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Our ref: KPMGSubmissionMay2023TaxBill

The Chair
Finance and Expenditure Committee
Parliament Buildings
Wellington

13 July 2023

Dear Madam Chair

KPMG submission - Taxation (Annual Rates for 2023-24, Multinational Tax, and Remedial Matters) Bill

We welcome the opportunity to make a submission on the Taxation (Annual Rates for 2023-24, Multinational Tax, and Remedial Matters) Bill (referred to hereafter as "the Bill").

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

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

KPMG's participation in the tax policy and legislative process

By way of background, KPMG spends significant time engaged in the Generic Tax Policy Process ("GTPP"). We provide submissions on Government discussion documents and Taxation Bills, engage with Officials and Members of Parliament and present to Select Committees. We respond to many requests for feedback from Inland Revenue on proposed policies, operational guidance and interpretations.

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

We engage in the GTPP because we can offer:

- A potentially different perspective to that of Officials and Government and can challenge some of the thinking around a particular policy or policy issue; and
- Practical experience of how tax law applies and therefore how a change may actually apply and be implemented.

We believe our involvement, and that of other advisors and professional bodies, produces better tax law and policy.

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

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

In particular, in relation to the trustee tax rate increase, it is disappointing that the full GTPP process was not followed. The change was announced on Budget Day – 18 May 2023 – with accompanying draft legislation. As outlined in our submissions below, there are fundamental issues with aspects of the proposed changes which are now having to be addressed at the Select Committee stage of the Bill. This, in our view, is sub-optimal and is what the GTPP was designed to avoid.

Summary of our key submission points on the Bill

OECD Pillar Two Global Minimum Tax

The Bill establishes the framework for application of the OECD's Global Minimum Tax Rate proposal (the so-called "GloBE" rules).

While we are supportive of New Zealand's engagement in the OECD's Base Erosion and Profit Shifting ("BEPS") Pillar One and Two work, we make the following observations.

There needs to be greater clarity on what will constitute a "critical mass" for application of the GloBE rules in New Zealand. The criteria for determining whether and when the GloBE rules should come into force also needs to take into consideration potential responses (including adverse trade and/or investment responses) from New Zealand's key trading partners.

The proposal in the Bill is to incorporate the GloBE rules into New Zealand's domestic tax law by 'reference', rather than by 'repetition' (i.e., by restating the GloBE rules as specific provisions in the Inland Revenue Acts). This is on account of the GloBE rules comprising not just the Model Rules but also associated OECD Commentary and Administrative Guidance. In some cases, the latter will override the Model Rules. This presents potential practical challenges in how the GloBE Rules should be interpreted and applied in New Zealand (particularly, how extensive incorporation by 'reference' should be).

Incorporation of the GloBE rules by 'reference' also means any future updates to the Commentary and Administrative Guidance will be automatically brought into effect in New Zealand. This would, prima facie, be without independent oversight or consideration of whether those changes are in New Zealand's overall national interest.

While the Bill contains the ability for the Government to reverse the effect of future updates via Regulation – a form of 'negative update' – our preference is to include a 'positive-update' requirement for adopting any substantive future updates to the GloBE rules in New Zealand. This recognises the need to move at speed while preserving the ability for appropriate scrutiny of, and consultation on, future updates where required.

Our more detailed submissions comment on these and other aspects of the GloBE rules and their application in New Zealand.

39% trustee tax rate

While we recognise the Government's rationale for increasing the trustee tax rate to 39%, we are concerned with the potential for over-taxation where beneficiaries have marginal tax rates of 33% or lower. This is likely to be the case with the vast majority of New Zealand trusts.

The fact sheets released at the time of the Budget announcement (and examples in the original Bill Commentary) on mitigating over-taxation have had to be amended due to concerns that the suggestions – crediting amounts to beneficiaries' current accounts or beneficiary distributions which beneficiaries choose to re-settle on the trust – may raise tax avoidance concerns in certain circumstances. This has created significant uncertainty as to how these rules are intended to apply in practice. While Officials have acknowledged these concerns, it highlights the challenges with simply increasing the trustee tax rate which will prima facie over-tax the vast majority of NZ trust beneficiaries, given the marginal tax rate profile of the taxpayer population.

Setting aside potential tax avoidance concerns, it is not clear to us whether the suggestions for mitigating over-taxation will be workable in practice. Take, for example, a common scenario where a family trust owns a rental property. If the property is debt funded, the denial of interest tax deductions is likely to mean the property will have net taxable rental income but may well be cash-flow neutral. (That is, mortgage interest repayments offset the rental stream). In this situation, we cannot see how a trustee would be able to distribute net rental income to beneficiaries as there will be no surplus cash. (While an amount representing the net rental income could be recorded as a loan owning to beneficiaries, trustees may be reluctant to do so as the beneficiary will have a claim against the trust which may not be able to be met if there are no liquid assets.) This brings into question the ability for trustees to comply with their obligations under the Trusts Act 2019, while trying to prevent over-taxation.

In our view, further work needs done to ensure that over-taxation does not become the default outcome under the proposed 39% trustee tax rate change. This should include reconsideration of whether targeted rules to address integrity concerns are more appropriate, rather than subjecting all trusts to the 39% trustee tax rate and addressing over-taxation concerns in an ad-hoc (and inevitably incomplete) manner.

If the proposed trustee tax rate change proceeds, we question the ongoing need for extensive NZ domestic trust disclosures each year. Those disclosure obligations (introduced with effect from the 2021-22 income year) were designed to help Inland Revenue get more detailed information to determine whether trusts were being used to shelter income from the 39% personal tax rate. More generally, this was to inform the Government's decisions around the trustee tax rate. As that decision has been made, we query the ongoing need for these disclosures, which impose significant costs for little benefit to those having to comply. At a minimum the thresholds for completing a trust disclosure should be raised.

Our detailed submissions cover specific issues in relation to the 39% trustee tax rate change and consequential amendments.

Other measures in the Bill

As noted above, we have not comprehensively covered every amendment in the Bill. We have summarised below our position in relation to some other key measures in the Bill.

- We support the proposal to provide an alternative tax treatment for backdated ACC and MSD payments and consider this should be extended to other lump sum payments, that relate to multiple years. An example is remediation payments by employers relating to non-compliance with the Holidays Act 2003. More detail is provided in our detailed submission.

- The remedial amendment to the Double Taxation Agreement ("DTA") source rule in section YD 4(17D) highlights wider concerns with the potential overreach of this provision. The rule should be narrowed with retrospective effect to apply only to income of a non-resident that may be taxed in New Zealand under a DTA because payments associated with that income are deemed to be connected with a permanent establishment in New Zealand (and

therefore determined to arise in New Zealand under an applicable DTA). Our detailed submission expands on our concerns.

- While we support clarifying the meaning of "building" for tax depreciation purposes, a wider review of the definition is needed.

Our other detailed submissions are attached as an appendix to this letter.

For completeness, we support of the following amendments in the Bill:

- The provision of taxation rollover relief (on depreciation recovery income and gains on revenue account property) for those impacted by the January and February 2023 North Island flooding event. We agree that replacement land/buildings should not need to be in the affected region.
- The payment of KiwiSaver contributions by Government to eligible Paid Parental Leave recipients.
- The remedial amendment to section RE 14C to clarify the application of this provision to non-cash dividends received through intermediaries, such as custodians.

Further information

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

Yours sincerely

Darshana Elwela
Partner

Rachel Piper
Partner

KPMG's detailed submissions on the Bill

OECD Pillar Two: global minimum tax

Applied GloBE Rules

Issue: Application date for the GloBE Rules

The Bill Commentary indicates that the Government will look to determine when a "critical mass" of countries has adopted the GloBE rules before confirming an application date for those rules in New Zealand. The application date will not be earlier than 1 January 2024 for the Income Inclusion Rule ("IIR") and 1 January 2025 for the Under-Taxed Profits Rule ("UTPR").

Submission

There needs to be greater clarity on what will constitute a "critical mass" for application of the GloBE rules in New Zealand.

The criteria for determining whether and when the GloBE rules should come into force also needs to take into consideration potential responses (including adverse responses) from New Zealand's key trading partners.

Comment

The Bill Commentary states that the application date for the GloBE rules will be set by Order-in-Council once the Government determines that a "critical mass" of countries has adopted the GloBE rules. We understand that this is designed to give comfort that New Zealand will not be an early adopter.

However, it is not clear what the threshold for "critical mass" will be. For example, we note that Australia has committed to adoption of the GloBE rules, with a 1 January 2024 application date for their version of the IRR and 1 January 2025 for their UTPR. Is this considered sufficient for a "critical mass", with New Zealand's timing to match Australia's?

In many countries, the GloBE rules will be considered not just applying a tax policy lens, but also for their fit with wider investment and trade policies (that is, taking an overall national interest perspective). In our experience, that is not generally the case in New Zealand. Consideration needs to be given to potential responses, including possible trade and investment retaliation, from New Zealand's key trading partners. In particular, we understand the adoption of the UTPR appears to be a concern for the United States.

Issue: Incorporation of GloBE Rules by reference is not comprehensive

Incorporation of the GloBE rules by 'reference' to the Model Rules, Commentary and Agreed Administrative guidance is not likely to be comprehensive enough to enact all elements of the Model Rules.

Submission

Consideration should be given to how to enact those components of the Implementation Framework for Pillar 2 (that have been agreed to by members of the OECD/G20 Inclusive Framework) which sit outside the Model Rules, Commentary and Agreed Administrative guidance (this may include any future releases that are relevant to the application of the GloBE rules).

Comment

Certain components of the Pillar 2 Implementation Package (such as the GloBE safe harbours) are referred to in the Model Rules, however the detail is left to be established in accordance with a common and agreed process. We consider this to be an insufficient basis to enact these further components of the GloBE Model Rules. For example, it is not clear that the incorporation by 'reference' approach taken in the Bill extends as far as incorporating by reference the transitional safe harbours agreed to by the OECD/G20 Inclusive Framework (per its 2022 guidance note on safe harbours and penalty relief).

It is also not clear whether there any future additional elements of the GloBE Model Rules (that are yet to be agreed to by the OECD/G20 Inclusive Framework) which sit outside the Model Rules, Commentary and Agreed Administrative guidance are intended to be incorporated by reference in an ambulatory manner.

Issue: Updating mechanism is insufficient to ensure proper consideration is given to whether future changes are in NZ's national interests

In our view, new section 226G of the TAA 1994 is unlikely to be used in practice and hence is insufficient protection for NZ to ensure that any substantive future updates to the GloBE rules at the OECD level (which will be incorporated by 'reference' into NZ's legislative framework) are in NZ's best interests.

Submission

The Bill should be amended to reflect a 'positive-update' approach to ensure proper scrutiny is able to be applied to any substantive future changes to the rules at the OECD level. This will help to ensure that full consideration can be given to whether those changes are necessarily in New Zealand's overall national interest, prior to implementation. It will also prevent New Zealand being an early adopter or adopting changes in a way that is out of step with how other countries choose to comply with any required updates.

Comment

Proposed section 226G of the TAA 1994 reflects a 'negative-update' approach by providing that the Governor-General, by Order-in-Council on the recommendation of the Minister of Revenue, can make regulations providing for the cancellation, reversal, or non-application of a change to the Commentary or the Agreed Administrative Guidance (including future tranches).

While acknowledging that a 'negative-update' approach is designed to ensures that NZ law is as closely aligned as possible with international norms, we fully expect that other countries participating through the OECD/G20 Inclusive Framework will take a national interest approach in deciding *when* to implement any changes agreed at the OECD level *and how* to implement updates.

In our view, it would be highly desirable to have a 'positive-update' requirement for any substantive future updates to GloBE Rules (Commentary or Administrative Guidance), via Order-In-Council. This would allow time for scrutiny and consultation on what these changes at a domestic law level could look like and whether they can be designed in a way that doesn't unduly prejudice business or investment but nevertheless still qualifies the GloBE rules for the purposes of any multilateral review process. It will also better support the policy process by highlighting any changes at the OECD level agreed to by Inland Revenue through their participation in the OECD/G20 Inclusive Framework.

Issue: Penalties for purposes of the GloBE rules

The penalties applicable for late registration and/or reporting requirements related to the GloBE information return are potentially disproportionate to the 'offences' involved.

Submission

More guidance is needed in relation to the Commissioner's discretion to issue a penalty up to NZ$100,000 under section 139ABB of the TAA 1994.

Comment

The penalties for late registration by a NZ entity impacted by the GloBE rules and for late reporting in respect of a GloBE information return that is required to be provided to Inland Revenue can be up to NZ$100,000 under section 139ABB (at the Commissioner's discretion). This seems disproportionate to the potential 'offense' and should only apply in exceptional circumstances.

More guidance is needed as to how this discretion is intended to be practically applied by the Commissioner to give clarity and protect taxpayers who may be doing their best to comply with the new legislation.

Issue: Allocation of the UTPR top up tax liability filing requirements among NZ Constituent Entities

The applied GloBE rules provide only for how to calculate the Undertaxed Profits Rule ("UTPR") top up tax liability on a jurisdictional level but not how to allocate the UTPR liability between Constituent Entities ("CEs") or determine which CEs have a filing requirement

Submission

Clarification is required on how a UTPR top-up tax liability for NZ is allocated between any CEs in NZ.

Comment

Proposed section HP 1(3) provides that CEs located in NZ would be jointly and severally liable for any Multinational Top-Up Tax payments that are charged to any one NZ-resident entity of the MNE group under the GloBE rules. However, this does not provide any clarity on which CE has the prima facie UTPR tax liability (which is determined on a jurisdictional basis) or how this UTPR liability is to be allocated between CEs (with associated filing obligations).

Issue: Foreign tax credits in respect of a Qualifying Domestic Minimum Top-Up Tax

The draft legislation should be clarified to provide that foreign tax credits are available for GloBE top-up tax paid under a Qualifying Domestic Minimum Top-Up Tax ("QDMTT").

Submission

Legislative clarification is required to confirm that foreign tax credits are available for GloBE top-up tax paid under a QDMTT.

Comment

We understand from the Bill Commentary that it is intended that a foreign tax credit would be available against a NZ Controlled Foreign Company ("CFC") tax liability or a head-office tax liability in respect of an overseas permanent establishment for GloBE top-up tax paid under a QDMTT.

Section LJ 3 defines what is included in the meaning of "foreign income tax" for the purposes of the foreign tax credit rules. Amendments to section LJ 3 are proposed to clarify that tax which is of substantially the same nature as Multinational Top-Up Tax is excluded from the meaning of "foreign income tax". This is to ensure that GloBE top-up tax paid under an IIR or UTPR would not be creditable for non-GloBE income tax purposes. However, it is arguable that GloBE top-up tax paid under a QDMTT is of substantially the same nature as Multinational Top-Up Tax given a QDMTT must (by definition per the Model Rules) determine excess profits in a manner that is equivalent to the GloBE rules.

Legislative clarification is required to confirm that GloBE top-up tax paid under a QDMTT is in fact included within the meaning of foreign income tax and therefore a foreign tax credit is available.

Trustee tax rate

Increasing the trustee tax rate to 39%

Issue: Over-taxation risk

Submission

The trustee tax rate change will result in over-taxation where beneficiaries have marginal tax rates of 33% or lower. This is likely to be the case for the vast majority of New Zealand trusts. Consideration therefore needs to be given to whether a more targeted approach should be adopted to address the integrity concerns that the trustee tax rate change is actually aimed at.

Comment

The Government's stated rationale for increasing the trustee tax rate to 39% is to *"help ensure that trusts cannot be used to circumvent the top personal tax rate"*. While we acknowledge this rationale, we are concerned with the potential for over-taxation where beneficiaries have marginal tax rates of 33% or lower. Given the general taxpayer population, this is likely to be the case for the vast majority of New Zealand trusts and their beneficiaries.

Officials clearly recognise this issue as the Bill Commentary and related materials discuss options to mitigate over-taxation at length.

We note the fact sheets released at the time of the Budget announcement (and examples in the original Bill Commentary) on mitigating over-taxation have had to be amended due to concerns that the suggestions – crediting amounts to beneficiaries' current accounts or beneficiary distributions which beneficiaries choose to re-settle on the trust – may raise tax avoidance concerns in certain circumstances. This has created significant uncertainty as to how these rules are intended to apply in practice. While Officials have acknowledged these concerns, it highlights the challenges with simply raising the trustee tax rate which will prima facie over-tax in most circumstances.

Setting aside potential tax avoidance concerns, it is also not clear to us whether the suggestions for mitigating over-taxation will be workable in practice (we refer to our example in our Summary of Key Submission Points). Some scenarios bring into question the ability for trustees to comply with their obligations under the Trusts Act 2019, while trying to prevent over-taxation of the trust's income.

Specific proposals, which we comment on below, have also been introduced to target scenarios where the Government recognises over-taxation is highly likely to occur (e.g., disabled beneficiary trusts and deceased estates). There are many other scenarios where over-taxation of trusts will no doubt occur, particularly trusts established for commercial purposes or other purposes unrelated to personal or family situations.

In our view, further work needs done to ensure that over-taxation of trusts (and their beneficiaries) does not become the default outcome under the proposed 39% trustee tax rate.

This should include reconsideration of whether targeted rules to address integrity concerns are more appropriate, rather than subjecting all trusts to the 39% trustee tax rate and addressing over-taxation concerns in an ad-hoc (and inevitably incomplete) manner. This would also remove the uncertainty created by the proposed suggestions to avoid over-taxation.

Issue: The proposals will result in over-taxation of various widely-held trusts, including Māori trusts and energy consumer trusts

Submission

Specific classes of widely-held trusts, where over-taxation is likely to occur, should continue to be subject to the 33% trustee tax rate.

Comment

Trusts are established for many purposes beyond the family trust context. There are a variety of types of "widely-held" trusts which are established for the benefit of a large class of beneficiaries. Examples include energy consumer trusts ("ECTs") settled in accordance with the Energy Companies Act 1992 which hold shares in energy companies on behalf of consumers in their geographical markets, and Māori post-settlement governance entities ("PSGEs") established pursuant to Treaty settlement legislation to receive, administer, manage and protect settlement assets on behalf of their members. (Many PSGEs in our experience are operated as complying trusts). These trusts do not pose the integrity concerns (circumventing the top 39% individual tax rate) that potentially justify an increase in the trustee tax rate.

Taxing trustee income at 39% will invariably result in significant over-taxation in the above cases. Further, the 'mitigating over-taxation' options discussed in the personal/family trust context are generally not relevant, or potentially even available, to such trusts. For example, in the PSGE context, the trustees are generally obliged to manage and protect the trust assets and will aim to grow the asset base for the benefit of members. This requires reinvestment of income rather than distributing the majority of (or all) income to beneficiaries each year.

We understand Officials' concern is that a general exemption for all "widely-held" trusts would be open to abuse (e.g., appointing a large number of beneficiaries to a discretionary family trust). However, we expect that for certain classes of widely-held trusts, such as ECEs and PSGEs, workable categorisations and definitions could be established, and the integrity concerns should be minimal (if at all).

For these specific categories of trusts, we consider that the trustee tax rate should be retained at 33%. While this may still over-tax some beneficiaries, it would not result in additional over-taxation relative to the current position. A modification approach (similar to the proposed approach for disabled beneficiary trusts) based on effective tax rates of beneficiaries is likely to be difficult for these categories of trusts, but could be allowed as option.

Issue: The NZ domestic trust disclosure rules should be repealed or amended if the proposal proceeds

If the proposed trustee tax rate change proceeds, we question the ongoing need for NZ domestic trust disclosures.

Submission

The NZ domestic trust disclosure requirements should be repealed or otherwise amended to lessen the compliance burden.

Comment

The Taxation (Income Tax Rate and Other Matters) Act 2022 increased disclosure requirements for trustees of NZ domestic trusts from the 2021-22 income year. The disclosure rules, including additional information to be supplied to the Commissioner, are outlined in section 59BA of the Tax Administration Act 1994. The additional disclosure requirements are comprehensive and include:

- A statement of profit and loss and statement of financial position (with simplified reporting requirements for certain trusts).
- The value and nature of settlements received (including services provided to the trust)
- Settlor details, including details of previous settlors if not previously supplied.
- The amount and nature of distributions made (i.e. whether taxable or non-taxable)
- Details of beneficiaries who received the distributions.
- Appointer details.

The stated purpose of the trust disclosure obligation was to "*support the Commissioner of Inland Revenue's ability to assess compliance with the new 39% personal income tax rate and assist the Commissioner in understanding and monitoring the use of structures and entities by trustees.*"

The proposal to increase the trustee tax rate to 39% addresses the integrity concerns underlying the NZ domestic trust disclosure requirements. We therefore query the ongoing need for these disclosures, which impose significant costs for little benefit to those having to comply.

At a minimum, the current income threshold for completing a trust disclosure should be raised significantly.

Beneficiary income derived by certain close companies

The Bill proposes an integrity rule to address concerns that the trustees of a trust could allocate beneficiary income to a corporate beneficiary which would pay tax on the income at the company rate of 28% rather than at the 39% trustee rate.

Where the relevant criteria applies, the proposed rule would treat the beneficiary income allocated to the company as being exempt income of the company and as trustee income for purposes of determining the rate of tax that applies (the 39% tax rate), who pays the relevant tax (the trustee) and who provides the tax return (again, the trustee).

Issue: Rule does not apply as intended where settlor of the trust is sole owner of the corporate beneficiary

Proposed section HC 38 applies when a close company (that is not a Māori authority or a tax charity) derives an amount of beneficiary income from a trust in an income year and a person for whom a settlor of the trust has "natural love and affection" holds (under sections YC 2 to YC 4) a voting interest or a market value interest in the close company.

Submission

If the trustee tax rate change proceeds, section HC 38 should be amended to ensure it applies where the settlor of the trust is the sole owner of the close company beneficiary.

Comment

It is clearly intended that the integrity rule should apply in the situation where the settlor of trust is also the sole shareholder of the close company that receives a distribution of beneficiary income from the trust.

As currently drafted, section HC 38 may not apply because a person for whom the settlor has "natural love and affection" (arguably) does not hold a voting or market value interest in the

company. This is because a settlor cannot have "natural love and affection" for themself. Therefore, if the trustee tax rate proposal proceeds, section HC 38 should be amended to clarify the integrity rule applies in this scenario.

Issue: Criteria for application of the rule should be narrowed

Submission

Proposed section HC 38 should be amended to only apply where there is a sufficient connection between the principal settlors of the trust and persons with material shareholdings in the close company.

Comment

As currently drafted, the integrity rule applies where *any* settlor of the trust has "natural love and affection" for *any* shareholder of the close company.

In theory, the rule could apply where a settlor of the trust has "natural love and affection" for a nominal (e.g., 1% or less) shareholder in the corporate beneficiary. It could also apply where a settlor has very little connection to the trust (e.g., settled $1 on a trust with $10m in assets, or is a deemed settlor of the trust due to providing goods or services to the trust at below market value).

Based on our understanding of the integrity concerns the rule is intended to address, we consider it should only apply where a "principal settlor" of the trust has "natural love and affection" for a significant shareholder in the close company. The significant shareholder test could be based on the associated person rules in section YB 3, including the general aggregation rule in section YB 3(3).

Deceased estates

In order to address potential over-taxation concerns, it is proposed that a trustee of a deceased estate can elect to apply a modification to income derived within 12 months of the deceased person's date of death, based on the deceased person's marginal tax rate.

Issue: The proposal is overly complicated and the 12-month rule is not justified and will result in unnecessary compliance costs

Submission

The modification should apply for the duration of the deceased estate's administration.

If our primary submission above is not accepted, the modification should apply for at least the full income year following the deceased person's date of death.

Comment

Our primary submission is that trustees of a deceased estate should be able to apply the modification for the duration of the deceased estate's administration.

We consider this is a reasonable approach to ensure the income arising to the estate is not over-taxed, particularly as we expect the majority of beneficiaries of deceased estates will not be on the 39% tax rate.

The Bill Commentary states that the proposed modification should only apply for a limited time so that it does not incentivise trustees to retain income rather than distributing amounts to the beneficiaries of the estate. We do not agree this would occur. The trustees of a deceased

estate will have a fiduciary obligation to the beneficiaries to efficiently administer the estate and wind it up in a timely fashion. The trustees would (likely) be in breach of their obligations if what the Bill Commentary is suggesting occurred. Further, it seems unlikely that beneficiaries will seek to delay or defer the wind-up of a deceased estate (as this would also delay/defer their access to any assets).

Inland Revenue’s Regulatory Impact Statement on the trustee tax rate change states that 12 months from the date of death is a reasonable length of time and should be adequate for most estates to be wound up. This is not our experience. In practice, most estate administrations will exceed 12 months (and in some cases may take many years). In principle, we do not agree that a time limit should apply for having to wind up deceased estates, for tax reasons.

If our primary submission is not accepted, then we recommend that the modification should apply for at least the full income year following the deceased person’s date of death.

The effect of the rule as proposed is that, where an election is made by the trustee of a deceased estate, up to four separate part-year returns and calculations will be required: a part-year return for the individual to the date of death in the year of death (year 1); a part-year return for the balance of year 1 (to which the modification applies); a part-year return for the remaining balance of 12 months post-death in year 2 (to which the modification applies); and a part-year for the balance of year 2 (where the 39% trustee tax rate applies).

We consider the better approach would be for the modification to apply, at a minimum, for the entirety of the income year following the deceased person’s date of death (i.e., year 2), to minimise compliance costs. This would mean that only a single tax calculation and return would be required for the income year following death.

Disabled beneficiary trusts

In order to address potential over-taxation concerns, it is proposed that a trustee of a trust established for the exclusive benefit of a disabled beneficiary will be taxed at the beneficiary’s personal tax rate.

The qualifying criteria includes that a “disabled beneficiary” is a person who, for some or all of the income year, receives a supported living payment on the grounds of restricted work capacity or has the child disability allowance paid.

Issue: The qualifying criteria for who is a disabled beneficiary is too narrow

Submission

The “disabled beneficiary” criteria should be amended such that it applies where the beneficiary would be *entitled* to the relevant benefits, whether or not they are actually received during the income year.

Comment

We understand that, in practice, the parents, guardians or trustees acting on behalf of disabled beneficiaries may choose not to apply for Government support payments that the disabled person may be entitled to. In some cases, this is because they do not wish to draw on the Government for financial support.

As the proposals are drafted, disabled beneficiary trusts where the beneficiary is eligible for Government financial support but has not applied to receive such support will be unduly penalised (the trust would be taxed at 39% rather than the beneficiary’s marginal rate). This adds a significant tax cost, ultimately reducing the resources available to the trustee to care for the beneficiary and is clearly a situation where over-taxation is likely to occur.

From a fairness perspective, we consider the criteria should be based on *entitlement* to such benefits, rather than their actual receipt. This would require the parents/guardians/trustees to make reasonable inquiries as to whether the relevant benefits are available for the disabled beneficiary and affirm this is the case (this could be a disclosure point in the trust's tax return).

Inland Revenue should also consult with other Government agencies to understand what information can be shared in relation to eligibility for and/or receipt of support payments and their duration, to simplify the process. We also note that there may be cases where a disabled beneficiary has been assessed as eligible for Government support payments for the rest of their life, in which case the trustee tax rate modification should apply regardless of whether support payments are actually received in a given year.

Taxation of backdated lump sum payments

Taxation of backdated lump sum payments

Issue: Application to other lump sum payments

The proposed law change should be extended to other lump sum payments, that relate to multiple years. An example is remediation payments by employers relating to non-compliance with the Holidays Act 2003.

Submission

We support the proposal to provide an alternative tax treatment for backdated ACC and MSD payments. This reflects the fact that the applicable tax rate would be lower had the payment been received over multiple years. We note that this issue arises in a number of other contexts as well.

For example, there has been significant publicity around non-compliance with the Holidays Act 2003, often across a number of years, by a range of employers (in both the public and private sectors). Typically, this has resulted (or will result) in lump sum remediation payments relating to multiple years.

An extract from the webpage of the Ministry of Business Innovation and Employment (“MBIE”) provides an indication of the nature of payments to employees. As set out below, of the 112 employers that have shared their approaches with MBIE, 22 have paid arrears with a gross average payment in excess of $1,000. The range of average gross payments per affected employee is $16,200 for at least one employer.

Holidays Act non-compliance remediation payments update as at June 2020

	Life-to-date Jul 2012–Jun 2020
Number of employers who have paid arrears (average gross payment per affected employee)	112
• $500 per employee or less	67
• Between $501 and $1,000	23
• $1,001 or more	22
Amount of arrears paid	$237.7m
Number of employees paid arrears	227.3k
Range of average gross payment per affected employee per employer	$29 - $16.2k

The liabilities arising because of Holidays Act remediation are largely driven by the complexity of applying the Holidays Act within the current payroll environment and, according to the regulator, has affected nearly all employers in New Zealand. Accordingly, on a principled basis, we believe the same over-taxation risk which is recognised for ACC and MSD lump sum payments can apply to these types of remediation payments.

The proposed law change should therefore be extended to other lump sum payments, if the payment relates to two or more (i.e., multiple) years and relates to a specified event, such as remediation for non-compliance with the Holidays Act 2003.

While we appreciate that this will have a net impact on revenue collection, failing to recognise the impact of receiving the payment in a single tax year to employees results in over-taxation to individuals (who have already been adversely impacted due to the error) and a windfall gain to Inland Revenue.

Remedial items

Double Tax Agreement source rule

Issue: Proposed amendments are not sufficient to address the scope of overreach

The Double Taxation Agreement ("DTA") source rule results in unintended overreach and should be narrowed with retrospective effect to apply only to permanent establishment issues.

Submission

Our primary submission is that the DTA source rule should be narrowed with retrospective effect to apply only to income of a non-resident that may be taxed in New Zealand under a DTA because payments associated with that income are deemed to be connected with a permanent establishment ("PE") in New Zealand (and therefore determined to arise in New Zealand under an applicable DTA).

If our primary submission is not accepted, we submit that the wording of the proposed amendment to section YD 4(17D) needs to be clarified/amended to achieve the legislative intent of excluding payments that are in the nature of technical services fees and payments that are connected to PEs outside NZ from the ambit of the rules.

Comment

We understand that the DTA source rule was originally considered by Officials in the context of strengthening New Zealand's source rules and preventing PE avoidance. At the time of the *BEPS – Transfer Pricing and Permanent Establishment Avoidance* Government discussion document considering these changes, it was not proposed to treat all income that New Zealand is allocated taxing rights to under an applicable DTA as having a New Zealand source. It was only upon introduction of the Taxation (Neutralising Base Erosion and Profit Shifting) Bill that the DTA source rule was first proposed (citing specific PE concerns in the Bill Commentary as the reason for its enactment).

We consider the potential overreach of this reform was not given appropriate consideration at the time it was enacted. While the various commentaries note that Australia has its own DTA source rule, it should be noted that this has formed part of the context in which tax treaties in Australia have been negotiated for some time. As an example of why this difference is important, we note that Australia would routinely negotiate to include the alternative formulation for dealing with third state PE issues as suggested by the 2017 OECD Model Commentary (refer para [30] in the Commentary to Article 11). New Zealand, on the other hand, did not have a DTA source rule in mind at the time that most of its treaties were being negotiated. At the time of its inclusion in the Taxation (Neutralising Base Erosion and Profit Shifting) Bill, we noted that the DTA source rule was a unilateral extension to New Zealand's taxing jurisdiction which could be viewed as a "bad faith" change by current and prospective partners.

Outside of the specific PE concerns targeted by Officials, the DTA source rule has been found to apply in other unexpected contexts including:

- Dividend income paid by non-resident companies in respect of shares connected with a New Zealand PE (this has been fixed in part for shares that are not revenue account property for the PE through amendments to sections YD 4(17C) and YD 4(17D)).
- Directors' fees paid to non-resident individuals from countries with an applicable DTA (the Commissioner has now determined the fees to have a NZ source in Interpretation Statement IS 19/01 but these conclusions were reached without any prior indication that these sorts of arrangements were necessarily a concern).

- Certain payments that are included in the definition of royalties under certain DTAs (for example "technical services fees" as noted in the current Bill).
- Certain payments that are connected to a PE in a third state but for which the relevant DTA still assigns taxing rights to the residence state (leaving it to the residence state to determine if taxation is appropriate in the circumstances as a matter of its domestic law – also noted as an issue in the current Bill).

We consider that the enactment of the DTA source rule has necessitated Inland Revenue and tax advisors now having to determine, in an ad hoc manner, which transactions are instances of overreach which require remedial amendments.

Moreover, we consider there are other examples where the DTA source rule could apply that have not been adequately considered or addressed by the proposed changes in the Bill. As an example, it seems to us that gains from the alienation of shares deriving more than 50 per cent of their value directly or indirectly from real property (modelled after Article 13(4) of the 2017 OECD Model Convention) could also potentially be captured in circumstances where there is an upstream sale of shares (held on revenue account) in a MNE group. It is not clear whether this type of transaction is intended to be caught by the DTA source rule or whether a further remedial fix is required.

Our primary submission is that the scope of section YD 4(17D) rule should be narrowed with retrospective effect to apply only to income of a non-resident that may be taxed in New Zealand under a DTA because it is deemed to be connected with a PE in New Zealand and therefore determined to arise in New Zealand under the relevant DTA. For example, royalties paid to a non-resident that arise in NZ through a PE that is deemed to be situated in NZ, noting that section YD 4(17C) appears to instead deal with income attributable to a PE in NZ of a non-resident. (That is, the business income of the non-resident with the NZ PE and not payments that are otherwise connected with that PE.) We consider this would align the DTA source rule with the original problem definition.

If our primary submission is not accepted, we submit that the legislative drafting of section YD 4(17D) needs to be further clarified to achieve its legislative intent. We note the following concerns:

- The description of "technical services fees" in YD 4(17D) is insufficient to cover the breadth of transactions that could be deemed to have a source in New Zealand and therefore subject to overreach due to certain services payments being included in the definition of royalty under an applicable DTA. For example, the NZ – Malaysia DTA does not refer to technical services fees but rather to *"the management, control or supervision …of a business or other activity carried on in the other Contracting State…"*.
- The reference to a "PE outside New Zealand" is not sufficiently clear in terms of how that PE is to be defined (and hence determined). In this regard, we note that the definition of PE in section YD 4B of NZ's domestic law is likely to be different to the definition of PE in terms of an applicable DTA that is being considered. In terms of using a DTA definition of PE, it should be noted that in most of NZ's DTAs the definition of PE is only as agreed between Contracting States that are parties to the DTA (and not for the purposes of defining when a PE may be determined to be in a third state). A notable exception is in Article 5(11) of NZ's DTA with Australia which specifically defines when a PE is determined to arise outside both Contracting States for the purposes of the other provisions of the DTA. If the intention is that the relevant principles of a PE definition in a particular DTA are to be used to determine when a PE is outside NZ and the other Contracting State for the purposes of section YD 4(17D), then this should be made clear in the legislation.

Clarifying the meaning of "building" for depreciation purposes

The proposed law includes a new definition of "building" in section YA 1 that for the purposes of the depreciation rules. A "building" will include part of a building owned under a unit title.

Submission

We support the proposal to introduce a new definition of "building". However, we recommend a wider review of what is a "building" should be undertaken.

Comment

The proposed amendment widens the ordinary meaning of the word "building", for tax depreciation purposes. This is sensible in the context of a building owned under a unit title where different owners may use the property for different purposes (e.g., commercial vs residential use).

However, in addition to the unit title situation, there are other situations where a building has mixed use.

We believe that it would be appropriate to undertake a wider review of the definition of "building" given the analysis in the Commissioner's Interpretation Statement: IS 22/04. In particular, where a building is used for both residential and non-residential purposes, in our view depreciation should be based on the proportional use of the building, rather than an all or nothing test depending on whether the building is predominantly or mainly used for residential or non-residential purposes.

Main home exclusion: construction period

For residential land acquired on or after 27 March 2021, the applicable main home exclusion from the 10-year bright-line test treats periods of construction as though they are 'main home' occupancy days despite the owner not living in the dwelling (provided the construction period adjoins the dates on which the dwelling was occupied as the person's main home).

For residential land acquired between 29 March 2018 and 26 March 2021 (to which the previous 5-year bright-line test applies), there is currently no equivalent rule for construction periods. Periods of construction do not count as main home days (even if the person subsequently uses the property as their 'main home'), which means that it is possible a person may not qualify for the main home exclusion solely because of construction delays. This has been the default setting for the bright-line test since it was introduced, prior to introduction of the 10-year bright-line test and new 'main home' exclusion which apply to land acquired after 26 March 2021.

The Bill proposes amendments to the main home exclusions in sections CB 16A and CZ 40 which will see the periods of construction being ignored for the purposes of determining whether a person occupied the dwelling as their 'main home' for more than 50% of the time during the bright-line period.

It is proposed that this change will be made with retrospective effect. The amendments to section CB 16A will apply where a person acquired the land on or after 29 March 2018 and disposed of it before 27 March 2021 (this proposal retrospectively comes into force on 29 March 2018). The amendments to section CZ 40 will apply to land disposed of on or after 27 March 2021 (and this change comes into force retrospectively from 27 March 2021).

Submission

We are generally supportive of these changes. They address an aspect of the rules which has been perceived as unfair and the issue may be exacerbated by recent disruptions in the construction sector causing construction delays.

However, there are a number of issues with the current legislative drafting that we consider should be addressed.

Issue: It is unclear how the proposed law change is intended to apply for a person who has already been assessed, particularly where the assessment is time barred

The proposed law change potentially applies to taxpayers' assessments dating back to the 2018 income tax year. In most cases, 2018 (and for some taxpayers' 2019) assessments are already time barred from re-assessment. For assessments which have been made but which are not yet time barred, a taxpayer generally must request that the Commissioner exercise his discretion to amend a previous assessment.

The Bill Commentary does not acknowledge the fact that this law change will retrospectively impact (reduce) the amount of tax that affected taxpayers were liable for in periods which have already been assessed.

Submission

Further legislative amendments are required to permit the Commissioner to re-assess time barred periods where the retrospective law change reduces the amount of tax the person owes in the time barred income year.

We also consider it should not be up to the Commissioner's discretion to issue refunds (whether for time barred periods or periods that remain open to re-assessment). There should be a legal obligation on the Commissioner to re-assess these periods.

We also recommend that Inland Revenue issue public guidance on this matter to ensure taxpayers understand the process for applying for a refund (and are aware of their rights to refunds in the relevant circumstances).

Issue: Design of the construction period rule

The proposed wording of the new rules in sections CB 16A and CZ 40 is substantially the same in both sections and states that for purposes of determining whether the residential land has been used for most of the bright-line period as a main home, the period in which the dwelling is constructed is 'ignored'.

This is a fundamentally different approach to the rules which apply to construction periods for land acquired after 26 March 2021. Those rules treat construction days as being 'main home' days (rather than 'ignoring' the days) and require that the construction period adjoins the dates on which the dwelling was occupied as a main home.

Submission

The construction period rules applicable to land acquired between 29 March 2018 and 26 March 2021 should be aligned with those applying to land acquired after 26 March 2021. We consider it is preferable to explicitly treat construction days as being 'main home' days, rather than the proposed wording which states the days are 'ignored'.

Consideration should also be given to whether any construction days should be required to be adjacent to days the person occupied the property as their main home. It is possible, for example, that a person could purchase land off the plans (intending to move in once completed)

but then disposes of their interest in the land to a third-party prior to settlement. Under the current approach, arguably every day in the ownership period is 'ignored' (because they are all construction days) and the application of the rule is ambiguous. We understand the policy intention is that construction days should only count as main home days if the property was ultimately occupied by the person as their main home.

Issue: Drafting error in section 9(1) of the Bill

Section 9(1) of the Bill proposes to insert the modified rule for constructing a main home as new section CB 6A(1B), to be inserted after section CB 6A(1). However, section CB 6A(1B) already exists in the Act (as is not being repealed or replaced by the Bill). This appears to be a drafting error.

Submission

The proposed new subsection needs to be renumbered.