KPMG
10 Customhouse Quay
P.O. Box 996
Wellington
New Zealand

Telephone +64 (4) 816 4500
Fax +64 (4) 816 4600
Internet www.kpmg.com/nz

The Chair

Our ref 8775212_1.docx

Finance and Expenditure Select Committee
Parliament Buildings

29 July 2016

Dear Sir or Madam:

KPMG submission - Taxation (Annual Rates for 2016-2017, Closely Held Companies, and Remedial Matters) Bill

KPMG is pleased to make a submission on the Taxation (Annual Rates for 2016-17, Closely Held Companies, and Remedial Matters) Bill (the "Bill").

We have provided detailed submissions, attached as appendices by topic. This covering letter highlights the main issues.

GST

We generally support the Officials' analysis and the corresponding suggested solutions. The suggested solutions to these issues aim to align the GST rules more closely with the underlying policy principle, making the system more equitable particularly to businesses, both residents and non-residents.

However, we do have some specific submissions.

GST and Capital Raising Costs

We support the proposed amendment to allow businesses to recover GST incurred on costs of raising capital to fund their taxable activity. We submit that the scope of this amendment be extended to include failed attempts at capital raising.

Agents acting for purchasers

We support the proposed amendment to allow agents to opt out of the agency rules for a supply made to a principal.

We do not agree with the inclusion of clause 320 which prevents a bad debt deduction being claimed by the agent.

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Cross border neutrality

We have two recommended amendments to section 54B so that it contemplates the following scenarios:

(1) Where a non-resident company has an existing GST registered New Zealand branch, but incurs costs in New Zealand for activities unrelated to the branch; and

(2) Where a non-resident company incurs costs in New Zealand in the course of making supplies outside New Zealand under section 8 (and therefore not taxable supplies).

Zero-rating of services connected with land, offshore property and services

We submit that the proposed amendments to sections 11A(1)(e) and 11A(1)(k) should be broadened to cover certain services which are closely connected to land but which may not be covered by the current drafting of the amendments (for instance, the booking of holiday accommodation), for consistency with the policy intent behind the zero-rating rules.

We also submit that an amendment is required to section 11A(1)(j) of the zero-rating rules to correct an unintended change to the section resulting from changes introduced as part of the remote services rules.

Finally, we submit that similar issues apply for sections 11A(1)(d) and 11A(1)(f) and appropriate amendments are required.

NRWT & related party lending

The proposed amendments in the Bill regarding NRWT on related party debt are broadly unchanged from the original proposals consulted on. (Our submission on those proposals are attached.) While the proposed amendments are an improvement on the original proposals consulted on, we remain concerned that they will increase the cost of capital for both related party and unrelated party borrowing.

We are concerned that these proposals appear to represent a unilateral New Zealand response to base erosion and profit shifting (BEPS) concerns, in advance of the Government's response to OECD BEPS Action 4 recommendations. We note the recent publication of the *New Zealand's Taxation Framework for Inbound Investment – A draft overview of current tax policy settings.* We acknowledge that this document does put some New Zealand context to the proposals.

However, we consider that further work is required.

Application of time bar to NRWT

We support the amendment to ensure ancillary taxes, such as FBT, as well as AIL are covered by the time bar. The proposed amendment clarifies that the four year time bar applies to ancillary taxes, as well as AIL. The amendment applies retrospectively, from the date of introduction of the bill.

We welcome the amendment to ensure ancillary taxes, such as FBT, are covered by the time bar. We also support the change to ensure that the time bar applies to reopening assessments where approved issuer levy ("AIL") has been deducted inadvertently instead of NRWT.

Closely held companies

We strongly support the amendments to the tax rules for closely held companies, in particular the Look Through Company (LTC) rules. The existing rules have a number of features that have been a barrier to taxpayers using LTCs. However, we have a number of concerns that the proposed rules unnecessarily restrict the use of LTCs.

We also strongly support the limiting of the tainted capital gains rules and relaxing of the RWT requirements in some circumstances and we consider the changes could be broadened to allow taxpayers to undertake commercial transactions without unnecessary tax obstacles.

BG1 override of DTAs

An amendment is proposed to section BH 1, which provides that DTAs entered into by New Zealand override domestic law, to make it clear that the general anti-avoidance rule (section BG 1) overrides New Zealand's DTAs and applies to cross-border transactions.

We consider further clarification is required in relation to how the domestic general anti-avoidance rule applies in relation to New Zealand's DTAs.

Related party debt remission

We strongly support the proposal to ensure that a related-party debt remission does not give rise to debt remission income.

We continue to have concerns that the limited scope proposed does not provide a comprehensive solution to the question of the tax treatment of debt remission income. For scenarios outside the proposed solution, there will be a greater risk that QB 15/01 can be successfully applied by the Commissioner. We submit that a more extensive solution is required.

Liaison with Officials and appearance before the Committee

Some of these submissions are technical. We would, with the Committee's approval, be pleased to discuss these submissions with Officials to assist the Committee.

We would be pleased to appear before the Committee in support of our submissions

Further information

Should you wish to discuss further with us any aspect of our submissions or require any further information, please do not hesitate to contact us.

Yours sincerely

John Cantin

KPMG
10 Customhouse Quay
P.O. Box 996
Wellington
New Zealand

Telephone +64 (4) 816 4500
Fax +64 (4) 816 4600
Internet www.kpmg.com/nz

Appendix 1: GST current issues

1 GST and Capital Raising Costs

We support the proposed amendment to allow businesses to recover GST incurred on goods and services used to raise capital to the extent that the capital funds their taxable activity. The amendment allows a more equitable GST position to be achieved for businesses making taxable supplies.

However, not all capital raising attempts are successful. The drafting of the proposed section (rb) should be inclusive of unsuccessful capital raising attempts.

We submit that (rb) be amended as follows:

the services are financial services supplied in the course of an activity of obtaining funds by a registered person who does not principally make supplies of financial services, to the extent to which the funds are used ***<u>or are intended to be used</u>*** *by the registered person for expenditure in an activity of making taxable supplies, if the financial services—*

This amendment will remove double taxation by allowing businesses to recover GST costs incurred in unsuccessful capital raisings.

2 Agents acting for Purchasers

We generally support the proposed amendment to allow agents acting on behalf of purchasers to opt out of the agency rules for a supply made to the principal. This will allow the parties to account for GST as though the supply was two supplies: between the supplier and agent, and between the agent and principal.

However, we do not agree with the inclusion of clause 320 which prevents a bad debt deduction being claimed for the supply by an agent to a principal where the principal has not repaid the agent.

We submit that in the case of non-payment by the principal, the agent should be able to claim a bad debt deduction (subject to existing bad-debt deduction rules) as the agent has already returned output tax on the supply to Inland Revenue. If the agent is unable to claim a deduction for the supply, Inland Revenue will be unjustly enriched.

3 Cross-border business-to-business neutrality remedial amendments

We agree with the proposed amendments to make two changes to the non-resident registration rules to ensure: (1) that a non-resident cannot register under the rules when they make supplies that are consumed in New Zealand, and (2) a non-resident that only incurs GST paid to New Zealand Customs Service is able register under Section 54B.

We submit that there are two additional issues that need to be addressed in relation to non-resident registration under Section 54B.

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Non-resident companies with a GST registered New Zealand Branch

Section 54B of the GST Act was introduced effective from 1 April 2014 to allow businesses that are non-resident, who do not carry on a taxable activity in New Zealand, to register for GST in New Zealand. Registering for GST under section 54B enables non-resident businesses to recover the GST on costs incurred in New Zealand.

However, it appears to be the current view of Inland Revenue that an overseas company cannot register under section 54B as a separately registered person if it has a New Zealand branch that is already registered under section 51 of the GST Act, even where the costs incurred have nothing to do with the registered branch activity in New Zealand.

Specifically, one of the conditions for registering under section 54B is that the person must not carry on a taxable activity or intend to carry on a taxable activity in New Zealand (i.e. section 54B(1)(d)(i)).

We understand that Inland Revenue's current view is that a Head Office and a New Zealand branch are the same legal entity for section 54B purposes. As such, the Head Office with a GST registered New Zealand branch would not be able to separately register for GST under section 54B on the basis that it has a New Zealand branch that carries on a taxable activity in New Zealand.

We consider that this outcome is inconsistent with the fundamental principle that GST should not be a cost for business (which is the rationale behind section 54B). The Head Office, which is carrying on a taxable activity overseas and is registered for an overseas equivalent of GST, should not bear the cost of the New Zealand GST.

We therefore submit that:

- Section 54B of the GST Act be amended to explicitly provide that a branch registered for GST is treated as a separate person from its Head Office and any other branches. Such an amendment would allow an overseas company with a registered New Zealand branch to be able to be separately registered for GST under section 54B.
- This amendment should have a retrospective effect from 1 April 2014 to be consistent with the original policy rationale behind section 54B.

Non-resident companies providing services to New Zealand GST registered entities deemed to be provided outside New Zealand or present in New Zealand

Section 54B, in its current state, fails to contemplate the scenario involving a non-resident entity that has a contractual arrangement to provide services to a GST registered entity in New Zealand and the services are deemed to be performed outside New Zealand under section 8(4).

The non-resident entity is unable to register for GST under section 51 as it is not deemed to be making taxable supplies in New Zealand.

The non-resident entity will be unable to register under section 54B as we understand that Inland Revenue's current view is that the non-resident is carrying out a 'taxable activity' in New Zealand (i.e. the continuous supply of services under its existing contractual arrangement). As such, the

non-resident is unable to register for GST and will bear the GST cost of expenses incurred in the course or providing services in New Zealand.

A similar result applies for a non-resident in New Zealand to receive goods and services for supplies it makes overseas. Inland Revenue considered the non-resident to be carrying on a taxable activity in New Zealand.

Again, this does not align with the fundamental principle that the GST impost should be borne by the final consumer of goods and services, and that GST should not be a business cost to suppliers.

We submit that section 54B(1)(d) be amended to replace the phrase “carrying on a taxable activity in New Zealand” with “carrying on a taxable activity that involves making taxable supplies in New Zealand”.

4 Zero-rating and associated GST issues

The remote services rule and the proposed amendments to the zero-rating rules have highlighted some technical deficiencies in the zero-rating rules. These arise from difficulties with the definition of land and the interpretation of “directly in connection” with certain items.

Submission One: sections 11A(1)(e) and 11A(1)(k)

Services connected with land – amendments proposed

The proposed amendment will expand the range of services that are zero-rated under section 11A(1)(e), where they relate to land outside New Zealand, and narrow the range of services which can be zero-rated under section 11A(1)(k), where they relate to land inside New Zealand.

This is because the current test that the service must be “directly in connection with” land has been interpreted in a restrictive manner by the Courts. This means that services that have a very close, clear and obvious link or association (per the OECD’s International VAT/GST Guidelines) with land outside New Zealand cannot be zero-rated under existing rules and vice versa for services connected to land in New Zealand.

We support the general expansion of the provisions relating to services connected to land both inside and outside New Zealand where the services are intended to enable or assist a change in physical condition, ownership or other legal status of the land. However, we consider the amendment may not go far enough to enable services that have a close, clear and obvious link with land outside New Zealand, to be zero-rated or connected to land in New Zealand, to not be zero-rated. There are certain scenarios which may not fall within the scope of the section as amended but which we consider should be covered by the new amendments to meet the policy intent.

The policy intent is the destination principle, i.e. services should be taxed in the jurisdiction in which they are consumed. The location of the land is considered to be the place where services connected to land are consumed.

The amendment for land outside New Zealand as currently drafted allows for the zero-rating of services which are:

> *supplied directly in connection with a parcel of land situated outside New Zealand, or with an improvement to such land, or are supplied in connection with such land or improvement and are intended to enable to assist a change in the physical condition, or ownership or other legal status, of the land or improvement.*

A similar amendment is proposed for services relating to land in New Zealand in section 11A(1)(k). This amendment applies to restrict the zero-rating of services where they are in connection with land in New Zealand.

Additional services which should be covered by the amendments

The comments we make below are applicable to both services supplied in relation to land in New Zealand and land outside of New Zealand, in line with the objective of ensuring that services supplied are subject to GST where the land is located.

The example below focuses on section 11A(1)(e), but the same problems arise in relation to section 11A(1)(k).

A travel agent (whether a non-resident or New Zealand resident) may provide a New Zealand resident customer with a booking at an offshore hotel. The travel agent does not supply the accommodation, but rather, facilitates or arranges the booking of accommodation.

Issue 1

The supply of accommodation made by the hotel under section 11A(1)(e) would be zero-rated for GST purposes on the basis that it is directly in connection with land situated outside New Zealand. This is in accordance with the Court's obiter comments in *Mololailai Interval Holidays New Zealand v CIR (1997) 18 NZTC 13,137)*.

However, the position is not entirely beyond doubt given that the "directly in connection with" test has been interpreted by Inland Revenue as requiring the relevant service to effect a legal or physical change to the land. *Mololailai* takes the view that the supply of accommodation is by way of a supply of a licence to occupy. This means that this is a supply "directly in connection with" land.

However, that this is the position is not clear. A licence to occupy is not generally considered legally to be an interest in land. Further, the extended definition of "land" in the GST Act only applies for the land zero-rating rules and does not explicitly cover licences to occupy. (These rules apply to zero-rate land supplied between registered persons.)

The public ruling (BR Pub 15/03) on legal services provided to non-residents relating to transactions involving land in New Zealand refers to legal services provided in relation to licences, leases, mortgages and sales of land as being able to be zero-rated under section 11A(1)(k). While there is no direct discussion in the commentary to the ruling regarding the inclusion of licences of land, the inclusion of licences implies that they may be regarded as "directly in connection with" land, similarly to leases and mortgages. This is despite a licence not affecting the legal interests in or nature of the land.

Submission 1

The supply of accommodation that is closely, clearly and obviously connected with the underlying land that the supply should be zero-rated. A supply of land in this circumstance should be covered by both sections 11A(1)(e) and (k). This may be achieved by applying the extended definition of land in the GST Act to these two provisions.

Issue 2

The supply of the booking service by the travel agent may also not be zero-rated under the proposed legislative change.

Per the case law, a service is not supplied directly in connection with land when it merely brings about or facilitates a transaction which has a direct effect on land, or when the service could be described as being “one step removed” from such a transaction. The supply of booking services is likely to be seen as “one step removed” from the supply of the accommodation which is directly connected to the land.

The proposed amendments are intended to bring such “one step removed” services within the relevant provision as “connected or related to the land”. As currently drafted, the proposed section may result in neither New Zealand resident nor non-resident suppliers being able to zero-rate the supply of booking services.

Specifically, the services may not “assist a change in the physical condition, or ownership or other legal status, of the land or improvement”.

However, they are services which are still linked with the land in such a way that it is logical, and in line with the policy intent of the section, to zero-rate them.

While such services may meet the less restrictive “supplied in connection with” limb, they may not meet the test of enabling or assisting a change in the physical condition or legal status of the land. Excluding some services from the scope of section IIA(1) (e) has the result of taxing services which directly facilitate or arrange services that are consumed outside New Zealand and relate to land offshore.

As outlined in the Commentary on the Bill, the proposed test is intended to enable other supplies of services with a very close, clear and obvious link or association with the property to be zero-rated. While the examples discussed above are remote services, they have clear and obvious links to particular offshore land. They are the arranging of something which is in itself able to be zero-rated or should be zero-rated (the supply of accommodation outside of New Zealand) and therefore it is in line with the policy intent that the arranging of that supply should also be zero-rated.

Acceptance of submission 1 may have the effect of extending the one step removed services which can also either be zero-rated or not (as relevant). An extended definition of land should mean that agency and other services related to an extended meaning of land are also connected to that land. However, it may be necessary to provide clear language to enable zero-rating or not.

Submission 2

Services which are in relation to land but which may not affect the physical condition, legal status and ownership of the land should be zero-rated or not as relevant.

If this is not achieved through an extended definition of land, a specific addition to sections 11A(1)(e) and (k) should be made.

Submission Two: section 11A(1)(j) – services physically performed outside New Zealand

Some of the problems with section 11A(1)(e) may have previously been solved by section 11A(1)(j).

Section 11A(1)(j) previously stated that services can be zero-rated if they involve the arranging of services that are physically performed outside New Zealand. However, the recent change to section 11A(1)(j) as part of the GST on remote services amendments appears to have had the inadvertent consequence of changing this outcome for remote services which relate to something physically done offshore. From 1 October, the section does not apply if the arranging service is a remote service provided to a non-registered New Zealand resident customer.

This would impact on remote services which arrange an offshore supply which is not itself a remote service. Under the current rules, the remote service would be able to be zero-rated as the "arranging of" a service physically performed offshore. However, from 1 October under the amendment, they will not be able to be zero-rated.

Examples of this include the arranging of a tour overseas by a travel agent or the arranging of tickets for an offshore concert or festival. The arranging service is a "remote service" but the underlying supplies are physically performed offshore. As such, the arranging of supplies, which are not themselves remote services, but are physically performed offshore is not able to be zero-rated under the subsection. This applies for both non-resident and New Zealand resident suppliers.

Other examples which would be similarly impacted include:

- The online facilitation by an agent of offshore functions, for instance, the booking of venues and catering;
- The online facilitation and placing by agents of New Zealand students in offshore educational institutions; and
- The arranging from New Zealand of the delivery of flowers overseas.

We acknowledge the amendment was made to ensure that the remote services rules operate effectively. Without the amendment, the remote services rule would not apply to a service which is the arranging of a remote service. However, the scope of the amendment appears to have been inadvertently drafted too widely.

The amendment has the effect of restricting the zero-rating of remote supplies where the underlying supply is not itself a remote service but is performed offshore. That is the underlying service is not consumed in New Zealand.

We consider the effect of the amendment is not in line with the policy intent of either the remote services rules or the GST Act generally. The policy intent, under the destination principle, is that the supply of services consumed offshore should be zero-rated. This includes the arranging of such a supply.

The arranging of services that are physically performed offshore should not be excluded from the zero-rating rules where the underlying service is not a remote service and is able to be zero-rated. The connection between the arranging of the offshore service and the actual service means that it is appropriate to zero-rate the arranging of the service. In this respect, the policy should be to treat both non-resident and New Zealand suppliers in the same way.

We consider that not only should the prior position be restored (i.e. that New Zealand resident booking agents arranging services that are physically performed offshore and which are not themselves remote services should be able to zero-rate their supplies) but also that the treatment of non-resident booking agents should be aligned with the treatment of a New Zealand booking agent. In both cases, the underlying supply is consumed offshore and able to be zero-rated.

Submission

The arranging of a supply which is physically performed outside New Zealand and which is not itself a remote service should be able to be zero rated.

Submission Three: associated GST issues

Similar issues relating to zero-rating, as a result of the remote services rule, arise under other provisions of the GST Act, specifically subsections 11A(1)(d) and (f). In each case, there is an offshore supply which is able to be zero-rated, and a related remote service which is not able to be zero-rated. For the same reasons as above, this result is not in line with the policy intent.

Section 11A(1)(f)

The problem arises in a range of situations, for instance, where an agent provides facilitation or arranging of bookings as a remote service to a non-registered New Zealand customer.

For example, section 11A(1)(f) allows a service to be zero-rated to the extent that it is “directly in connection with” movable personal property situated outside of New Zealand when the services are performed. For example, a car or bus rental offshore may be considered a service in connection with movable personal property outside New Zealand. Where this is booked through a third party, the arranging supply, based on the case law, is likely to be “one step removed” and is not directly connected with the movable property (i.e. the car or bus).

This is not in line with the policy which aims to tax on a location basis. Although the recipient may be in New Zealand at the time of the supply, the underlying supply is able to be zero-rated and will be performed offshore. As such, it is logical and in line with the policy intent that the remote supply which is connected to the offshore supply is also able to be zero-rated.

As with the accommodation example, this has the result of one “element” of the supply (the supply of a car rental) being zero-rated and the other “element” of the supply (the online facilitation of the booking of the car or bus rental) being subject to GST in New Zealand. However, if the offshore supply of the car or bus rental itself will be zero-rated, it follows that the arranging of the car or bus rental should also be zero-rated.

The current result is not in line with the underlying policy intent of the legislation which is that GST should not apply where goods or services are consumed outside New Zealand. This will impact suppliers providing for bookings online, whether they are in New Zealand or offshore.

Submission

That section 11A(1)(f) be amended so that services in connection with movable personal property outside of New Zealand are also able to be zero-rated.

Section 11A(1)(d)

The remote services rule also raises questions as to the appropriate zero-rating of travel insurance.

Section 11A(1)(d) allows the zero-rating of insurance over international transportation of passengers or goods. Travel insurance generally also covers activities such as overseas medical care and loss of property. However, these activities may be seen as not directly relating to the transportation of passengers or goods.

It is unclear whether section 11A(1)(d) applies to zero-rate all of the travel insurance premium?, given that it refers to the “transport of passengers or goods”. In practice, travel insurance has not been apportioned between these different risks. The total insurance is treated as related to international transportation.

Further, currently, Section 11A(1)(j) could be seen as providing the ability to zero-rate the insurance of these activities as well. It applies to zero-rate a service physically performed offshore. (We do note that the place of physical performance of insurance is itself uncertain.)

However, as discussed in our previous submission, section 11A(1)(j) cannot apply from 1 October 2016. The supply of insurance is a remote service. Further, our submission with respect to section 11A(1)(j) would also not apply to allow zero-rating.

Allowing for certain portions of offshore travel insurance to be zero-rated, yet not others is not in line with the policy intent of the legislation. It is unclear that this result is achieved.

Submission

Given the uncertainty raised by the remote services rule for insurance services, we submit, consistent with the policy intent, that such supplies be clearly zero-rated.

A specific amendment to section 11A(1)(d) should be made to cover the insurance of persons and goods while outside New Zealand or in connection with international travel.

KPMG
10 Customhouse Quay
P.O. Box 996
Wellington
New Zealand

Telephone +64 (4) 816 4500
Fax +64 (4) 816 4600
Internet www.kpmg.com/nz

Appendix 2: NRWT: related party and branch lending

5 Interest on related party debt proposals

The amendments as introduced are broadly in line with the proposals consulted on by Officials. We therefore refer back to our comprehensive submissions on those proposals rather than re-drafting extensive submissions again. (A copy of that submission is attached)

We remain of the view that there has been no clear statement of the underlying policy of the NRWT rules and the proposed changes appear to be ad hoc solutions to a set of disparate problems.

(We note the recent publication of *New Zealand's Taxation Framework for Inbound Investment – A draft overview of current tax policy settings.* This does not in our view fully resolve our concerns.)

The amendments will increase the cost of capital for unrelated as well as related party debt. In some cases, this will increase New Zealand taxation cost by 500% for long-term previously committed investment. To date, Officials have not coherently addressed either concern.

We are also concerned that the amendments will increase the prospects for double taxation. There is no proposal to limit withholding tax for non-deductible interest. This is particularly a problem as New Zealand is unilaterally making amendments which will precede the Government's response (if any) to the OECD BEPS Action 4 interest deductibility recommendations expected later this year. We are concerned that the OECD proposals if implemented in NZ could further inappropriately limit interest deductibility. Any increase in withholding taxes will increase the double taxation risk that potentially applies. Our strong recommendations is that changes to the NRWT and AIL regimes be considered concurrently with any changes to the interest deductibility rules to ensure consistency and coherence.

The proposals are clearly not beneficial where the investor is a tax exempt entity (such as a sovereign wealth fund or an exempt pension fund) in its home jurisdiction. The proposed New Zealand tax increases will be a final tax for such investors.

Furthermore, we are concerned about the coherence of the proposals with wider Government policy initiatives. In its Business Growth Agenda, the Government has projected a significant need for capital to fund export growth much of the needed capital will need to be sourced from offshore. These proposals will likely make that capital more expensive and/or potentially reduce the supply of capital as a result.

We also reiterate our concerns regarding the significant compliance cost the NRWT changes will impose on New Zealand borrowers and their funding arrangements given officials' apparent view that the overall impact of the changes is likely to be minimal from a revenue raising perspective. This is based on the forecast additional revenue from the total package being around $57 million per annum once fully implemented. This suggests officials have either

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underestimated the revenue impact and/or have not fully factored in the business costs of these changes.

AIL registration requirements

6 ***Issue 1: Approved issuer criteria too restrictive***

We welcome the changes made to the original proposals outlined in the officials' issues paper, so that AIL will continue to be available for widely-held borrowers and lenders or where the total interest payable to non-residents is $500,000 or more per annum. However, we still consider that the additional criteria proposed in replacement section 86G of the Stamp and Gift Duty Act 1971 is unduly restrictive.

For example one of the requirements for the widely-held borrower is that it be a company, which would preclude Partnerships and limited partnerships from being able to access AIL (unless the lender is widely held or interest payable to non-residents exceeds $500k per annum) The proposed criteria will limit the range of offshore funding sources for genuine third party arrangements, which will in turn increase the cost of funding.

Ultimately, the issue is Inland Revenue's ability to enforce compliance with the AIL rules. The proposed approach of denying access to AIL for some genuine 3rd party debt arrangements is not the correct solution. The focus should be IRD targeting high risk arrangements rather than a blanket exclusion.

Submission

Proposed section 86G includes additional criteria to determine eligibility for AIL. The additional criteria means that some genuine third party arrangements will no longer be entitled to use AIL and should not proceed. If the proposal proceeds, the entry criteria should be widened, e.g. to include partnerships & Limited Partnerships.

7 ***Issue 2: Remove $500,000 threshold***

The Bill proposes to restrict access to the AIL regime to borrowers who have paid or expect to pay at least $500,000 interest to non-residents in the previous year, the current year or next year. This requirement is overly restrictive and means that AIL will no longer apply to genuine arm's length arrangements involving small and medium sized borrowers. We believe the threshold should be lowered to a more reasonable level i.e. $50,000.

Submission

If our submission above is not accepted, the $500,000 threshold in proposed section 86G(4) should be reconsidered to ensure that smaller borrowers are not unfairly disadvantaged.

8 Branch lending

The amendments in the Bill will restrict access to the existing NRWT and AIL exemptions for offshore and onshore branch lending arrangements.

Issue 1: Bank branch funding

Proposed subpart FG deems an amount provided by a foreign bank to a New Zealand branch to be a notional loan to the branch and treats the amount that the branch records as a deduction as notional interest paid by the branch to the bank subject to AIL or NRWT.

Although this rule is proposed to only apply to banks, there does not appear to be any strong policy rationale for applying this treatment to registered banking groups but not to other financial institutions.

Submission

The notional loan rules for New Zealand branches of foreign banks should be extended to other financial institutions, e.g., regulated non-bank deposit takers, insurers and asset managers, as well as dedicated finance or treasury companies within multinational groups.

KPMG
10 Customhouse Quay
P.O. Box 996
Wellington
New Zealand

Telephone +64 (4) 816 4500
Fax +64 (4) 816 4600
Internet www.kpmg.com/nz

Appendix 3: Closely-held companies (e.g. LTC entry rules, tainted capital gains, etc.)

Detailed submissions and comments

9 Look through company entry criteria

Clause 262 (43), (48), (56), (57), (58), (59) and (60)

"Several amendments are proposed to tighten the LTC eligibility criteria to ensure that LTCs operate as closely controlled companies, as originally intended. They relate in particular to who can have an interest in a LTC and how the five or fewer 'counted owners' test applies."

Submissions

Shareholding trusts - clause 262 (57)

We disagree with the proposal to expand the counted distributions definition to include trustee income and corpus as well as beneficiary income.
In practical terms the three principal benefits of the LTC regime are flow through of income, flow through of losses, and the flow through of capital gains.

In the case of flow through of income, this benefit cannot be inappropriately passed on to an excessively wide group by distribution of trustee income and corpus, as trustee income has already been taxed and corpus is the original capital invested/settled. Similarly, in the case of losses these are also trapped at the trustee level.

The only instance where a benefit could be passed on to a wider group is in the case of capital gains made through the LTC. The inability to distribute capital gains free of tax from a company is a specific anti-avoidance rule to prevent the streaming of tax free capital gains in preference to dividends that are subject to additional taxation in the hands of the shareholders. In the case of LTC's all income of the LTC is taxable to the shareholders. Therefore, there is no policy rationale to seek to protect against the distribution of capital gains to an excessively wide group of shareholders.

More importantly, in practical terms, we believe the risk of the use of trusts to benefit an excessively wide group is likely to be overstated. A true discretionary trust becomes impractical outside of the charitable context where the beneficial class becomes wider than close family members that the settlor would realistically wish to benefit. For example, attempts to use one trust to benefit two different family groups invariably results in a unit trust for taxation purposes. This would of course breach the LTC shareholding requirements.

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One class of share – clause 262 (59 and (60)

We strongly support the proposal to allow an LTC to have more than one class of share if the rights to distributions of the company's net income and assets are the same for all members of the class.

Corporate beneficiaries – clause 262 (56)

We do not support the proposal to prevent LTC shareholding trusts with corporate beneficiaries making distributions.

We consider the potential revenue at risk is minimal. We suggest a more appropriate rule would be to limit the counted distributions to a distribution of LTC income.

Charities and Maori Authorities – clause 262 (48) and (56)

We support the grandfathering of existing Maori Authorities being beneficiaries of trusts that are LTC shareholders.

We also support the change from the Issues Paper that charities can be beneficiaries of trusts holding LTCs where they have no control or influence in relation to the operation of the entity and distributions of the trust.

Foreign income restrictions – clause 262 (43) and (56)

We do not support the proposal to limit the foreign source income of a LTC. The stated reason is to mitigate reputational risks for NZ through use of LTCs as conduit investment vehicles. While this is a legitimate concern, we do not believe the appropriate policy response is to limit the types of income a LTC can derive. This approach will not only impact non-residents and foreign trusts, but New Zealanders who are the majority of LTC users and owners.
For example owners of a LTC moving overseas could inadvertently trigger the loss of LTC status. There would seem to be little reputational risk arising in a situation where shareholders in an LTC move to Australia.

If the proposal proceeds, the foreign income threshold needs to be raised to a more commercial level. We suggest that the foreign income component of an LTC be raised to a maximum of 50% of the LTC's gross income. The proposed $10,000 income threshold should be removed altogether as it is arbitrary and has no regard the size of an LTC.

We consider the same outcome could be reached by the NZ foreign trust investing in a limited partnership (LP) rather than a LTC. We note that LPs can be widely held.

We consider the introduction of these rules may impact genuine scenarios. For example owners of a LTC moving overseas could inadvertently trigger the loss of LTC status. There would seem to be little reputational risk arising in a situation where shareholders in an LTC move to Australia.

10 Look through company entry tax

Clauses 14, 106, 178 and 262

"The proposed amendment to section CB 32C modifies the income adjustment calculation (commonly known as the entry tax) done when a company converts to a LTC to ensure that:

- *The taxable income that arises to LTC owners as a result of the calculation is taxed at each shareholder's personal tax rate; and*
- *For QCs converting to LTCs, that the entry tax formula does not tax owners of QCs any more than they would be if they liquidated before the conversion."*

Submissions

We agree that the current entry tax adjustments results in a tax advantage to 33% (and 30%) tax rate shareholders, in respect of pre-LTC tax paid retained earnings.
QCs transitioning to LTCs

The Bill proposes the normal LTC entry adjustment calculation will be required on transition of a QC, with the QC's retained income and imputation credits being distributed to the shareholders. Any accumulated losses under the QC rules will be forfeited.

At the time of the introduction of the LTC rules, the Government indicated that it would also undertake a review of the dividend rules for closely held companies, to simplify their operation.

We believe a number of those QCs will have held off becoming LTCs, in the hope that the promised review of close company dividends would lead to a simpler regime than the LTC rules. This has not eventuated. The actual proposals included in the Bill are limited in scope and / or subject to further consideration as part of Inland Revenue's Business Transformation process.

In these circumstances, we do not believe it is fair to penalise taxpayers who have held off transitioning from QCs to LTCs in the hope that the close company dividend review would yield greater change than now appears to be the case.

We therefore recommend that a further transitional period be allowed for QCs to become LTCs without adverse tax consequences. This should mirror the two year transition period originally allowed at the time of introduction of the LTC rules.

Values at time of entry – clause 106

The Bill proposes a retrospective technical change to section HB 13 to "clarify" that, on conversion to an LTC, the values at which the assets and liabilities are deemed to be held by the owners are the tax book values. This rule will apply for both an ordinary company and a QC that converts to a LTC.

We do not support a retrospective change as this could have significant adverse consequences for companies that have become LTCs. Further, there was no analysis of the actual problem, and its extent in either the original Issues Paper or the commentary to the Bill to justify the change.

We believe the haste with which the LTC rules were enacted will have contributed to the lack of clarity around entry values. Taxpayers should not be penalised for deficiencies in the rules, when they have acted in good faith.

We submit that this proposal should have prospective effect only.

11 Deduction limitation rule

Clauses 97 and 105

- *"The deduction limitation rule, which limits a LTC owner's LTC deductions to the amount that they have economically at risk, will be restricted to LTCs in partnership or joint venture."*

Submission

We strongly support the proposed change to section HB 11 to remove the restriction on a LTC owner's deductions to the amount that they have economically at risk.

12 Debt remission

Clauses 56, 104 and 119

- *"Two retrospective changes to the debt remission rules in the context of LTCs and partnerships are proposed. The first change ensures that remission income does not arise to a person who is a LTC owner or partner and who remits a debt owed by the LTC or partnership, which may be a limited partnership (referred to as self remission). The second change clarifies that debt owed by a LTC upon liquidation or election out of the LTC regime must be adjusted for any credit impairment."*

Submission

We support the retrospective changes to clarify that 'self remission' should not be taxable to shareholders in an LTC or partners in a partnership.

We consider that clause 104 requires clarification to define 'credit impairment' and clarify how that is taken into account for the debtor.

The effect of the amendment is to provide that the lender gains access to a potential deduction under section DB 6 by virtue of a negative Base Price Adjustment (BPA) arising. However, while the amount arising under the BPA remains assessable, a deduction is available under section DB 6 only where the general permission is satisfied. An interest free loan to a LTC or LP may not satisfy the general permission.
We suggest that rather than seek to provide a deduction for the loss, the actual problem should

be addressed by removing the assessment of income. This can be achieved by including self remission under the definition of excluded "income" for the person in their capacity as debtor.

A more elegant solution to this issue would be to include a section under the transparency rules under sections HB 1or HG 2 to provide that transparency applies in respect of the natural love and affection exemptions under section EW and that for these purposes one could have natural love and affection for oneself, irrespective of the legal nature of the person or entity.

13 Qualifying companies – continuity of ownership

Clauses 98 and 262

- *"The bill proposes that qualifying company (QC) status will cease if there is a change in control of the company."*

Submission

We disagree that QCs should lose their QC status if there is a change in shareholding of over 50% in aggregate.

We disagree with the comment that QCs provide the "opportunity for tax deferral on income through the taxing of the income in the first instance at the company rate, which differs from (and is often lower than) the top personal rate". This tax deferral is no different to the tax treatment of ordinary companies that are taxed at the company rate and only topped up to the top personal tax rate when a distribution is made to shareholders.

More importantly the population of QC's cannot increase meaning the revenue at risk (if any) can be managed.

If this proposal proceeds, there needs to be 'rollover relief' (i.e. QC status should not be lost) where the change in shareholding is due to family succession. A QC structure is commonly used for farming businesses, which are a prime example of a business that is typically passed down through generations.

An LTC is generally not suitable for farm succession due to an omission in the rollover relief for trading stock on transfer of LTC interests not including livestock. In our view this omission should be addressed. Income arises due to livestock being held on the national standard cost method which is used to a greater or lesser degree by almost all livestock farmers. Either livestock should be included in the rollover relief under s HB 6 or QC status should be maintained for transfers to associated persons.

14 Tainted capital gains

Clause 23

"The scope of the "tainted capital gains" rule is being narrowed to address the current overreach of the rule, and make it more targeted. Specifically, the rule will only apply to asset sales between companies that have at least 85% common ownership, with the original owners still retaining at least 85% interest in the asset at the time of liquidation. The rule currently applies to associated party transactions."

Submission

We strongly support the proposal to remove the tainting of capital gains when an asset is sold to an associated person where the level of ownership is less than 85% of the time of sale or liquidation. This is a welcome change from the original proposal consulted on.

15 RWT on dividends

Clauses 20, 239, 240, 241 and 242

> *"Two amendments are proposed to deal with the current over-taxation of certain dividends under the resident withholding tax (RWT) rules:*
>
> - *The first will allow a company to opt out of deducting RWT from a fully imputed dividend paid to corporate shareholders.*
> - *The second provides a new formula for determining the RWT obligation when cash and non-cash dividends are paid contemporaneously.*
>
> *A third proposed amendment deals with an unintended restriction, because of the need to deduct RWT, on the rule which allows a dividend to be backdated to clear a shareholders current account."*

Submission

While we support the change, we consider the RWT requirement to withhold should be removed altogether for dividends between companies. There is no policy reason for deducting RWT in this situation.

We note the requirement to gross up non-cash dividend means additional RWT must be withheld, even though this additional amount is ultimately refundable to the shareholder and comes at an additional cash cost to the payer. This highlights the cash flow issue many companies face with the current gross-up requirement for deducting RWT on non-cash dividends generally. The wider issue needs to be considered.

We support the retrospective amendment to ensure RWT does not deter a company from making a commercial decision to declare a dividend to be backdated to clear a shareholder's current account.

16 Other issues – 'natural person' shareholders of close companies

Clause – not addressed in the Bill

Submission

The definition of a natural person shareholder, in the context of the close company definition needs clarification. We understand the Commissioner's view is that a natural person includes a trust. This should be confirmed, as it is currently unclear whether a trust can be a shareholder of a close company.

Appendix 4: Detailed submission on loss group and imputation credits

We support the proposal to allow the transfer of imputation credits as part of a loss transfer to ensure shareholders of non-wholly owned companies are not tax disadvantaged when losses are grouped and dividends paid. We make the following suggestions to improve the operation of the rules.

17 ***Submission 1 – allow Maori Authorities to access the imputation credit transfer mechanism***

The imputation credit transfer mechanism is limited to companies that are eligible to maintain an imputation credit account. However, we consider that the proposal should be extended to Maori Authorities which have similar mechanisms to imputation, as they face similar issues.

A similar problem exists for Maori Authorities, particularly in a sister company situation, where a Maori Authority is the parent and owns more than 66% of a profit company and a loss company. There would be an imputation shortfall if the Maori Authority is the recipient of a dividend and if it is unable to transfer credits to make up for the imputation credit shortfall.

Maori Authorities should be able to make an imputation credit transfer (this would create the relevant debit and credit entries in its Maori Authority credit account) to a profit company on behalf of a loss company, equal to the imputation shortfall as a result of loss grouping between the company and the loss company. This would then allow the profit company to pay a fully imputed dividend to the Maori Authority and any minority shareholders.

Submission 2 – four-year time bar

The proposal requires an imputation credit transfer to be made within four years of the balance date of the tax return that includes loss grouping.

We understand the rationale for the four year time limit is to align with the statute bar. This is not a valid comparator. Assuming the minimum 66% shareholding commonality is met between the time of loss grouping and the imputation credit transfer, there should be no time based restriction. Particularly, if the loss company is required to provide information to Inland Revenue at the time of transferring the imputation credits.

Appendix 5: Section BG 1 override of NZ DTAs

18 ***Submission***

An amendment is proposed to section BH 1, which provides that DTAs entered into by New Zealand override domestic law, to make it clear that the general anti-avoidance rule (section BG 1) overrides New Zealand's DTAs and applies to cross-border transactions.

While the amendment is referred to by officials as a remedial clarification, we understand that the proposed change is part of a range of measures to amend New Zealand's domestic tax rules as part of the BEPS work. Australia, Canada and the United Kingdom have all made legislative changes in recent years to ensure their domestic general anti-avoidance rules override their double tax agreements ("DTAs").

As a unilateral amendment, the proposed change could be regarded as a case of "treaty override". However, it appears to be consistent with the Commentary to the OECD Model Tax Convention (at paras 22-22.2 of the Commentary on Article 1), which states that there is generally no conflict between domestic anti-avoidance rules and DTAs.

As a general principle (and in accordance with the rule of law), we consider that DTAs should be interpreted based on the OECD Commentary that would have been available to the negotiating parties at the time of entering into the relevant DTA.

The paragraphs referred to above were incorporated into the OECD Commentary in 2003. Therefore, while we consider that the position is clear that section BG 1 applies in relation to New Zealand DTAs signed after the Commentary was amended in 2003, there is some uncertainty regarding whether section BG 1 applies to DTAs concluded before 2003. The proposed unilateral amendment to section BH 1 does not alter the position in this respect. It is also unclear whether the other Contracting States to DTAs entered into by New Zealand before 2003 accept that section BG 1 overrides the relevant DTAs.

In addition, notwithstanding the proposed amendment making it clear that section BG 1 may apply where a DTA also applies, further guidance from Inland Revenue is needed on what the position is in a case where there is a conflict between the domestic law position and the treaty position.
Further guidance is also needed on how Inland Revenue regards the role of section BG 1 compared with specific anti-avoidance measures contained in our tax treaties (such as the LOB previsions contained in the Dividend Article of New Zealand's more recent DTAs).

KPMG
10 Customhouse Quay
P.O. Box 996
Wellington
New Zealand

Telephone +64 (4) 816 4500
Fax +64 (4) 816 4600
Internet www.kpmg.com/nz

Appendix 6: Related-party debt remission

Our detailed submissions on the proposed related-party debt remission regime are outlined below. As a general comment, we support the proposal that a related-party debt remission does not give rise to debt remission income.

19 Commissioner's finalised view on debt capitalisation

The Commissioner's QWBA 15/01 relies on a conclusion that Parliament did not contemplate that a debt capitalisation's effect would "avoid" the consequences of a debt remission. We continue to have significant concerns with the Commissioner's view.

The debt capitalisation approach to dealing with related-party debt was well known by taxpayers and Inland Revenue Policy and no policy concerns were ever raised. Rather, the debt remission rules were included to address other avoidance concerns. In the absence of those concerns debt capitalisation was considered an acceptable solution to debt remission problems.

In our view, this supports the contrary conclusion that Parliament did, in fact, contemplate that debt capitalisation is not tax avoidance. We note the reasonableness of that conclusion can be confirmed by the Minister's announcement.

However, in the absence of legislation, a taxpayer's only option to correct the Commissioner's view is to dispute the conclusion through the Courts. This is a solution with an unacceptably long time frame. Despite our view (and that of many others) of the incorrectness of the conclusion, this significant period of uncertainty will unnecessarily constrain commercial responses to dealing with related party debt.

Accordingly, we continue to support a legislative response.

20 Domestic tax base scope for the proposal is too narrow

KPMG has previously submitted that we consider the scope of the proposed legislative amendments should be wider, in particular, that the solution should not be limited to debt issued within wholly owned groups and/or on a pro rata basis.

We acknowledge that the proposed legislation in the Bill has been extended to include look-through companies and limited partnerships. However, there are still scenarios in which a debt remission will not give rise to a change in the ownership of the debtor or the owners' net wealth. These include:

- Family trusts;
- Sister companies;
- Where not all shareholders are creditors; and
- Where debt and equity is not issued on a pro-rata basis.

For example, under the proposed legislation, debt remission income will arise where debt is remitted by Company A (creditor) to Company B (debtor), both of which are wholly owned by an individual shareholder. This is because the creditor (Company A) will not be captured within

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the proposed definition of "creditor's associate" as the associated person (the individual shareholder) is not a member of the same wholly owned group of companies as Company A and Company A is not a natural person. In this scenario, there has been no change in net wealth nor a dilution of ownership.

We consider a further legislative change is required to expand the application of the proposed regime to the above scenarios.

21 Pari Passu debt – methodology

The proposed legislation defines "pari passu debt" as:

> *(i) a debt for a creditor group member (member debt), if the member debt, expressed as a fraction of the total member debt for the debtor, corresponds to the* ***creditor group member's creditor's interests in the debtor, expressed as a fraction of total creditor interests held by all creditor group members****. For the purposes of this definition, the creditor group member is treated as having the creditor's interests of their creditor's associates, to the extent to which the associates are not creditors of the debtor; and*
>
> *(ii) does not include a member debt, if the creditor group member is a non-resident who was not originally issued the debt.*
>
> *[emphasis added]*

Based on this definition, the legislation does not achieve its stated purpose as the numerator "creditor group member's creditor interests in the debtor" is expressed as a fraction of "total creditor interests held by all creditor group members". This means that unless an owner or an associated person of that owner are creditors of the debtor, that person's ownership interests are not included in the calculation. This poses a concern as it will result in an increase in the creditor's (or associated persons) ownership interest upon remittance of the debt by the creditor and a corresponding dilution of the ownership interest of other shareholders. We do not consider this is an intended outcome of the legislation.

We submit that the "creditor group member's creditor interests in the debtor" should instead be expressed as a fraction of total ownership interest.

22 Clear and simple legislation

Simple language

The purpose of rewriting the Income Tax Act was to ensure the legislation was written in a way that made it easy for taxpayers to understand and apply.

We consider the language used in the proposed legislation could be simplified to ensure it is easily understood. In particular, we submit that the term "pari passu" in clause 57 be replaced with a simpler term, such as "pro-rata".

Clear and concise legislation

The proposed legislation sees an increase in the creditor's available subscribed capital as a result of a debt remission. We understand that it is intended that the increase in available subscribed capital is attributed to a creditor's associate if the creditor does not have an ownership interest in the debtor. However, this is not clear in the legislation as it is currently drafted.

We submit that the legislation should expressly state that this is the intended outcome/result.

KPMG
10 Customhouse Quay
P.O. Box 996
Wellington
New Zealand

Telephone +64 (4) 816 4500
Fax +64 (4) 816 4600
Internet www.kpmg.com/nz

Appendix 7: Life insurance

Treatment of fees for managing policyholder investments (clauses 61, 62 63, 65 and 66)

23 ***Submission***

The proposed changes should be extended to expressly confirm that fees for managing policyholder investments are not assessable income for the life insurer and not deductible to the policyholder prior to the application date for the changes. This is for taxpayers whose positions are not validated due to filing based on the proposed changes.

Comment

Support for changes

We support the introduction of the provisions to codify the taxation of fees charged by a life insurer to a policyholder for managing policyholder investments. In our view, the provisions, which treat the amount paid by the policyholder as income for the life insurer and allow a deduction for the policyholder, are consistent with the commercial practice and the contractual arrangements between the life insurer and policyholder.

Concern regarding historical positions

The provisions clarify the taxation of fees for managing policyholder investment going forward and validate positions taken consistent with the changes. However, we are concerned that there remains uncertainty regarding the historical taxation of such fees, particularly since the new life insurance rules have been in place since 1 July 2010.

Inland Revenue has expressed the view through industry forums that fees for managing policyholder investments are not deductible against policyholder income. Our expectation that a number of taxpayers will have filed tax returns based on this view. These taxpayers will not have their positions validated by the proposed changes. There would seem be a certain irony that taxpayers filing based on a view expressed by Inland Revenue are left in a position of uncertainty.

Under the current rules, the fees charged to the policyholder for managing policyholder investments are arguably a "premium" for tax purposes as it is paid under a contract of insurance. While Inland Revenue has expressed the view that the fees are not deductible against policyholder income, it has not as far as we are aware, expressed a view regarding the assesability of the fees for the life insurer. That is, whether the fees would be regarded as a life risk or saving component of the premiums. We would assume the latter given the validation of historical tax positions consistent with the changes and the need to introduce legislation to treat the fees as income for the life insurer.

We consider that the proposed changes should be extended to expressly confirm that the fees are not assessable income for the life insurer and not deductible to the policyholder prior to the

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application date of the changes. Alternatively, Inland Revenue should provide guidance to this effect.

This would allow a reassessment of historical returns if the fees were treated as assessable income. This would, in our view, ensure that life insurers that have filed based on the views expressed by Inland Revenue are not disadvantaged compared to those whose position will be validated under the proposed changes.