

14 January 2009

The Chairperson
Finance and Expenditure Select Committee
Parliament Buildings
WELLINGTON

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Dear Sir

Taxation (International Taxation, Life Insurance and Remedial Matters) Bill.

This submission is from Grant Thornton New Zealand.

Grant Thornton New Zealand is a national association of independently owned and operated firms. This submission is made on behalf of those firms.

We do not wish to appear before the committee.

General

We have reservations regarding the reinstatement of this Bill in full and in particular the short time frame given to make submissions. Last year when the Bill was first referred to the Select Committee it was widely accepted that the Bill would lapse when Parliament rose prior to the General Election. Therefore most interested parties delayed preparing submissions until they saw the outcome of the election and what parts of the Bill remained in tact. It is somewhat surprising to see that now that the Government has been formed by what were previously Opposition parties that it should remain fully in tact. However it is accepted that there are large parts of the Bill, in particular the International Tax Reforms, which had majority cross party support.

However to announce on the 18 December 2008 that submissions would close on 15 January 2009 would appear to give organisations little time to prepare submissions given that most organisations (including Parliament) are closed for 2-3 weeks over the Christmas break.

That being said we have the following specific submissions to make which are limited to, due to time constraints, items that we consider the most important to our clients.

Tax Treatment of Relocation Payments and Overtime Meal Allowances (Clauses 34, 35, 42, 485, 545, 547-549, 616, 617 and 619)

In December 2007 Grant Thornton made a submission to the "Relocation and Overtime Meal Allowances Project" that the Officials proposals should not be proceeded with because:

- Firstly the analysis in IG 3162 is incorrect and it focuses solely on relocation expenses and overtime meal allowances where there are a number of other allowances that need to be considered. In asking for submissions on what further allowances and reimbursing payments should be exempted the Government appears to have accepted that the analysis in the Exposure Draft can be applied to all allowances/reimbursing payments and therefore all these payments are now taxable and need to have an exemption specifically inserted for them in the Act.

- Rather than applying the quick fix we consider that the Government's needs to review what their policy position is on such payments and then enact legislation that fairly reflects that policy intent. There is no coherent policy behind the current legislation as it has "evolved" over time as restrictions have been placed on the ability of employees to claim deductions in relation to expenditure that they incur in relation to their employment. These changes have been made to reduce administration costs but clearly result in an untenable result, from a purely tax policy perspective. Some previous Governments have also expressed the view that the employers should be reimbursing employees for these expenses but with the implicit understanding that these payments should not be taxable.
- We believe that IG 3162 is incorrect in that it focuses on the case law that came out of the repealed Fourth Schedule of the Income Tax Act 1976 and as such does not truly consider what the situation would be if the "employment limitation" did not exist. We accept that this is an unusual situation and it is probably natural to revert to the situation that existed immediately prior to the latest change in legislation. It may well have been what the legislators had in mind at the time of the latest change but we doubt it. Be that as it may the only effective way we believe to resolve this issue, whether Inland Revenue accept that their analysis is wrong or not, is to start again with a clean sheet.
- It may well be that the preferred solution from a pure tax policy perspective would mean that any reimbursement of expenditure incurred in the production of assessable income with no capital limitation should be able to be reimbursed tax free, may cause Government problems in terms of risk of "non-tax salary substitute" as referred to in the Government's media statement of 20 November 2007. However to overcome these "issues" the Government could prescribe limits on the expenditure that is able to be reimbursed tax free – ironically much like the old 4th Schedule.
- Finally society has changed dramatically from when these previous rules were made. Therefore to base amending legislation for relocation expenses on cases heard 30-40 years ago would not appear to be logical. That is, if the cases which heard today where the employment legislation is vastly different from the 1970s and 80s when those cases were decided would the result be the same? Further, and without belabouring the point, these cases were very much decided on the basis of the legislation at the time which included the 4th Schedule and therefore in our opinion of limited or no precedential value.

IG 3162 has still not been finalised (despite the statement made in the Commentary to the Bill in July 2008 that "this guideline is likely to be finalised in the near future") which indicates that the Office of the Chief Tax Counsel is having great difficulty coming to a conclusion which makes it even more surprising that the previous Government was willing to make amendments to legislation based on the OCTC's "draft and preliminary" conclusions. (There is a suspicion that the statement made in the Commentary was made without approval from the OCTC as when Grant Thornton contacted them soon after the commentary was issued they were not even close to finalising the draft.)

Further Officials' in proposing these changes have appeared to ignore the historical background to the changes to the taxation of these allowances introduced in 1995 when the "otherwise deductible" test rather than the "incurred" test was introduced. While the purpose was to prevent the payment of tax free allowances for capital expenditure the effect of the amendment went a lot further than intended. Once this was noted, shortly after the amendment became law, the Commissioner of Inland Revenue gave a public assurance that these changes were not intended and would be legislatively addressed if necessary. This never occurred and given that IG 3162 has interpreted the legislation with no regard to this "legislative history" the effect of the amendments proposed in the Bill, would be to retrospectively endorse the 1995 amendment which was clearly not Parliament's intention at the time.

Although the amendments are intended to create certainty in this area in our view the amendments do not serve this purpose, especially in relation to reimbursement payments and allowances that do not relate to overtime meals or relocation. The Officials Paper called for submissions on other payments that should be considered for similar amendments as well as overtime and relocation and we understand that they did receive a number of suggestions. Still the amendments are limited to the two only and it is unclear where that leaves the taxability of the remaining allowances, of which there are many, and the argument could be made that the

Commissioner, if he is to uphold the letter of the law should review the taxation of all these allowances since 1995, despite the fact that he made a public statement that it was not the intention to treat the allowances in such a manner.

As we indicated in our submission in response to the Officials Paper such a piecemeal approach will not create certainty and in fact will create much more uncertainty for the majority of allowances that are paid by employers and will have a flow on effect to whether employees have been taxed correctly as far back 1995.

This is not solely a policy/legislative issue although it appears to have been driven solely out of the Policy Division of IRD. What needs to happen is that the “operational” areas of Inland Revenue review the Commissioner’s statement made in 1995 and determine what action needs to be taken to practically reinforce this statement for the years since 1995 till now. Then the Government needs to decide what its policy position is for all allowances going forward and not pick two out at what appears to be random. Any certainty created for these two particular allowances/payments will be far outweighed by the uncertainty created for all other allowances payments.

Reforming the Income Tax Act Definitions of “Associated Persons” (Clauses 7, 10-13, 18, 40, 41, 57, 82, 120, 152, 182, 183, 186, 188, 201-203, 408, 414, 415, 431, 436, 477, 502, 502, 503 and 624)

These amendments also emanate from an Officials Paper issued in March 2007 which was universally disparaged. Grant Thornton made a submission on this Paper and the main thrust was that the proposed changes to make land developers unable to hold investment properties in another vehicle distinct from their land development activities and not to be subject on tax on those investment properties as part of their land development activities, were inequitable. In summary our submissions were as follows:

- This is a “back door” capital gains tax introduced in direct contradiction with many reviews by various governments over the years and the rejection of such a tax.
- The proposals treated real property differently from all other property whereby a taxpayer is able to hold property on capital account even if that taxpayer would ordinarily, because of their personal characteristics, hold property on revenue account.

We did suggest, as we understand many other submitters did, that as this “loophole” had been known to policy makers for many years that their lack of action to remedy it was an acknowledgement that the original legislation went too far. It would appear that some submitters may have questioned what the original intention was and therefore as justification the Commentary to the Bill quote a passage from the Hon W E Rowling in 1973 to back up the statement that “It was a deliberate decision by Parliament that gains sold by property developers within ten years of acquisition are generally taxed”. While that may be true, successive Governments since 1973 were made aware of this so called loophole and that the original intention was being subverted and chose not to take any remedial action. Surely the Government (and we do acknowledge that the Government now is different to the one who made the statement in the Commentary to the Bill) has its own views on this in 2009 and is not bound by decisions made by the Government in 1973.

There were many submissions to the original Officials’ paper which pointed out the unintended consequences of the proposals in the paper. Many of those have been remedied on the subsequent legislation but some still remain. For example we have had discussions with Officials regarding the effect of the changes of the associated persons definitions on the exclusion from dividends of the “capital gain amount” in section CD 44 of the Income Tax Act 2007.

Briefly all distributions made by a company to its shareholders are treated as dividends and are taxable to the shareholders subject to a number of exceptions. One of these relates to a “capital

gain amount” paid on liquidation of a company which is treated as exempt in the hands the shareholder. On the basis that amounts should retain the same character in the hands of shareholders as they do in the hands of the company, any “capital” amounts should be exempt in the hands of shareholders. However for whatever reason in the case of companies passing capital amounts to shareholders the exemption is limited to amounts paid on liquidation (except for qualifying companies). Further section CD 44 (11) provides that a capital gain amount is not derived if the property is disposed of to a “related person” but section CD 44(12) provides that this does not apply if the company is a “close company” and the related person is not a company. It is proposed that the “related person” definition currently used in section CD 44 will be replaced with the new associated person definition which will widen the scope of the section CD 44 exclusions, that is make many more “capital gain amounts” taxable.

We approached Officials’ on the basis that:

- This was clearly an unintended consequence of the amendments to the associated person definitions.
- If the Government was concerned about the “capital gain amount” provisions then any amendments need to be made via an overt policy process not via “the back door” as was occurring in this case.
- In any event the current legislation is not particularly well targeted. It is clearly an anti-avoidance legislation to prevent companies making artificially inflated capital gains and pass them out tax-free to shareholders. However rather than targeting transactions not at market value it targets the relationship between the company and the shareholders, in an arbitrary manner.

Officials responses were rather vague but were along the lines that:

- The current related person definition and the new associated person definition are conceptually similar because the related person definition clearly embodies an associated persons concept.
- The Rewrite project would have replaced the related person definition with a more robust associated person definition if this “associated person project” was not looking at it.
- There will be situations where persons will be associated for the purposes of section CD 44 where they are not currently a related person but this is just a natural consequence of the rationalisation of the associated person definition. Further not all the changes are “in the revenue’s favour”.

In response we noted:

- It was not within the ambit of the Rewrite Project to make the change now proposed as there clearly is an (unintended) policy change which was not within the ambit of the Rewrite project.
- While “rationalisation” of a Tax Act is a noble ideal, such rationalisation cannot ignore the practical consequences of changes made as a result and nor should an informed policy process be subverted as a result (which is the same reason why such policy changes were not part of the Rewrite project which is another “rationalisation” of the Act). Policy decisions should not be made in a theoretical vacuum.
- The fact that all the unintended changes “are not all one way” is irrelevant. It should not be a matter of swings and roundabouts where one taxpayer’s gains are offset against another’s losses.
- It is rather disingenuous to state that the changes are about “rationalisation” – the clear impetus behind the changes to the associated persons rules was the taxation of land provisions.

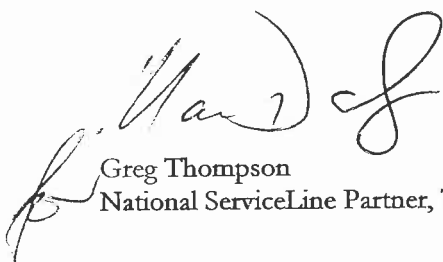
We agree that the provisions surrounding these “capital gains” need reviewing but would suggest that it would be more appropriate to review them in the context of what should be a “dividend” in the hands of shareholders. As noted above it appears to us that any “anti avoidance” provision would be much better targeted at ensuring the transaction is made at market value rather than at the relationship between the parties. Further the property most likely to be used in any such arrangements, and the most difficult to value, intangibles, could be excluded as occurs elsewhere in the Act.

Our submission would be that the associated persons provisions be withdrawn from the Bill and be subject to separate consideration, if the new Government agreed with the Bills proposals, or amend them if necessary. The current proposals after all are based on an issues paper that had fundamental design flaws and therefore was an inappropriate starting point for any rational decision making process. If this submission is not accepted then we consider that the related person definition in section CD 44 should not be changed but rather should remain in tact until a proper review of these provisions is undertaken. That is, they should not be regarded as “collateral damage”.

Should you wish to discuss any of the issues please contact me.

Kind Regards

Grant Thornton



Greg Thompson
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