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The Chair
Finance and Expenditure Committee
Parliament Buildings
Wellington 2140

Our ref 150430KPMGsub2015TaxBill

30 April 2015

Dear Sir

KPMG submission - Taxation (Annual Rates for 2015-16, Research and Development, and Remedial Matters) Bill

KPMG welcomes the opportunity to make a submission on the Taxation (Annual Rates for 2015-16, Research and Development, and Remedial Matters) Bill (the "Tax Bill").

We are broadly supportive of the key changes in the Tax Bill, including:

- Cashing-up certain research and development ("R&D") tax losses to companies.
- Greater deductibility of non-deductible and non-depreciable (i.e. "black hole") R&D expenditure.
- Clarifying the GST treatment of bodies corporate fees and expenditure.

However, we have made a number of suggestions to improve the operation of those rules.

We note the Tax Bill also contains a number of remedial and other policy matters. We have commented on specific changes. Absence of a comment does not necessarily imply support for (or disagreement with) a particular change, rather that we have necessarily focussed more on some issues, and not others in the time available.

Cashing up R&D tax losses

While we support the proposal, we are concerned that the detailed design may make the proposal unattractive for business.

Issue 1: Complexity

The proposal is aimed at small start-up businesses. This is clear from the first qualification requirement, which is that more than 20% of a business's salary expenditure must be on qualifying R&D activity (the so-called wage intensity calculation). Mature businesses will generally not have sufficient R&D wage intensity to meet this threshold.

There will be complexity for start-ups to comply due to the nature of the current legislative drafting, the need to determine what is eligible R&D and what is refundable, complete and file

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the required electronic forms and maintain records (such as the impact for imputation credit account purposes). There will therefore be the need to engage external advisors.

As an example, certain activities and expenditures will not qualify as R&D under this proposal, meaning business may need to make adjustments to the ordinary R&D definition used for accounting and tax deductibility purposes, to access the proposals. Determining eligible R&D based on the current tax definition will be complex enough, with having to worry about additional exclusions. (Based on our prior experience with Inland Revenue, this is likely to require the most disclosure and review.)

There are also various caps on the amount that can be cashed-up – including a total dollar threshold, a cap based on total losses of the business, their total qualifying R&D expenditure, and salary expenditure.

We do not believe the compliance costs are warranted, keeping in mind the small start-up businesses this change is aimed at and the revenue at stake.

Claw-back mechanism

Further, it is proposed that any cashed-up amounts will need to be repaid if the resulting R&D asset is sold, more than 90% of the shares in the company are sold, or the company is liquidated. The losses will be reinstated in these circumstances.

While we can understand the rationale for a "claw back" mechanism if the business is wound up or the company is sold, as this would result in the tax losses underlying the refund being forfeited, this is not the case if the R&D asset is sold, but the business continues. A sale of an R&D asset should not trigger the claw back mechanism in these circumstances.

We further note that there is a practical problem with imposing a refund obligation on a company which is wound up. (One of the potential tax liabilities arising for insolvent companies is currently being consulted upon through the *"Related parties debt remission"* Officials Paper.) There seems to be little practical point in imposing a refund obligation when a company is unable to repay.

Imputation account issues

The proposal will also have other impacts, such as on the company's imputation account (as cashed-up losses will be netted against income tax paid). These amounts will need to be tracked to ensure that dividends are not over-imputed.

Issue 2: cash flow benefit will not arise until after a tax return is filed

The proposal is designed to help alleviate cash flow problems for start-up companies. However, the actual cash flow benefit will only be realised after a company has filed their tax return (and the accompanying R&D income statement), as this is when the refund will arise. This will generally be after the cash is spent as the return can only be filed after the tax year ends.

Issue 3: Inland Revenue's administration of the proposal

The success of the proposal will depend heavily on how Inland Revenue actually administers the proposal.

An overly strict approach by Inland Revenue in reviewing claims, resulting in delays in the cash-up of R&D losses will impact on the take up of the proposal, not to mention exacerbating the cash-flow issue discussed above.

Our concern is that Officials' proposed approach seems to be based on their administrative approach to the R&D tax credit regime (this was indicated in a discussion document on the cash-up proposal). That is not the right benchmark. R&D tax credits provided an incentive through the tax system, hence a stricter approach could be justified. This is not the case here as the intention is to bring forward the benefit of a tax loss and not to provide an entitlement. We also consider that the more targeted approach, for start-ups particularly, means that this approach is not suitable.

Submissions on issues 1 to 3

While we support the intent of the cash-up proposal, we recommend the design and administration of the proposal be simplified to deal with the concerns outlined above.

- We recommend relaxing the entry requirements. For example:
  - the rules for determining eligible R&D expenditure should be simplified by aligning with the definition of R&D currently used for tax purposes (i.e. in section DB 34 of the Income Tax Act 2007), without additional carve-outs; and/or
  - the refundable amount under the proposal should be capped at the lesser of the total dollar threshold and the tax effective value of an eligible business's total tax losses, without the need for other caps (e.g. based on salary expenditure).
- The situations in which the claw-back mechanism applies also needs further consideration. It should not apply where the R&D asset is sold, but the business continues.
- The administration by Inland Revenue needs to take into account the key driver of the proposal, which is to alleviate cash-flow concerns for start-up business, and ensure that lengthy and costly delays in processing the cash-up of tax losses are accordingly mitigated. The administration of the proposal should not be based on the previous R&D tax credit regime.

Issue 4: definition of "R&D expenditure" should include capitalised expenditure

Eligible "R&D expenditure" in section YA 1 of the Income Tax Act 2007 is defined as expenditure for goods and services to the extent to which they relate to research and development but not including expenditure for which no deduction is available.

Our concern is that, as drafted, the expenditure on goods and services relating to R&D must be directly deductible. Where the expenditure relates to R&D that is capitalised and depreciated instead, there is arguably no direct nexus. This is notwithstanding the depreciation deductions creating tax losses.

Submission on issue 4

We assume the intention is that the proposal should apply in the above circumstance, as the company will have incurred real costs (e.g. salary and wage expenditure, which comprise the capitalised depreciated costs). This should be clarified.

Issue 5: R&D support for large business

As noted above, the 20% R&D wage intensity test means the proposal will be of limited value to most medium to large businesses. There are also restrictions on use of the proposal by listed companies or where the group does not meet the 20% threshold.

However, they may qualify for other assistance. Much of this is outside the tax system.

One of the challenges for business is understanding the different types of Government assistance that is available. We note the Government has committed significant funding for R&D and innovation but only a fraction of this is currently being accessed.

Submission on issue 4

We believe that there is a role for Government and its agencies in better communicating and socialising the available R&D assistance with the business community and advisors.

Other issues

We submit that the ability to include only 66% of contract R&D costs as part of total R&D labour expenditure in the wage intensity calculation should be reconsidered.

This apportionment is designed to exclude non-labour costs and profit from the contract price. However, this is a genuine R&D cost to a business and the total amount should be take into account in determining whether the proposal applies. (It also unnecessarily adds to the complexity of the proposal, as outlined earlier.)

Black hole expenditure

We are supportive of the changes in the Bill which will remove the scope for non-deductible and non-depreciable expenditure, in the following situations:

- Capitalised expenditure relating to intangible assets that are not depreciable assets for tax purposes, but only when the asset is derecognised for accounting purposes. (Any deductions will also be clawed-back if the intangible asset becomes useful again, or is sold.)
- Capitalised expenditure relating to existing patents, patent applications and plant variety rights (which is not currently included in the depreciable cost base of these items).
- Capitalised expenditure incurred on design registrations and industrial copyright.

Submission

While these are useful clarifications, the changes are mainly at the margins. For example, the allowance of a tax deduction for capitalised expenditure on a non-depreciable asset when that asset is derecognised, allows no deductibility during the life of the asset (which is the correct timing for offset against any income earned).

This is a consequence of New Zealand's depreciation rules, which allows depreciation only where an asset can be demonstrated to have a finite economic (in the case of intangibles, legal) life. We note that other countries have different approaches, including economic life based on accounting, or self-assessment of economic life of an asset by taxpayers. The accounting life of the asset provides a useful benchmark as this would match the tax position with reported profits. Taxpayers can be expected to have regard to reported profits given that the reported profit has other impacts for the company and shareholders. These alternative approaches should be explored.

Further, the issue of black hole expenditure more generally remains a concern. KPMG believes that the issue of black hole expenditure, generally, needs to be looked at and dealt with comprehensively rather than in the current ad hoc manner.

GST and bodies corporate

The Tax Bill will treat body corporate fees, which are used to fund expenditure such as building maintenance, insurance and security, as supplies for GST purposes. This will mean that a body corporate is required to GST register if its total supplies, including those to members, is greater than $60,000 annually.

However, the Tax Bill effectively allows a body corporate to treat member fees as exempt GST supplies. This means a body corporate is only required to register for GST if supplies to non-members exceed $60,000. The net result is that:

- Bodies corporate that have already GST registered can continue to remain registered. However, if they deregister they will not receive refunds of GST paid on member fees held at the time of de-registration.

- Bodies corporate that have not GST registered can continue to remain un-registered if supplies to non-members remain below $60,000. However, if a body corporate registers, it will have a one-time GST cost based on cash and non-cash investments held at the time of registration and ongoing GST obligations (e.g. to pay output GST and claim input GST on expenditure).

Submission

We strongly support the approach in the Tax Bill.

Comment

The Government's original proposal was to treat bodies corporate members' fees as GST exempt in all cases and deny GST claims on bodies corporate expenditure. That would have resulted in considerable compliance costs, including having to repay previous GST refunds and/or claim back GST already paid.

The solution in the Tax Bill is more workable and pragmatic. It provides taxpayers with flexibility to keep doing what they are doing or to change their GST position, prospectively, if so desired.

However, it also means that bodies corporate and their members who have been taking a "practical" approach to claiming GST refunds, by members claiming their respective share of input tax, may need to register for GST.

Potential technical issue

A body corporate is defined by reference to the Unit Titles Act 1972 and Unit Titles Act 2010. The different references apply at different times. We are concerned that the reference to the 2010 Act would not include bodies corporate established under the 1972 Act so that the proposed amendment would no longer apply when clause 249(2) of the Tax Bill applies.

Submission

Clause 249(2) should refer to any body corporate subject to the Unit Titles Act 2010. This should mean that those established under section 75 of that Act as well as those deemed to be by virtue of section 219 to be a body corporate for the purposes of the GST Act are covered.

International tax remedial amendments

The Bill contains a number of policy and remedial changes to the Controlled Foreign Company ("CFC"), Foreign Investment Fund ("FIF") and new Foreign Superannuation tax rules. We comment on specific measures below.

Base protection measures

- The choice between an annual or more frequent (e.g. daily) basis for calculating Fair Dividend Rate ("FDR") income will be available only once every four years. We can see the see the rationale for this change. A taxpayer is able to undertake the calculation with the benefit of hindsight (e.g. an annual FDR method when share values are increasing and the unit valuation period FDR method when share values are falling, to minimise the value upon which FDR income is calculated).

- The normal pre-paid expenditure spreading rules will apply to the expenditure of CFCs. The concern is the current rules allow immediate deductions for expenditure that would be spread if the CFC was a New Zealand company. We note that a taxpayer required to apply the CFC rules incurs significant compliance costs. We encourage the Finance and Expenditure Committee to consider whether this rule, which increases the "correctness" of the amount attributed is necessary, when compared to the costs of complying.

- It will not be possible to cherry pick the application of the CFC test group rules when applying the active business exemption – e.g. consolidating active CFCs with passive CFCs when the latter has income, to access the active exemption for the group, but not when the passive CFC has losses (as these can be carried forward). This "consistency" requirement has been drafted as an anti-avoidance rule to allow the Commissioner of Inland Revenue to reject a test grouping election. Our concern is how this power will be exercised in practice as there may be legitimate reasons for changing test groups (with the result that the composition of CFC income/loss may change from year to year) but which may result in this rule applying. Guidance on the criteria the Commissioner will apply should be provided.

Amendments to the CFC and FIF rules

We support the following CFC and FIF changes in the Tax Bill:

- Limiting the test for the Australian FIF exemption to the period over which the FIF is held.

- Allowing groups of foreign companies acquired (or disposed of) during a year to be included in CFC test groups.

- Clarifying that the personal services attribution rule, or the CFC rules, can be used for attributing income if personal services are provided through a foreign company. Currently both rules apply, with the CFC rules a more complex undertaking.

- Aligning the income attribution for FIFs held directly and indirectly through a CFC.

Foreign Superannuation remedial amendments

The Tax Bill contains the following remedial amendments to the Foreign Superannuation tax changes enacted in the Taxation (Annual Rates, Foreign Superannuation, and Remedial Matters) Act 2013.

- Confirming that the new Foreign Superannuation tax rules, rather than the FIF rules, apply to foreign superannuation scheme interests acquired when a person was NZ tax resident but non-resident under a Double Tax Agreement ("DTA"). We support this change.

- Application of the new rules for foreign superannuation scheme interests, rather than the FIF exemption, where the holders' foreign superannuation scheme interests (combined with other FIF interests) have a cost of NZ$50,000 or less. While we agree that those with low-value superannuation interests should be able to apply the new rules, we disagree with a number of the detailed features of this change. For example, that a low-value superannuation interest would not be eligible for the 4 year exemption period; instead the assessable period for a low-value superannuation interest begins when the person first acquired the rights in the scheme. Similarly, that the Formula Method will not be able to be used for such interests. This will "over-tax" low value superannuation interests relative to other Foreign Superannuation scheme interests. We strongly recommend these features be reconsidered.

- Restatement of the previous FIF exemption for Australia regulated superannuation schemes. We support this remedial amendment as the initial exclusion was in error.

- Confirming that where pensions have been returned as taxable income prior to 1 April 2014, individuals will not be penalised for FIF non-compliance, if those rules should have applied instead. We again support this change, as it will remove a historic tax risk for taxpayers who have attempted to comply with their tax obligations.

Tax status of tertiary education institute subsidiaries

We support the proposed exemption from income tax for a Tertiary Education Institution ("TEI") being widened to include income earned by a business, such as a subsidiary, for the benefit of the TEI.

Extension to business carried on for the benefit of a charitable trust

We believe this exemption should be extended to include income earned by a business, such as a subsidiary, for the benefit of a charitable trust. Specifically, clause 76 of the Tax Bill, amending section CW 55BA, refers to section CW 42. We believe that CW 42 contains an unintended omission by excluding businesses carried on by a company for charitable purposes and owned by a charitable trust, from the income tax exemption for charities.

Background

We note that under section CW 42, income derived directly or indirectly from a business carried on by, or for the benefit of a charitable trust, society, or institution is exempt if the following criteria are satisfied:

- The trust, society or institution carries out its charitable purposes in New Zealand;
- The trust, society or institution is a tax charity when the income is derived; and
- No person with some control over the business is able to direct or divert, to their own benefit or advantage, an amount derived from the business.

Whilst the direct business income of a charitable trust is exempt from income tax, it is necessary to determine whether income earned by a business, including a charitable business or a company or other entity controlled by that charitable trust, is also exempt. This includes an analysis of whether the charitable trust's control over the business (by virtue of their ability to direct or divert an amount derived from the business for their own benefit) prohibits the income tax exemption in CW 42 from applying to the charitable business of the company or other entity.

Section CW 42(5) states that a person is treated as having some control over the business if they have an ability to able to direct or divert an amount from the business to their own benefit or advantage. Furthermore, section CW 42(5)(b) adds that a person has control over a business if their ability to determine or influence the benefit or advantage arises because they are *"a shareholder or director of the company by which the business is carried on"*.

Therefore, a charitable trust owning shares in a company operating a charitable business may be regarded as having control over that charitable business under section CW 42 of the Act.

Benefit or advantage is then defined in section CW 42(8) and includes in section CW 42(8)(b) "*deriving an amount that would be income of the person under 1 or more of the following provisions: … (v) section CD 1 (Dividend)".*

The inclusion of the words "*would be"* in section CW 42(8)*,* along with *"able to direct or divert"* in section CW 42(1)(c) mean that the potential ability to derive a dividend as a shareholder of the company carrying out a charitable business may prevent the company's charitable business income from being exempt from income tax. This prevention of tax exempt status could apply even if a dividend is not actually paid, as long as the charitable trust has the ability to receive a dividend in their capacity as shareholder.

The restriction on the income tax exemption for business income of a charity would appear to be an unintended outcome. Practically, the application of CW 42 as currently drafted means that a charity is not able to derive tax exempt charitable business income in a subsidiary company (which may be desired for legal limitation of liability purposes, for example), but that same income would be tax exempt if derived directly by the shareholder charitable trust.

Further, we understand that the rules in section CW 42 are intended to prevent non-charitable enterprises benefiting from the tax exempt income derived by a non-charitable entity it controls. Paragraph 50 of Inland Revenue's Operational Statement 06/02 states that:

"Section CW 35(1) [of Income Tax Act 2004] also applies to companies that carry on a business for the benefit of a trust, society or institution and do not have charitable purposes or objects. Such a company does not have to register with the Charities Commission in order for the business income that is directed to a trust, society or institution to be exempt. The amount of business income so directed will be exempt from tax provided the recipient trust, society or institution-

- *Carries out its charitable purposes in New Zealand, and*
- *The trust, society or institution is itself registered with the Charities Commission."*

The commentary supports the assertion that business income derived by a company that is directed to an eligible charitable trust should be exempt.

Submission

We recommend that charitable subsidiaries set up by charitable trusts be afforded the same treatment as subsidiaries of TEIs. We submit that the section CW 42(1)(c) be re-drafted as follows:

"Income derived directly or indirectly from a business carried on by, or for, or for the benefit of a trust, society or institution of a kind referred to in section CW 41(1) is exempt income if –
….

*(c) no person, **<u>other than a charitable entity referred to in section CW 41(1)</u>**, with some control over the business is able to direct or divert, to their own benefit or advantage, an amount derived from the business.*

"Public unit trust" definition remedial amendments

Change of reference

The Tax Bill contains a remedial amendment to the definition of "public unit trust" in section YA 1, to remove the requirement that regulated offers are made under the Financial Markets Conduct Act 2013 (there being no equivalent concept of offers to the public in the Financial Markets Conduct Act 2013).

Submission

We strongly support this amendment. However, this remedial amendment is to reverse an unintended change made on the introduction of the Financial Markets Conduct Act 2013, the relevant section of which took effect from 1 December 2014. The amendment is currently proposed to take effect from enactment of the Tax Bill. As the unintended change was effective from 1 December 2014, we submit that the proposed amendment should take effect from that same date.

Change to the level of allowed investment

We do not support the amendment to reduce the 25% shareholding percentage in paragraph (b)(vi) and (viii) of the "public unit trust" definition, to 5%. This is not a remedial amendment resulting from changes to Financial Markets regulation.

This change could have significant impacts for unit trusts that currently rely on paragraph (b) of the "public unit trust" definition, who will be caught unawares and potentially lose their status as a result. The change has not been consulted upon and it is not clear that the amendment is required or justified to address any perceived or real concerns.

Submission

We submit this change be omitted from the Tax Bill and subject to wider consultation, rather than being enacted as a remedial amendment, which it is not.

Foreign Investment Vehicle definition in section HM 3

Section HM 3(2) currently states that:

A trust that is, for Australian tax purposes, a managed investment trust under the Taxation Administration Act 1953 (Australia) is a foreign PIE equivalent if it meets the requirement in subsection (1)(a).

We understand that the definition of a "Managed Investment Trust" is to shortly be moved from the Taxation Administration Act 1953 (Australia) to the Income Tax Assessment Act 2007 (Australia). Once enacted, this will potentially make the above provision, inoperative.

To "future proof" section HM 3(2), we recommend that the words ***"or successor Act"*** is added after Taxation Administration Act 1953 (Australia).

Other issues in the Tax Bill

We support the following changes in the Tax Bill:

- Repeal of the recent changes to the tax return filing requirements for individuals which were intended to apply from the 2016-17 income year, in anticipation of Inland Revenue's Business Transformation changes. We note these changes were intended to stop individual taxpayers from "cherry picking" refunds, by requiring an income statement (Personal Tax Summary) for the previous four years as well as the year of refund.
- Allowing employers in the same group as a person in the business of lending money to the public (e.g. a bank) to use market rates of interest to calculate FBT on employment-related loans. Presently, a bank that employ its employees through a special purpose group company is not able to use its own market lending rates to benchmark the fringe benefit component on employment related loans. This is because the employing group company is not technically in the business of lending. The proposal fixes this nonsensical outcome and we welcome it.
- Allowing provisional tax pooling to meet use of money interest ("UOMI") charges on additional tax resulting from an amended assessment or resolution of a tax dispute, from 3 July 2014. While this is a positive step, the need for tax pooling reflects underlying concerns about the application of the UOMI and penalties regimes, generally, which need to be more fundamentally addressed. If these regimes are not to be restricted, we support a wider application of the funds in a tax pool to meeting tax liabilities. These funds, if a wider application was allowed, have the potential to reduce the historical tax debt at a significantly lower cost to both taxpayers and Inland Revenue.
- Ensuring the property transfer rules (e.g. from trusts to beneficiaries or on settlement/transfers of relationship property) work as intended.
- Remedial amendments to the bad debt deductibility rules (e.g. to clarify that the capital limitation does not apply to prevent a bad debt deduction for a loan if the lender has entered into the debt in the normal course of business) and the financial arrangement rules (e.g. to clarify the allocation of financial arrangements income/expenditure when two companies amalgamate).

Further information

Please do not hesitate to contact us, John Cantin on 04 816 4518, or Darshana Elwela on 09 367 5940, if you would like to discuss any aspect of this submission. We would also be pleased to appear before the Finance and Expenditure Committee, on our submission, if this opportunity becomes available.

Yours sincerely

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