedging methodology as it allows the FDR hedge portion to be calculated at the start of the hedging period and applied for the duration of the period for all hedges entered into during that period. (In contrast, both existing FDR and FX hedging methodologies require calculations for FDR hedge portions for any new hedges). Further, no quarter end testing to check if FDR hedging percentages are greater than 105% of the portfolio value is required (unlike the existing methodologies).

We welcome this change. The portfolio method (together with the proposed 5% foreign cash balance de minimis) should make the rules more workable for funds that primarily have exposure to global (including ANZ) equities. However, as noted in submission 1, we also recommend the option for funds to agree a bespoke FDR and FX hedging methodology with Inland Revenue.

Submissions

While we support the proposed portfolio method, we also have the following concerns with the requirements to apply it:

- The Bill as drafted proposes that only "daily unit valuers" (as described for FDR calculation purposes) will be allowed to apply it. It is not clear why the availability of the portfolio method should be so limited. The proposed limitation appears to be on the incorrect assumption that only funds that unit price daily will have significant hedge turnover (which is what this method is aimed at, to reduce compliance cost). We, therefore, recommend that the portfolio method should also be available to funds with a unit pricing frequency of a month or less.
- It is also proposed that once the portfolio method is elected, that selection will be binding for a minimum period of 4 years for all hedges entered into. While we understand the desire for a consistency requirement, this seems too onerous. For example, it is likely during the early life of a fund that the portfolio method may be attractive, for simplicity. However, as fund size, investment scale and sophistication increase, there may be the need for more accurate methods. To provide flexibility, we recommend that the consistency requirement for applying the portfolio method is reduced to 12 months.
- The period for calculating FDR hedge portions under the portfolio method will be limited to a maximum of a month (with this period also then set for a minimum of 4 years). That is, we understand that new FDR hedge portion calculations under the portfolio method will need to be done monthly. This appears to be on the assumption that (most) hedges should "roll" (that is, mature) monthly. Therefore, requiring a new calculation at least monthly is designed to align with this. However, in practice, hedging strategies and durations will vary. Therefore, we would support greater flexibility which allows the period under the portfolio method to be matched with the actual hedging strategy of the fund (the period could be capped at a quarter, if some limit is required). Similarly, we are concerned that requiring the period initially selected to be used for the next 4 years is unduly restrictive, as hedging strategies can and will change over time. Similarly, to our comment above on the ability to opt out of the portfolio method after a reasonable period, we recommend the period requirement be limited to 12 months.

Issue 5: Other FDR and FX hedging rule amendments

We support the following technical amendments in the Bill:

- Allowing eligible hedges to have no NZD leg provided these hedges are entered into to adjust the hedging of existing hedges that have one leg in NZD.
- An optional look through rule to apply the FDR and FX hedging rules for "funds of funds"-type investment structures. While we support the change, we note that allowing "qualifying hedge funds" to apply the FDR and FX hedging rules for the eligible assets held by a fund that they invest in will require additional information to be communicated by the latter. The current reporting schema between PIE funds is well established so we assume that this additional information reporting may need to be incorporated into it.
- Allowing the transfer of eligible hedges into another fund, by amending the definition of eligible hedge to also include a hedge that is "acquired" at fair value.

- Remedial amendments to ensure the rules operate as intended for "hedges of a hedge" and to exclude New Zealand securities listed on foreign exchanges from the definition of non-eligible assets.

The Bill also introduces an equivalent of the FDR "quick sale" rule where hedges are entered into and settled within a unit valuation period. This is designed to limit the ability to avoid a tax liability on such hedges under the FDR and FX hedging rules. While we understand Officials' concern around the present ability to avoid a tax liability on such hedges (under either the FDR or financial arrangements rules), this needs to be weighed up against the additional complexity such a rule adds to what is already a complex set of rules. In particular, it is not clear to us how much of a problem this is in practice, such that a law change is required. We therefore recommend that its inclusion be reconsidered.

Local authorities – taxation of dividends

We are supportive of the proposed amendments in the Bill to treat dividends as exempt from tax where they are derived by a local authority from a wholly-owned Council Controlled Organisation ("CCO"), port company or energy company and the removal of the limitation on tax loss grouping between a local authority and a CCO.

Submission

The dividend exemption should be extended to include dividends received by a local authority from non-wholly owned CCOs or port companies or energy companies, as well as dividends received by a CCO from another non-wholly owned CCO.

Comment

We have concerns that the exemption for dividends is currently only limited to dividends from a wholly-owned CCO, port company and energy company to a local authority.

This means that dividends from a non-wholly owned CCO to a local authority or another CCO would still be taxable. This makes no sense when the stated rationale for historically not exempting such dividends – competitor neutrality – has now been accepted by the Government as not being adversely impacted by permitting such dividends to be exempt to local authorities in the same way that charities and the Crown is exempt. Therefore, we consider that the dividend exemption should be extended to all dividends derived by a local authority regardless of source and whether derived directly or indirectly.

Similarly, under the current proposal, in a case where there is an intermediary CCO holding company in the group that is wholly-owned by a local authority and in turn holds shareholding interest in other less than wholly-owned CCOs, any dividends derived from such non-wholly owned CCOs would remain fully taxable to the CCO holding company. We consider this to be unintended and, if not addressed, there is a real risk that sound governance and oversight provided by CCO holding companies could be lost solely for tax reasons. This could result in non-optimal outcomes for local authorities and their ratepayers.

Early payment discount (EPD) rate change

The Bill proposes to replace the current 6.7% EPD rate with "the rate that is 2% greater than the Commissioner's paying rate set by an Order in Council".

Submission

The amendment should not proceed as this is clearly not a remedial change but rather an explicit policy change. Further, the rationale for this policy change is not clear.

Comment

The 6.7% EPD rate was previously introduced to encourage taxpayers receiving self-employed or partnership income to pay tax in their first year of business so that they did not find themselves liable for both provisional tax and terminal tax payments in their second year of business. The rationale for the 6.7% rate was explained in *Making tax easier for small businesses: a government discussion document* (2003) as being approximately equivalent to a 10% pre-tax discount on tax payable for early payment. We understand from the 2003 discussion document that the 6.7% rate was set after consultation with businesses.

The proposed change alters the rate to tie it to the prevailing use of money credit interest rate plus 200 basis points. However, there does not appear to be any policy rationale as to why the effective 10% pre-tax discount on tax payable is no longer appropriate.

Current rates being considerably lower than 6.7%, the proposed amendment could be expected to result in fewer taxpayers opting to take advantage of the EPD by making advance tax payments. This may result in a tax collection risk for Inland Revenue where taxpayers find themselves unable to meet their obligations in their second year of business.

Issue: Tax pooling and EPD settings

We consider that:

- Non-safe harbour taxpayers should be able to access tax pooling to meet their tax liabilities in their first year as a provisional taxpayer.
- It remains appropriate for the EPD to apply where tax payments are made via a deposit to a tax pooling intermediary rather than direct to Inland Revenue.
- It is appropriate to include LTCs in the definition of "small-business person" for the purposes of the EPD, given that the policy intent is for LTCs to be taxed in a similar manner to partnerships.

Share for share exchanges and available capital distribution amount

The capital gain amount will be increased on a subsequent sale of a company acquired by a share for share exchange. This change in the Bill is proposed to deal with the effect of the share for share exchange limitation on Available Subscribed Capital ("ASC"). The effect of that rule is to convert a capital gain into a taxable distribution.

This proposal has been the subject of previous consultation (and KPMG's submission is attached). The commentary and available Regulatory Impact Statements do not provide the reasons why this particular solution has been proposed.

Submission 1

Alternatives to the proposal should be considered.

Comment

The concerns this policy addresses are complex. The ASC limitation rule is necessary to prevent revenue reserves being converted to tax free capital gains. The existing policy is that capital gains, except for look through companies, can only be distributed tax-free on a liquidation of a company. This rule was a reaction to companies creating internal capital gains to make tax-free distributions. This is a historical problem as the associated person capital gains rules address this. However, the solution proposed uses that existing policy despite New Zealand's lack of a capital gains tax.

Although simpler than some options, the proposed solution does not question the existing policy.

We consider that should be done. We consider there is no good policy reason to retain the current policy in the absence of a comprehensive capital gains tax.

Submission 2

Memorandum accounts for ASC and capital gain amounts should be established and the time bar rules should apply to the amounts recorded in these accounts.

Comment

The proposal is that the capital gain amount is amended after the Acquirer has sold the Target and on its liquidation. This may be sometime after the Target is acquired in the share for share exchange.

The onus is on the taxpayer to prove a tax treatment. The information may not be readily available at the time. However, the Commissioner would only challenge this treatment when the Acquirer is liquidated. The Commissioner may therefore benefit from the onus being on the taxpayer.

A memorandum account which records ASC, capital gain amounts and potential adjustments (including that proposed by the amendment) with the time bar applying should mean the Commissioner is motivated to confirm or otherwise the company's position on a more real time basis.

Inland Revenue's new IT system should be able to cope with collecting and tracking this information over time. Disclosure of share for share exchanges may be useful for Inland Revenue's verification activity for the sale itself.

We can see no policy reason why this submission should be declined.

Submission 3

Officials should be asked to confirm the intended effect of the rule if the value of the Target decreases.

Comment

The proposal is that a capital gain amount is deemed for the amount of ASC limited. This capital gain amount is added to the actual capital gain amount from the sale. For example:

Share for share consideration	$1,000
ASC limitation	$900
ASC	$100

Sale Price of Target	$3,000
Actual capital gain amount	$2,000
Deemed capital gain amount	$900
Total capital gain amount	$2,900

The above is the correct result. However, assume the sale is for $900. The result should be:

Actual capital loss	($100)
Deemed capital gain amount	$900
Total capital gain amount	$800

That this result is intended and achieved should be confirmed.

Hybrid and branch mismatches – imported mismatch rules

The proposal in the Bill clarifies the imported mismatch rule to better align with the OECD's BEPS Action 2 Report (the "OECD Report"). The amendment applies retrospectively, except where that clarification is inconsistent with the current rules the application date is delayed (i.e., where deduction is for payments that can be traced to a hybrid mismatch through loss grouping, group contributions of income, or consolidation).

Submission

We generally support the proposed amendments but we:

- highlight two problems which we consider will continue to arise;
- provide brief comments in support of the amendments which narrow the application of the imported mismatch rule; and
- note our previous submission that the imported mismatch rule (or rather the hybrid mismatch rules as a whole) would be clearer if the branch rules were separate and recommend the hybrid rules be so amended.

General support

The hybrid mismatch rules are among the most complicated, and the imported mismatch rule the most complicated of those rules, in the Income Tax Act.

There are reasons to oppose the inclusion of hybrid mismatch rules at all but, as New Zealand has accepted that it should implement them, it is important that the rules are as clear and as certain of application as possible.

Our experience with trying to apply the current rules is that their intended application and effect is not always clear. The OECD Report must be used to apply the current rules. More clearly aligning the rules with the OECD Report is therefore sensible as the Act's provisions can be more readily aligned with the Report's examples.

We support alignment. Where we have considered the application of the imported mismatch rule based on drafting in the Bill, rather than the current Act, a clearer result applies.

Examples and application of the OECD Report

The OECD Report and the Commentary to the Bill has examples which are "plain vanilla". Payments can be seen to fund other payments so that it is easier to see that the rule may apply.

It would be useful to have examples of offsets and other matters which are considered to satisfy the rules.

While not wanting to limit these additional examples, clarifying how inconsistences between the Act and OECD Report would be addressed would be helpful. For example, Chapter 4 of the OECD's Report makes clear that the term "payment" under the Reverse Hybrid Rule "would not typically cover the cost of acquiring a capital asset and would not extend to an allowance for a depreciation or amortisation". Such amounts may be payments under domestic law, albeit that we understand that the hybrid mismatch rules would be interpreted consistent with the OECD's Report.

Other countries' rules

The OECD Report intends to provide an interlocking set of rules which prevent hybrid results around the world. Not all countries have implemented the rules. This means that New Zealand taxpayers must determine the effect of other countries rules.

We note this because the OECD's BEPS 2.0 (Pillar 1 and 2) project relies on implementation by every country to be most effective. The problem of interaction with other countries' tax rules will arise when and if New Zealand decides to implement BEPS 2.0.

Narrowing of the rules

Amendments to deal with the existence of hybrid mismatches in the chain and where dual inclusion income exists such that the hybrid rules do not apply.

The current rules potentially deny expenditure deductions. This is so even if the intended benefit is not for New Zealand but for the foreign owners (where their country allows this benefit). There is also the potential for multiple denials.

We support the narrowing of the rules.

Branch rule separation

The Act currently deals with branches and other mismatches in the same section. This adds to the length of the section and makes for convoluted drafting. This is because a branch may not actually incur the expenditure. The drafting must take this into account.

Separate sections which deal directly and only with branches will simplify and clarify the rules for branches and other taxpayers. (One of the amendments is to deal with branch charges which would not be required if specific branch rules existed.)

Restricted Transfer Pricing rule remedial amendments

Issue 1: Deemed dividend for disallowed interest

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, applying the restricted transfer pricing rules results in more interest being denied than is the case under the arm's length test. As the legislation does not contemplate this, the difference between the arm's length interest and the allowable interest under the restricted transfer pricing rules retains its status as interest.

The proposed changes in the Bill would amend the rules so that the amount of a deemed dividend is calculated 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.

Submission

While we note that this change may be favourable to taxpayers who can impute the deemed dividend amount, it needs to be seen in the overall context of the restricted transfer pricing rules which are substantively interest limitation rules. We request clear guidance on the characterisation of the restricted transfer pricing rules and consistent application of that characterisation.

Comment

There has been mixed messaging to-date on the nature of the restricted transfer pricing rules – variously as consistent with New Zealand's obligations under Double Tax Agreements to allow arms-length interest deductions (this was the statement by Officials when the rule was originally enacted), an anti-avoidance measure, and a separate interest pricing rule.

However, in practice, Officials have argued that the restricted transfer pricing rules (despite the name and their placement in the Income Tax Act) are in substance interest limitation rules, akin to thin capitalisation.

If this change proceeds, the nature of the rules will become further confused for the following reasons:

- Denials under interest limitation rules, retain their characterisation as interest. Denials under interest limitation rules like thin capitalisation are not considered deemed dividends.

- The definition of a dividend is the transfer of company value which includes transfers provided by a company which are more than the market value of what is being received. Therefore, the characterisation as a deemed dividend implies that the restricted transfer pricing rules are intended to approximate market value or an arm's length amount which is consistent with a transfer pricing rule (but not an interest limitation rule).

These implications would add to the existing inconsistencies around the rules such as that Competent Authority relief may be available for restricted transfer pricing adjustments on a case-by-case basis which is incompatible with the characterisation of restricted transfer pricing as interest limitation rules.

A clear statement of the nature of the rules and a comparison of the rules and the proposed amendment to this statement should be undertaken. Any amendments to fully achieve the objective should be consulted on to ensure that the policy and its implementation are consistent.

Issue 2: Third-party test for loans more than five years

The third party test to allow loan terms of more than five years when there is significant third party borrowing with terms of more than five years currently compares the relevant individual cross-border related borrowing with borrowing from third parties. This is being amended to ensure that this test compares all cross-border related borrowing with borrowing from third parties. We support this change.

R&D Tax Incentive remedial amendments

We support the amendments to the Research and Development Tax Incentive (the "RDTI") provisions proposed in the Bill, notably:

- Extension of due dates (clauses 142 and 145 of the Bill).
- Tax year cut-off for claiming supporting activities (clauses 92 and 144 of the Bill).
- R&D tax incentive – transitional support payment (clauses 56, 64, and 132 of the Bill).

Issue: Impact of Delayed CAM application processing on GA submissions

Submission

We recommend that a further remedial amendment is included in the Bill as regards the Criteria and Methodologies assessment (the "CAM") process which COVID-19 has demonstrated requires rectifying due to the implications of unexpectedly long processing times.

In brief, we suggest that if the Commissioner is still assessing a CAM application leading up to the due date for a General Approval application (the "GA"), the taxpayer automatically receives an extension of time for their GA submissions. This will provide the taxpayer with sufficient time to prepare their GA submissions in the event that the CAM application is declined immediately before the GA deadline, or even after the GA deadline.

Comment

A GA submission for R&D activity must be filed by the seventh day of the second month after the relevant income year. However, large R&D performers can elect out of the GA scheme, into an alternative compliance mechanism known as the significant performer regime. To be eligible for this alternative regime, the taxpayer must provide a description of their CAM for identifying and tracking R&D activities and expenditure to the Commissioner no later than by the end of the sixth month of that income year.

If the CAM application is declined, the taxpayer reverts to filing a GA application for that year. Accordingly, it is important that sufficient time is allowed for to work through the CAM process, because if the taxpayer files neither a CAM application nor a GA submission for that income year, the ability to claim an RDTI is permanently lost.

For this reason, a remedial change was made to the Tax Administration Act 1994, bringing forward the due date for CAM applications from the same date as GA submissions, to earlier in the income year. This requires the taxpayer to prepare their CAM application documents much earlier and allows them more time to respond to questions from the Commissioner. Thus, if their CAM application is declined, there is enough time left in the income year to complete a GA submission.

In practice however, even though taxpayers have filed their CAM applications by the new, earlier, due date, the Commissioner's processing times have extended significantly. This is due to the impact of COVID19, resulting in multiple extensions of due dates for RDTI claims which has dramatically increased the workload of officials for the affected period.

A concern that arises is that as taxpayers gets closer to the end of the income year without knowing the eventual outcome of their CAM applications, they will need to start preparing GA submissions for that income year as a backup plan in the event that the CAM application is declined, or a decision on the CAM application is not yet made by the GA deadline.

For example, a taxpayer with an income year ending 31 March 2022 which has filed its CAM application by the due date of 30 September 2021 will need to start preparing a GA submission in February 2022 to comfortably make the 7 May 2022 GA deadline.

Given current processing times, and the intervening standard Christmas break, it is highly unlikely that these taxpayers will have certainty by February 2022, so they will be put in a position where they need to prepare GA forms just as a backup, increasing their compliance costs.

As noted above, current processing times are a result of COVID19, so may not be reflective of future processing times. However, in future, there could be other unforeseen factors causing extended CAM processing times.

Accordingly, we submit that the Tax Administration Act 1994 is amended so that if a taxpayer has filed their CAM application on time and a decision is still pending with the Commissioner leading up to the GA deadline, the taxpayer will automatically receive a six-month extension of time for their GA submission.

Given that the taxpayer would need certainty of the extension of time in the months leading up to the GA due date, the extension coming into effect would need to be triggered early i.e. it is impractical to notify the taxpayer in April of a CAM declinature and expect the GA forms to be completed by the seventh of May.

We are cognisant of the fact that taxpayers who have filed CAM applications are already facing the uncertainty described above heading into the end of the 31 March 2022 income year, and that passage of this Bill may not be in time to allay their concerns. Accordingly, we have also separately requested an extension of time for the 2022 income year, on similar terms as recommended above, under the Commissioner's temporary COVID-19 powers, pursuant to section 6I of the Tax Administration Act 1994.

However, as noted above, for future income years there could be reasons other than COVID-19 which extend processing times, hence the need for a permanent solution, as we've proposed above.

Other measures in the Bill

Clause 173(1) removes the two-year time limit for COVID-19 related information sharing between Government agencies.	This appears to be a sensible change given the ongoing effects of the pandemic.
Clause 139 allows Inland Revenue held information to be released	The concern addressed by this proposed change is that a Court could take a broad interpretation of the current rule to prevent the Commissioner releasing information which does not relate to a person or an entity. This concern appears overstated and it is most likely that Inland Revenue has itself raised this possible broad interpretation. This interpretation appears to ignore the policy for the most recent amendments to the secrecy rules. To the extent that is the case it is concerning that one part of Inland Revenue considers the policy intent has not been achieved. However, it is likely to be most efficient to amend the Act than leave the issue open. The Committee should test with officials how this interpretation has been arrived at and why the Commissioner considers that Parliament did not achieve the original policy purpose.

KPMG's previous submissions on interest limitation and ACDA consultation

KPMG Centre
18 Viaduct Harbour Ave
PO Box 1584
Auckland 1140
New Zealand
T: +64 9 367 5800

Our ref: 19444727_1.docx

David Carrigan
Deputy Commissioner, Policy and Regulatory Stewardship
Inland Revenue Department
P O Box 2198
Wellington

14 July 2021

Dear David

KPMG submission on "Design of the interest limitation rule and additional bright-line rules"

General comments on the interest limitation proposal

While we agree with the Government's concerns around housing affordability and objective of creating a well-regulated housing market that can respond to population growth and changes in preference, we are not convinced the interest limitation proposals will help achieve this objective. And certainly, not without significant adverse impacts on the efficiency, coherence and simplicity of the tax system.

We have attempted to analyse the following impacts:

Effect on the housing market

We understand the anticipated effect on the housing market is that house prices will either decrease or not increase as much and that rents will increase. (See Joint Report: Demand-side measures to moderate house price growth Treasury:4405852v1 ("the Joint Report")).

We understand the argument is, in short:

- the after-tax return will decrease as a result of the policy, meaning investors will be prepared to pay less. This is assumed to have a flow on consequence to the whole market, including owner occupiers.
- for the rental market it is assumed that investors will seek to equalise their after-tax returns by increasing rents in the short-term.

We have found no further extended discussion from Officials or Government supporting this analysis. We understand that standard economic approaches would suggest the above propositions generally do not hold.

Further, the residential loss ring-fencing rules were also aimed at reducing house prices. (By a similar logic, deferring net losses reduces cashflow from rental investment so that investors should pay less.) However, there has been no discernible impact on house prices. They have continued to rise which suggests that tax changes are making little difference.

This is also consistent with the view of the Tax Working Group that the tax system is not an appropriate lever to address housing affordability concerns. It is put, simply, a blunt instrument when the underlying causes are diverse.

(Mis-)alignment with tax policy objectives

We note that at the time of legislating the bright-line extension to 10 years, the accompanying regulatory analysis suggested both Inland Revenue and the Treasury were not in favour of the interest limitation proposals. In fact, the Joint Report, in Annex 3 in particular, provides analysis for why denying interest deductions should not proceed from a tax policy perspective. Apart from the impact on the tax system discussed below in the trade-offs, the proposal would unequally tax some types of rental investment. This would amount to over taxation.

Further, the Joint Report confirms that an owner-occupier is not tax disadvantaged compared to an investor. An owner-occupier is not taxed on the imputed rental income. (From a practical perspective, we note that any attempt to impose such taxation would be unlikely to succeed as imputed rental income is not intuitively income and therefore a proper object of an income tax.)

Is there a tax policy problem?

The current Act allows interest deductions if borrowed money is used to produce assessable income. There is no apportionment of interest if the money borrowed has dual purposes – to produce rental income and to allow continued holding of property which produces a gain which is non-taxable. In turn, the dual holding purpose is insufficiently strong a purpose to make a gain on sale taxable under current rules.

In short, interest which, in part, finances a non-taxable gain is fully deductible.

A possible answer to this problem is the proposed total denial of interest deductions. However, this will over-tax income as no deductions are allowed against rental income (see the Joint Report's own analysis). It is not a first best policy solution as a consequence.

Judging the trade-offs

The discussion document in paragraph 1.5 outlines a number of economic and tax policy objectives which may need to be traded off. These trade-offs are impossible to analyse/evaluate as there is no meaningful analysis provided on the effect on housing affordability or housing supply. The lack of any supporting economic, or other, analysis to suggest that limiting interest deductions would improve housing affordability whilst not limiting new housing supply is a significant concern. Even without that analysis, there are significant doubts that the housing objectives will be met, but in our view the effect of the proposals will be to:

— ***Reduce overall investment efficiency.*** The changes will have effects on the efficient allocation of investment. That must be true as the interest limitation (and bright line extension) changes are designed to make residential rental investment less attractive, from a tax perspective, relative to other asset classes. This will affect the efficient allocation of investment, after-tax, as that is the intention. It is not clear to us what "unintended" effects on investment allocation the Government is concerned about.

— ***Reduce overall tax system coherence.*** The proposal moves the tax system further away from one where different investment activity is broadly taxed in the same way (i.e. a broad-based system) to one where there are multiple "jagged edges", depending on investment type/activity. We recognise that Government may have non-tax policy objectives for certain tax changes. The interest limitation proposal is simply the latest in the proliferation of ad hoc taxation measures by different Governments. Every ad hoc measure, in our view, further reduces the coherence of the system and risks eroding confidence in the stability and, importantly, predictability of the system.

— ***Significantly increase tax complexity***. The length of the discussion document, at over 140 pages, is instructive in this regard. What sounds simple in a media statement – limit interest deductions on residential property investment, with a carve out for new builds – is anything but due to the various definitional and boundary issues and inter-linkages with other regimes. While the rules will be simple for some, there will be a myriad of ways residential rental properties are owned and finances are organised, which will mean there will be considerably complexity for others. Our detailed comments touch on these issues.

As we have not seen the evidence which justifies the proposal for its effect on non-tax policy, judging the tax policy trade-offs is effectively meaningless. To the extent there is a relevant principle to be derived, it is "do the least harm".

KPMG's principal submission: the Government should not proceed with the interest limitation changes

If there is any analysis of the impact of the interest limitation proposals that supports the non-tax policy objectives, we strongly recommend ***that analysis supporting the proposals is released*** so that submitters are able to make informed submissions.

However, as the proposal has not been shown to produce the non-tax policy objectives and is detrimental to tax policy objectives, we submit that ***the policy should not proceed***.

Despite this conclusion, we understand that the Government has decided to proceed. Our supplementary submissions and detailed analysis proceeds on this basis.

Supplementary submission 1: simplicity should be preferred in the design of the rules

Given the proposals is unlikely to advance any tax policy objective, the "least harm" is likely to be generated by making simplicity the primary objective. Wherever there is a choice to deal with potential behaviour which may be of concern or a perceived need to produce a perfect answer, ***we submit the simplest approach should be preferred. This should be kept in mind when designing the rules***

Supplementary submission 2: the application date should be deferred

To ensure that the rules can be appropriately designed and legislated for and to allow taxpayer education to occur, ***we strongly recommend that the application date be shifted from 1 October 2021 to 1 April 2022 (the start of the 2022-23 tax year) at the earliest.***

Given the truncated consultation process on the detail design and time pressures on legislative drafting, there is a high risk that the interest limitation draft legislation will be sub-optimal when introduced later this year. The 1 October 2021 application date as announced in March will mean that investors will become subject to the rules as the legislative process is still ongoing.

In our view, given the potentially wide impact of these rules and the possibility for change during the process (e.g. at Select Committee stage), it is better for the rules to have application from a prospective date to provide certainty (and the best chance to get the rules right before they apply).

This would have the added benefit of ensuring that only one set of rules needs to be considered for the 2021-22 income year (i.e. full interest deductibility), rather than 100% denial of any interest costs arising on or after 1 October for residential land acquired on or after 27 March 2021 with a 25% denial of the interest cost for residential land acquired prior to this.

As an alternative, the application date could be split so that the rule for acquisitions prior to 27 March 2021 would only apply from 1 April 2022. This would allow investors to properly consider the new rules and apply them prospectively. The new rules would however apply for any acquisitions after announcement date.

Our submission is consistent with Officials views as expressed in the Joint Report.

Detailed submissions

Our submissions on the discussion document are attached.

Further information

Please do not hesitate to contact us, Rachel Piper on 09 363 3525, Darshana Elwela on 09 367 5940 or John Cantin, on 04 816 4518

Yours sincerely

R.K. Piper

D. Elwela

Rachel Piper
Partner

Darshana Elwela
Partner

Chapter 2 – Residential property subject to interest limitation

In defining the type of residential property that should be subject to interest limitation, if the proposal proceeds, we agree that starting point should be whether the property can be used to provide residential accommodation on a long-term basis in New Zealand. Therefore, we support carving out any residential property / land situated outside of New Zealand.

We also support excluding from the scope of the interest limitation rules property that is carved out under paragraph (b) of the "dwelling" definition.

In the "issues for further discussion" feedback is requested on the following:

Change of use from main home during the phase out period for properties acquired before 27 March 2021

We agree the phase out of interest deductions should be available in this scenario.

Dual purpose (business and residential) buildings on the same title

we support an apportionment approach, rather than a predominant use (i.e. "more than 50%" business or residential purpose) test. This should be based on existing apportionment principles (i.e. based on time and space).

Employee accommodation

We agree this should be excluded from scope having regard to the public policy objective underlying this change. Employers providing their employees with accommodation, particularly in critical industries, should be a supported outcome. (There is no tax advantage to the employer or employee as the provision of accommodation, other than in specific circumstances, is taxable).

Student accommodation

We support an exclusion designed around the requirements outlined in sections 5(1)(h) and 5B of the Residential Tenancies Act 1986. The additional requirements imposed under that Act, including the need for accommodation providers to implement, and tenants to abide by, "house rules", should be sufficient to mitigate risk of substitution.

Short-stay accommodation

Any carve-out for short-stay accommodation should be based on objective criteria, such as features of a dwelling/premises that would make it difficult to substitute for long term residential accommodation. This may include features such as lack of standalone amenities (such as a fully functional kitchen) or private living areas (e.g. if such spaces are largely communal).

Serviced apartments

Similar to short stay accommodation, a carve-out should be based on features that make it difficult to substitute for longer-term accommodation. Where a serviced apartment is otherwise contained in a "commercial dwelling", such as where the space is predominantly used for hotel operations, this may also warrant the application of the carve-out. While there may be a degree of substitutability, the type of building structure and its overall use, suggests to us that a serviced apartment in such a setting is unlikely to be a good substitute for long term accommodation.

Māori collectively-owned land

We broadly agree that a carve out for rented papakāinga housing may be appropriate on the basis that papakāinga housing does not compete with owner-occupied housing.

In terms of identifying and defining papakāinga housing, an option may be to limit papakāinga to that on Māori land or Māori freehold land, identified through land records in the Te Kooti Whenua Māori (Māori Land Courts).

Our understanding is that papakāinga housing is often funded by Kainga Whenua Loans. We also understand that it is not uncommon for papakāinga housing to be held in, for instance, company structures alongside other non-residential property assets. As such, in the absence of a full exemption for papakāinga housing there is a potential for tracing to be required. It is possible that papakāinga may be structured in other ways, and further consultation with Te Puna Kokiri and Māori around the structure of papakāinga may be appropriate.

Chapter 3 – Entities affected by interest limitations

Chapter 3 proposes that the interest limitation rule should apply to companies that currently receive an automatic deduction for interest under section DB 7, provided they are either "close companies" or "residential investment property-rich" companies.

Residential investment property-rich company definition

Where a company holds an ownership interest in a residential investment property-rich company, the discussion document proposes that the ownership interest is treated as a "residential investment property" for the purposes of the threshold. We consider that the rules should allow this approach at a taxpayer's option, rather than making it compulsory. Where a taxpayer does not apply this rule, direct tracing for interest would be required.

Valuation considerations

Determining whether a company is residential investment property-rich requires the company to determine the value of its residential investment properties and compare this to the value of its total assets. The discussion document proposes applying the rules in existing section EL 19 to determine the relevant percentage.

While we agree that adopting the existing test in section EL 19 for this purpose is likely to be sensible given that taxpayers and their agents are likely to have some familiarity with the test, we note that any test requiring taxpayers to determine valuations for assets is likely to create compliance difficulties (and additional costs) for taxpayers.

Allowing taxpayers to apply the annual valuations set by local authorities is therefore support to reduce compliance costs. We also support the proposal to allow taxpayers to optionally use accounting or tax book values, rather than market values, for other property.

We note that under section EL 19, assets values are tested at the end of the taxpayer's income year. This creates a risk that a company acquiring land at the end of the income year may technically breach the test even if for most of the year it held no residential property assets. An option that allows taxpayers to test the percentage on an averaged quarterly basis, as is available in the thin capitalisation rules, may be preferable in this regard.

To reduce compliance costs, we submit that taxpayers should be allowed the option of using their accounting book values, as in most cases this should result in lower asset values (as typically, for accounting purposes, depreciation will be at a higher rate than for tax purposes).

Single company test for applying the test

The discussion document proposes that the "residential investment property-rich" test should apply on a company-by-company basis. The exception is for tax consolidated groups, where the test can be applied on a whole of group basis (i.e. treating the group as a "single company").

Requiring taxpayers to form a tax consolidated group in order simply to measure their "residential investment property-rich" percentage as a single company does not seem reasonable. We recommend that any "group of companies" (as defined in section IC 3 of the Act) should have the option of applying the test on a single company basis, by consolidating all companies in the New Zealand group (similar to the test used for thin capitalisation).

Chapter 4 – Interest limitation

Our basic propositions for determining what interest should be subject to the proposed limitation rule is:

- The existing rules are used to calculate the amount of interest, for tax purposes. This means either the financial arrangement or the cash basis persons rules will apply to determine the amount of interest potentially subject to the rules;
- This interest is allocated to private or taxable purposes as currently; and
- Interest incurred for taxable purposes is allocated to:
  - Residential property covered by the new interest limitation rule:
  - Other taxable income purposes (fully tax deductible).

Interest expenditure

We see no need to amend the current rules on how interest expenditure is calculated. This includes non-New Zealand dollar borrowing – the net expense (including foreign exchange gains and losses) should be the object of the rules. We note that interest is deducted first against any foreign exchange gains under this treatment. This is consistent with the current approach of the Act to determining interest expenditure.

Private interest expenditure

For existing loans, private borrowings should already be determined. That allocation should continue to be the basis for applying the transitional phase down rules.

Once the interest limitation rules are enacted, we assume that the private/taxable purpose allocation will be done when money is borrowed. Private interest expenditure would continue to remain non-deductible.

Tracing for companies

For companies, as there should be no private borrowing there would be no requirement to trace. For existing borrowings, the rules that apply to establish the purpose to be used in the transitional phase down will determine how the borrowing is allocated.

New borrowing/acquisitions

We assume the allocation to residential property would be determined at the time of borrowing. Interest allocated to residential property would be non-deductible in the current year. This interest should be carried forward and potentially offset/deducted in the year of sale (if the sale is taxable) per our submissions on Chapter 5.

This means:

- If no residential property is acquired, there would be no non-deductible interest. That would appear to be the case whether or not residential property is subsequently acquired (as the money has already been borrowed for another purposes).
- If residential property is acquired, borrowing will need to be traced to that use and interest deductions will be denied accordingly.

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Specific allocation rules proposed

Refinancing

We agree that refinancing of loans used to acquire property, subject to the phase out of interest deductibility, should still qualify for the transitional phase down rule.

However, we disagree with the proposed treatment for a loan refinanced in another currency. This is inconsistent with the Act's scheme to treat all loans as if they were NZD loans on an accrual basis. (This is the effect of the current rules dealing with foreign exchange gains and losses.) The answer is a simple application of current policy leaving commercial decisions on how best to borrow to taxpayers.

Non traced loans

We consider that option 1 (apportionment) is logical if the original borrowing is likely to be for the original cost of the relevant assets. However, this is less likely to be the case for revolving credit facilities and ignores the ability to restructure borrowings.

We therefore prefer option 2 (stacking), for simplicity. We note that there are likely to be winners and loser from this approach as it will depend on how market values have changed (compared to the original cost and amounts borrowed). However, as any restructuring of borrowings would also be market value based, option 2 provides an equivalent result.

From a pure policy perspective, option 1 is likely to raise the question of whether a specific anti-avoidance rule is required to prevent restructuring or whether section BG 1 may apply to restructuring. We consider that option 2 does not raise those questions.

Example 12 – revolving credit facility

Example 12 (on page 49) assumes that the loan amount subject to the transitional phase down rule should not be increased for any reason. This leads to the high water mark proposal.

We have difficulty seeing any policy problem illustrated in the example which requires a solution of this type.

In the example, the increases are due only to the timing of the receipt of rent and the payment of interest. On an end of the day basis, there is no increase in the amount borrowed. There should be no need to adjust the qualifying deductible borrowing.

We understand that some facilities could allow for additional borrowing. We submit that the approach should be:

- Additional borrowing for the purposes of the existing residential property activity should be deductible but subject to the transitional phase down rule.
- Additional borrowing for new residential property will be subject to the proposed rules (i.e. deducible for a new build and non-deductible for existing residential property).
- Additional borrowing for private or other taxable use, would be deductible or not based on the use of the funds.

This would allow a simple calculation of net borrowings for each purpose to be done annually to determine the proportion of interest subject to each rule.

This approach has simplicity as an advantage. It is justified on the basis that it is reasonably foreseeable that a taxpayer will incur further expenditure as a result of having acquired residential property. The interest is therefore properly attributed to the pre-change use.

Offset arrangements

We note the effect of an offset arrangement is that interest expenditure is "deducted" against interest income first (as the offset reduces interest paid to the taxpayer.) Accordingly, offset arrangements should only be within the rules if there is net interest expenditure.

Our suggested approach to revolving credit facilities could be applied to determine how much, if any, of this interest is subject to the residential property rules.

Foreign currency denominated loans and hedges

As above, we disagree with the proposed approach to foreign currency denominated loans and therefore foreign exchange hedges. In principle, there is no difference between New Zealand dollar denominated loans and foreign currency denominated loans. This is the approach taken by the Act which assumes an economic equivalence between the net result of a foreign currency denominated loan and New Zealand dollar borrowings.

On this approach, interest expenditure would be calculated as currently on a foreign currency loan and subject to the proposed rules accordingly.

If there are any foreign exchange hedge instruments, the result of the tax calculations for the foreign currency loan should be included in the net interest calculation for the loan.

Chapter 5 – Disposal of property subject to interest limitation

Options for treatment of revenue account disposals

We do not favour Option A (deductions denied). Under Option A, investors could potentially face a tax liability where they have actually made an economic loss on disposal of residential property, or a tax liability that significantly exceeds that on other investments with an equivalent economic return. The clear fairness and coherence concerns with Option A are not outweighed by any housing affordability objectives.

We prefer Option B, as its effect is that interest deductions should be available where returns from holding the property are appropriately taxed. We do not favour Options C or D, which add additional complexity in order to address a perceived arbitrage risk (discussed further below) and will over-tax residential property as a result.

Options for treatment of capital account disposals

We favour Option F, which allows a deduction only to the extent that the interest expenditure exceeds the non-taxed gain on sale of the property.

In our view, Option F effectively recognises that the interest cost incurred relates to both the capital gain amount and the taxable income that has already been returned during the period of ownership.

Arbitrage considerations

From a tax policy perspective, we do not see any reason why anti-arbitrage rules are required.

To the extent that a policy decision has been made to tax residential land, all "economic income" (whether from holding for rents or capital gains) will be taxed and allowing deductions is consistent with taxing only the net economic return to an investor.

Setting aside the tax policy considerations, from a social policy view, we also do not see any justification for the suggested anti-arbitrage approach. To the extent a tax loss might arise due to allowing a deduction for capitalised interest on disposal, at the margin, this may encourage investor to sell rather than hold on to the property. To the extent this increases available supply, this could be expected to benefit owner-occupiers.

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Chapter 6 – Development and related activities

KPMG supports the proposed exemption for development activity. Land developers are adding to the housing stock and should be entitled to a full interest deduction.

We also agree that the exemption should apply on a property by property basis rather than on a taxpayer basis.

KPMG does not agree with the comment at para 6.11 that almost everyone who develops residential property will hold the property on revenue account under section CB 7. Many taxpayers developing residential property will not be caught by section CB 7.

We therefore agree with the proposal that the developer exemption needs to be wider than just covering CB 7 to also capture one-off developments by people who are not in the business of developing land and also property development on land that is not captured by section CB 7.

Where land is not acquired for the purpose of development, but that intention is formed later, interest should be deductible from the time the intention to undertake a development is formed. The interest should be deductible on both the additional debt used to fund the development acquisitive and also on the debt used to acquire the property (for the time the intention to develop the property is formed).

We support an exemption to allow interest on debt funding for remediation work where the work is necessary to extend the life of a residential property, bring it to a more suitable standard for habitation (for example, remediation specifically to meet the 'healthy homes' standard to uplift the quality of New Zealand rental stock), or to convert a building from non-residential to residential use. We believe this is consistent with the wider policy objectives of the new build exemption.

Chapter 7 – Definition of "new build"

We agree that an exemption should be made for new builds in order to ensure new housing supply is not constrained, if the interest limitation proposal proceeds.

We agree with the proposed definition of new build.

We agree that, in principle, renovating an uninhabitable dwelling so that it becomes habitable should qualify for the new build exemption on the basis that this increases the total housing supply. Again, having regard to the Government's wider housing objectives, it seems counter-intuitive that these types of conversions should be excluded from the new build exemption. This would create an incentive to demolish rather than remediate, at the margin, for tax purposes

While we acknowledge the potential complexity from differentiating between renovating an uninhabitable dwelling and other renovations, we do not believe this would be insurmountable. And to our general comment, if the trade-off is between accuracy and simplicity/supporting the wider objectives, we would err on the latter.

Chapter 8 – New build exemption from interest limitation

Fixed new build exemption period supported

If the interest limitation proposal proceeds, we support the proposed new build exemption being available to both early owners of a new build, and to any subsequent purchasers of properties that qualify as a new build.

It is important that, for an initial owner looking to invest in new housing supply, there is a secondary market available on the eventual sale of properties and the tax system does not create uncertainty around valuation on sale.

Interest deductibility will be one of the variables that is taken into consideration when determining the pricing, and ultimately the feasibility, of a new build project. It is therefore important that investors have certainty over the period that they, and/or any future owners, will be entitled to claim an interest deduction at the time they make the investment decision.

We therefore support allowing interest deductibility for a fixed period for both early owners and subsequent purchasers.

It is important that the period of the new build exemption does not discourage the development of new housing stock. We suggest that the new build exemption should apply for a maximum period of 30 years. This includes for early owners who hold the property for more than 30 years (i.e. interest deductibility would cease after year 30 for them). We note that there is no exact science to picking the exemption period. One argument is to align the period with the Commissioner's estimated useful life for buildings – 50 years. However, an argument could be made that this is too generous. A 30 year period reflects, in our view, an appropriate balance between the need for certainty (which a fixed exemption period would provide) and a realistic total period for debt funding a new build (including where there may be multiple owners).

Continued investment rule not supported

We do not support the proposed continued investment rule, where a residential property that is subject to the new build exemption may be owner occupied.

It is simply not practical to require subsequent purchasers to undertake due diligence regarding use of the property by all earlier owners in order to confirm their eligibility to claim interest deductions (through continued application of the new build exemption). Further, the period being considered for the new build exemption will exceed the general record keeping period of 7 years. So, unless information on the applicability of the new build exemption is collected by Inland Revenue periodically (e.g. as part of the tax return), and is available to subsequent owners on acquisition, this will be a difficult rule to both comply with and enforce.

There will also be circumstances where an initial owner may need to temporarily move into a new build for a period of time before renting it out (for instance, if a person develops two properties at once, one to live in and the other to rent, and lives in the latter while the former is being completed) where the initial owner should not be precluded from applying the new build exemption.

Ultimately, we do not believe that the value of the continued investment rule in potentially creating more stock for first-home owners is justified for the additional complexity of the rule.

Chapter 9 – Five year bright-line test for new builds

We support retention of a five year bright-line period for new builds.

We recognise the rationale for wanting to limit the benefit of the shorter bright-line to early owners only. However, consideration should be given to whether its application to subsequent purchasers as well may better support the Government's objective of encouraging new housing supply.

Chapter 10 Rollover relief

We support the availability of rollover relief for both interest deductibility (during the interest phase out period and under the new build exemption) and for a wider range of scenarios under the bright-line test.

Rollover relief under the new build exemption should apply regardless of the new build exemption option chosen.

From a policy perspective, rollover relief should not only be available if new build exemption is limited to early owners in perpetuity. If the new build exemption is time capped (i.e. applies for a total fixed period across both early owners and subsequent purchasers), rollover relief should still be available for designated events.

Scope of bright-line rollover relief for family arrangements.

Paragraphs 10.7 and 10.8 outline an increasingly common occurrence where parental support may be necessary for first home buyers to enter the housing market. The discussion document notes that such arrangements can give rise to adverse tax consequences under the bright-line test. We agree and note that these issues will be exacerbated with the extension of the bright-line period to 10 years. In particular, we are concerned that the bright-line test could apply if a person other than the principal borrower(s) must also be listed on the title for a residential property in order secure bank funding (i.e. effectively acting as the guarantor). We submit that these types of situations should be addressed as a matter of priority, rather than "work being undertaken at a later date".

Application of full bright-line test rollover relief for settlements on a family trust.

We strongly support the extension of the bright-line test rollover relief to situations where residential land acquired prior to the bright-line test (or that was subject to the 2 or 5 year versions but following their expiry) is transferred to a trust.

However, the parameters for availability of such relief are not clear (for example, paragraph 10.31 suggests that rollover relief may be allowed where "a settlor settles land onto a trust in return for the trust providing the settlor the right to occupy the property free of charge (i.e. for natural love and affection)".

We believe this should also be the case where pre-bright-line test residential property is gifted to a trust or the property is sold to a trust in exchange for a loan. In both cases, if the transferor is also the settlor and a beneficiary of the trust, there is no change in economic ownership of the property, so there is no reason why the bright-line test should apply when it did not originally (or the bright-line period has otherwise lapsed).

Chapter 11 – Interposed entities

These proposals contain the most difficult rules to apply in practice. The require serious simplification to allow them to be used.

Affected assets percentage and apportionment calculations – closely held and other interposed entities

Paragraphs 11.6 to 11.9 do not specify when the calculation is performed. However, paragraph 11.14 and subsequent imply that this could be a year end test or a daily test (or something in between). 11.16 states that a "daily calculation" does not require a calculation everyday but that a calculation must be done for every day.

A good dose of common sense is required.

The PIE rules require daily calculations and attributions of income and expenditure for each PIE. These calculations are carried out by systems developed and operated by sophisticated fund managers and administrators.

A full attribution regime for company income has not been implemented in larger part due to the difficulty of doing daily calculations and attributions.

In both cases, the calculations are those of the entity itself. For the interposed entity rule, the shareholder would be required to access information from the entity and calculate their own apportionment. The entity would have to be able to provide that information on a daily basis.

This is an onerous burden. We can only conclude, in the words of a former Minister of Revenue and Finance, that this is an "ideological burp" and not to be taken as a serious proposal.

Most companies will only prepare annual financial statements. That should be the starting point for what is possible and realistic for them to provide to shareholders.

This means that an avoidance rule should be considered. An appropriate rule could eb modified from the thin capitalization rules. We are not aware of any specific difficulties with applying these rules or that have not achieved their objective. On the latter, any uncertainty of application is likely to mean that changes in the ratios are most likely the result of commercial decisions. Further, any "asset stuffing" to increase the non-residential property proportion would need to be funded. Existing funds would not change the proportion (i.e. from cash to some other asset). Other increases would require either debt or equity funding. The terms of such funding would likely make it easier to determine whether the anti-avoidance rule should apply.

Trusts

We have referred to companies as an inter-posed entity as it is difficult to see how borrowing to fund an inter-posed trust would be effective. A taxpayer borrowing to provide equity to a trust would not normally be considered to be borrowing to produce assessable income. A trust is therefore most likely to be involved in the on-lending scenario covered at paragraphs 11.28 to 11.30 and considered below.

Widely held companies

If implementing the proposals will be difficult for close companies, it will be even more difficult for shareholders of widely held companies. Information is unlikely to be able to be provided on a timely basis. If the company is listed there will be insider trading and NZX rules which may limit the type and timing of information provided to shareholders.

The current interest deductibility rules provide some certainty of deductibility. For investments in widely held companies, the interest deduction and therefore the taxable income, may be volatile.

We consider that a widely held company rule may not be required. It is unlikely that borrowing to invest in affected companies will be done to allow deducible interest.

However, if the rule proceeds, then the apportionment should be based on the company's prior year balance sheet. This is likely to assist investors with estimating their current year tax and also would reduce delays in the provision of information required for an income tax return.

For example, the company would provide shareholders with its 31 March 2022 percentages to be applied to the calculation of 31 March 2023 tax position.

If this approach was taken, then an apportionment should be allowed.

Look though companies and partnerships

A clarifying provision to ensure that the debt is apportioned to the assets of the LTC or partnership seems reasonable. However:

Depending on how this is drafted, it may raise questions on the taxation of an LTC or partnership more generally. Those consequences should be considered and dealt with.

The shareholder or partners access to relevant information should be considered. As this rule would mean that loans are traced to assets consideration needs to be given to how the primary rules can be given effect for a taxpayer who is not the entity with the entity's access to information.

Existing interposed entities

Given that nothing in the proposed rules is simple, we disagree with the proposal for existing loans. If due to compliance costs a taxpayer chooses not to apply apportionment and tracing rules, that should be the taxpayer's choice. Other taxpayers should have the same ability as direct acquirers of residential property.

Disposal of interest in inter-posed entity

Our submission on existing interposed entity treatment suggests that denied interest should be allowed as a deduction if either the property asset or the sale of the shares in the interposed entity is taxable.

On-lending

We agree that in the example it is only an anti-avoidance rule which needs to be considered. We note that less than market interest on-lending would raise the possibility that BG 1 would apply. (However, we note the restricted transfer pricing rule is premised on related party borrowing making no or very little margin. This is contrary to the market value assumption that is implied as required by BG 1.)

We have considered an alternative example. Zeean lends to her Family Trust, at interest, which acquires shares in LandCo. The Family Trust would be subject to the interposed entity rule and its interest would be apportioned in accordance with those rules. The anti-avoidance considerations would still apply to the interest rate charged by Zeean to the Family Trust.

Chapter 12 – Implications for the loss ring-fencing rules

As an initial observation, on the basis that the Government proceeds with the interest limitation rule as proposed, it would seem that rental investment properties are very likely to produce taxable profits, with losses being expected only at the margins. This is particularly so given that depreciation deductions are no longer available for residential investment properties. On that basis, our preferred approach is that the existing rental loss ring-fencing rules are repealed.

We further observe that if the rental loss ring-fencing rules are not repealed, we would expect the interface between the proposed interest limitation and the existing rental loss ring-fencing rules to become exceedingly complex. This is likely to result in potential unintended consequences.

To the extent the Government is not prepared to repeal the existing residential loss ring-fencing rules, we support carve outs for new builds and development properties on the basis that doing so will encourage new supply to the market, with the objective of lowering prices for potential owner-occupiers.

For reasons given above we do not consider that anti-arbitrage rules should be required, and we would not favour such rules in any case as they will likely result in considerable complexity.

Chapter 14 - Administration

Chapter 14 considers the administrative aspects arising from the Government's proposal to limit interest deductions and extend the bright-line tests for residential investment properties. We comment specifically on the questions raised by officials below.

Adding a field to tax return

We do not consider that any particular issues should arise from adding a new field to the tax return to capture the amount of interest relating to residential investment property debt. To the extent that taxpayers have had to trace their borrowings to residential property and determine the interest subject to the proposed deduction denial, itemising that amount in their tax return should not be an onerous task.

Record keeping

In light of the proposed extension of the bright-line test to 10 years, Inland Revenue should provide further detail as to its expectations around record keeping. Under the current settings, taxpayers are expected to keep records for a period of seven years from the end of the year to which the records relate.

Because the proposed 10-year bright-line test could 'bite' between year seven and year 10 without the taxpayer anticipating a tax liability, there is a risk that taxpayers may have discarded records at year seven making it difficult or impossible to quantify any tax liability.

In a practical sense, the new bright-line test may now imply that records must be held for 10 years.

Code Compliance Certificates

The Discussion Document suggests that Code Compliance Certificates ("CCC") might be used to evidence that a property is a new build under the proposed test. We consider that this is likely to be a reasonable approach given that all new builds will have a CCC issued once they are constructed to a standard suitable for occupation. We are not aware of any integrity risks that could arise from this approach.

Subsequent purchasers

To the extent that subsequent purchasers are able to take advantage of the new build exemption, there is a potential commercial risk as to the information that the subsequent purchaser will need to establish that the exemption applies. Depending on the design of the subsequent purchaser rule, and whether the rule requires any form of disclosure by the vendor so that the purchaser can determine its tax obligations, there could be a potential contractual risk between vendor and purchaser (similar to the kinds of risks under the GST CZR rules). There may be value in consulting with ADLS as to whether any of the standard terms in the ADLS SPA require amendment, or whether a specific disclosure schedule is necessary.

KPMG
10 Customhouse Quay
PO Box 996
Wellington 6140
New Zealand
Telephone +64 4 816 4500
Fax +64 4 816 4600
Internet www.kpmg.com/nz

Mr Paul Fulton
Policy and Strategy
Inland Revenue
PO Box 2198
WELLINGTON
BY email: Paul.Fulton@ird.govt.nz

Our ref ACDA response.docx

18 December 2020

Dear Paul,

Available capital distribution amount: special rules for liquidations and share for share exchanges

Thank you for the opportunity to comment on the proposals in your letter of 13 November 2020.

You will appreciate that the deadline for responses is tight and is competing with many other policy and operational issues. We have not had the time to consider the proposal in detail. However, we have arrived at in principle solutions which we consider are worth exploring further.

There are broadly three issues raised in the letter. These are:

— Issue 1: the potential for double counting of capital gains (and converting revenue reserves to capital gain amounts) in the current available capital distribution amount ("ACDA");

— Issue 2: share for share exchange available subscribed capital ("ASC") rules can convert capital gains to revenue reserves;

— Issue 3: a revenue account property shareholder company can access capital gains of a subsidiary.

Issue 1 and 3

In principle

We see merit in addressing the first and third issues by having ACDA calculated at the parent level, i.e. there is no flow through.

Our recall of the need for the flow through rules is there was a risk that a gain made on a liquidation of a company would be a tainted capital gain. The flow through rules addressed that by deeming a gain which took priority over any actual gain made by the shareholder.

As the tainted capital gain rules have been amended, it is arguable (but preferably it may be better to put it beyond doubt legislatively) that a liquidation gain would not be tainted. The shareholder would no longer have the asset (the shares) from which the gain is made.

This change to the tainting rules provides a significant simplification opportunity – to allow gains to be tested at the parent level only.

This would seem to address both issue 1 and 3 as there would be no opportunity to double count or for a capital gain to arise for a revenue account property shareholder.

Further work

We assume that any dividend paid on liquidation would not be included in the parent's ACDA calculation. This needs to be tested.

Further, we have not fully explored the consequences of this approach for different scenarios to determine whether there are any unexpected outcomes. This should be done as in our view this approach is much simpler than the proposed deeming rules.

Issue 2

We have not fully worked through the examples and scenarios. However, a much simpler solution would be to adjust the available ASC in a share for share exchange. In outline, it would work as follows:

- Consideration for the shares acquired less
- Revenue reserves of the target company
- Less cash and debt paid for the target shares
- Equals ASC for the shares issued.

This solution appears to deal with both implicit and explicit capital gains from the target company. Further, if the parent company solution for issue 1 is adopted, there should be no double counting of gains.

We note that this means the return of capital, rather, than the liquidation, rules would apply. However, that appears to be an appropriate trade off when New Zealand continues to not have a comprehensive capital gains tax.

We also understand that this proposal would need to consider whether a specific anti-avoidance rule is required.

ASC and ACDA memorandum accounts

The letter states there is no current intention to require memorandum accounts for ASC and ACDA. The concern with the current rules is that it is not until there is a liquidation or distribution that ASC and ACDA need to be confirmed. This creates evidence problems as there may be a significant period between ASC/ACDA being generated and it being used.

We submit that it is timely to introduce memorandum account rules. These should have a statute bar applied for credits to the memorandum account to provide taxpayers with certainty.

A memorandum account filed each year would also provide useful information to Inland Revenue. It would directly advise Inland Revenue of an amount treated as a non-taxable capital gain for example which may not be obvious from the tax return.

We acknowledge that the rules for the opening balance require some consideration. Any issues may be addressed by allowing both taxpayers and Inland Revenue an extended time to amend the balance. It is also likely that the level of evidence required should be modified. For example, an issue of shares at a consideration should be sufficient to establish ASC.

Policy principle

The current rules provide different tax outcomes depending on which company in the structure is sold. We consider the tax rules should apply to produce the same tax outcome whichever company is sold.

We have not tested our proposals against this principle. That should be done.

General

We trust that this response, albeit short, is clear and of assistance. We would be pleased to discuss it further. Please contact John Cantin on 04 816 4518 in the first instance if you have any questions.

Yours sincerely

John Cantin
Partner

Rob Hill
Partner