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The Chair
The Finance and Expenditure Committee
Parliament Buildings
Wellington

4 September 2019

Dear Madam Chair

KPMG's submission on the Taxation (KiwiSaver, Student Loans, and Remedial Matters) Bill

KPMG is pleased to make a submission on the Taxation (KiwiSaver, Student Loans, and Remedial Matters) Bill (the "Bill").

General comments

We are supportive of changes to allow Inland Revenue to pay employer contributions to KiwiSaver scheme providers based on employment income information filed with the Commissioner. This would be in advance of those contributions being received by Inland Revenue. We note that the practical operation of these rules will be key, as Inland Revenue will still need to be satisfied that the employer is able to pay the employer contribution (and it is unclear how this test will be administratively applied by the Department).

We also support the amendment in the Supplementary Order Paper, which is designed to allow early access to KiwiSaver balances for life-shortening congenital conditions. Given the difficult circumstances in which this withdrawal mechanism will be accessed, we recommend that the application process be made as straight-forward as possible.

We support the refund mechanism proposed in the Bill for R&D tax credits. However, we have concerns regarding proposed exclusions from the R&D tax credit regime. Specifically:

- By referring to persons who derive exempt income as being excluded from the regime, the Bill unintentionally excludes many potential applicants who may derive small amounts of exempt income.
- The carve-out for charities. The tax credit regime is intended to encourage R&D because of its benefits for the wider economy. Charities should be in the scope of the credit for the same reasons as for profit businesses. The fact that they are not "income" taxpayers does not alter the logic for their entitlement to the credit. The R&D credit is, because it is agnostic as to the activity or business, delivered through the tax system.

We submit that:

- The Bill should expressly list the tax exempt entities which the Government wishes to exclude from the R&D tax credit regime, instead of referring to persons who simply derive exempt income (which may be an immaterial amount or from an innocuous source) as the identifying factor.

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— Charities should remain within the scope of the regime, including for refundability. Any changes to carve out charities should be subject to the full Generic Tax Policy process, with any change applicable only from the 2021-2022 income tax years onwards.

Our detailed submissions on the R&D tax credit provisions and certain other matters in the Bill are attached.

Further information

Please contact us, if you would like to discuss any of our submission points (John Cantin, on 04 816 4518 or Darshana Elwela, on 09 367 5940).

As always, we would be pleased to present to the Committee on our submission.

Yours sincerely

John Cantin
Partner

Darshana Elwela
Partner

Detailed submissions on the Bill

R&D tax credit

Support for R&D tax credit refund mechanism

As a general comment, KPMG supports the R&D tax credit refund mechanism introduced in the Bill.

However, we are concerned about the manner in which the restriction for tax exempt entities has been drafted, which will result in unintended consequences. Furthermore, we are also concerned about the exclusion of charities.

We elaborate on these two concerns below.

Issue: Restricting access to tax exempt entities vs. receipt of exempt income

Comment

The Bill excludes persons who receive exempt income, other than levy collecting bodies and those receiving exempt income under sections CW 9 and CW 10 of the Income Tax Act 2007.

Based on the current wording in the Bill, an entity receiving a single dollar from a Part CW source would be ineligible for the R&D tax credit. There are a wide range of part CW sources which could inadvertently exclude taxpayers from the regime.

Below are several examples of how the current Bill will exclude taxpayers from the R&D tax credit, for no justifiable policy reason.

Distributions from complying trusts (Section CW 53)

If a business receives a distribution from a complying trust, it will be ineligible for the R&D tax credit. By way of example, large numbers of New Zealand businesses receive payments from power companies as distributions from complying trusts. (The gross distribution amount will typically comprise both a taxable distribution, with imputation credits/withholding tax deducted, and a non-taxable distribution, being tax-paid trustee income.)

The Bill, as drafted, would prima facie exclude businesses from the R&D tax credit, merely because they receive a payment from their power company. This cannot be intended.

Power company payments are the most obvious example of distributions from trusts, but one can imagine a whole range of scenarios where businesses receive tax paid distributions from complying trusts (e.g. from investment trusts, family trusts, trusts established by the government and so on).

Income from the disposal of companies' own shares (Section CW 58)

If a company receives proceeds from the disposal of its own shares, it would also be excluded from accessing the R&D tax credit. One can foresee scenarios of companies performing R&D, buying back shares from investors and later selling those shares, being excluded from claiming the R&D tax credit.

By way of an extreme example, a company has annual revenue of $10 million and their exempt income from buying and selling their own shares is $1,000, they will be excluded from the R&D tax credit even though their exempt income is only 0.01% of their total revenue.

Exempt income for partners (Section CW 55B)

Partnerships are eligible for the R&D tax credit. However, the partners may derive exempt income pursuant to CW 55B and Part HG. Accordingly, if a partner derives any exempt income, they will be excluded from the R&D tax credit.

Individuals accessing the R&D tax credit

The above examples look at the R&D tax credit from an entity perspective, which is likely where the majority of claims will come from. However, individuals (i.e. natural persons) are also eligible to apply for the R&D tax credit. Similar to our analysis above, if an individual receives any exempt income, they will be excluded from the R&D tax credit regime.

Scenarios where exempt income is likely to exclude individuals from the R&D tax credit include:

- An individual who receive fees for jury service (section CW 26)
- An individual who receive payments from trusts (section CW 53)
- An individual who receives an exempt pension (section CW 28)
- An individual who receives a compensation payment (e.g. for a workplace accident) (section CW 34)
- An individual who receives an exempt distribution from a Maori Authority (section CW 55)
- A transitional resident who receives foreign sourced income (section CW 27)

We understand from the commentary on the Bill that the types of entities the government wishes to exclude from the R&D tax credit regime are:

- Charities (this issue is discussed separately below); and
- Government agencies

It is worth noting that in the Cabinet Papers regarding exclusions from refundability, Officials make reference to restricting access to tax exempt organisations, not those who may simply receive some exempt income (along with taxable income).

We believe the Bill, as drafted, creates a much larger restriction than what was intended, as a consequence of relying on the receipt of exempt income to determine eligibility, regardless of the nature or percentage of that exempt income.

In terms of reflecting the correct policy intent, it would be more accurate to specifically list in legislation the types of tax exempt entities which should be excluded from the R&D tax credit.

We note that an alternative option Officials may consider is excluding "a person whose main source of income is exempt income" (or similar, or wording to that effect). However, we suggest caution as this may create a compliance burden on R&D tax credit applicants to determine whether or not they are eligible (as this could change from year to year). Objectively, such a test could create issues for start-ups with no, or low levels, of revenue who may have exempt income that exceeds their taxable revenue (if any). This exempt income could be from, say, power company payments, funding from investors in the form of distributions from complying trusts, funding from iwi in the form of exempt distributions from Maori authorities, and so on.

Submission

We recommend the Bill expressly lists the type of entities which the Government wishes to exclude from the R&D tax credit regime, rather than referring to any person who derives exempt income being excluded.

Issue: proposed exclusion for charities

Comment

The Commentary to the Bill on excluding charities from the R&D tax credit regime notes the following:

> *"The rationale behind this exclusion is that tax exempt entities sit outside the tax system, so should not benefit from incentives provided from within the tax system. Charities, which come within the tax-exempt entity exclusion, do not pay income tax, and receive additional Government support in the form of GST concessions, an exemption from FBT, and the donor tax credit regime."*

Based on the sentiments expressed by Officials and Government in previous consultation on the R&D tax credit regime (during 2018), we are concerned by this rationale.

As a general comment, as the goal is to increase R&D being performed in NZ, it should not matter whether or not income tax has been or will be paid. This conclusion is reflected by the fact that loss-making companies can qualify for the R&D tax credit, and there is no test as to whether or not they are likely to be tax-paying in future.

More specifically, the matters referred to are not relevant to the purpose of the R&D credit. The income tax exemption, any GST or FBT concessions/exemption, and donor tax credits are aimed at the charitable activity of the charities. None of these are aimed at encouraging R&D by charities. On the same logic, any business which received support from Government would not be entitled to an R&D credit.

Importantly, during the consultation phase on the Taxation (Research and Development Tax Credits) Bill (tabled in Parliament on 25 October 2018 and enacted on 7 May 2019), there was no indication that charities would be excluded. In fact, that legislation expressly included charities within the scope. Submissions on that Bill and support for the regime was on that basis.

If the Government now wishes to exclude charities, this should be properly consulted on as part of the Generic Tax Policy Process, to allow those entities that will be adversely impacted to make their case for inclusion (including their contribution to the wider NZ R&D eco-system).

Bypassing this wider consultation and reversing course via a remedial matters Tax Bill raises serious questions about the process followed for such a fundamental change to the scope of the R&D tax credit regime.

Submission

For the reasons outlined above, charities should remain within the R&D tax credit regime as enacted, and included for refundability, for the 2019-2020 and 2020-2021 income tax years since those years will be "active" by the time this Bill is passed.

Any change to the original policy position should go through public consultation. Removal (if it proceeds) should only be applicable from the 2021-2022 income tax year onwards.

Provisional tax and interest concession amendments

In summary:

- We support the proposed amendment to allow a taxpayer to estimate their final instalment of provisional tax, without losing the benefit of the "interest concession" in section 120KBB of the Tax Administration Act 1994.
- We support clarifying the application of the "lesser of calculation" for standard method taxpayers. We understand the proposed amendment will allow instalments, for use of money interest calculation purposes, to be based on the lower of the 105% and 110% residual income tax ("RIT") thresholds for the prior year (CY-1) and two years prior (CY-2), respectively, if the instalment is prior to the filing of the CY-1 return. The change is therefore intended to be taxpayer friendly. This should be supported by appropriate guidance on the application of the new rules (see also our submission point below).
- We do not support the change to remove the ability for taxpayers to choose the provisional tax instalment to which a particular payment is applied. The stated concern is that taxpayers may be able to use payments to reduce exposure to late payment penalties on later instalments. This should not be a concern if the payment that is transferred was made on time (i.e. at or before the relevant effective date of that future instalment). In our view, the interest provisions currently compensate Government (and taxpayers) for time value of money. It appears to us the key driver are constraints in the START system – that should not determine the correct tax policy settings.
- As a general comment, we consider that further guidance and examples would be desirable on application of the "interest concession" in section 120KBB. While a Tax Information Bulletin was prepared following enactment of those rules, there are a number of nuances and practical issues that are not covered, which could usefully be clarified so that there is consistent understanding of how the interest concession rules apply.

Bright-line main home exclusion

The proposed amendment is designed to align the period of ownership for the main home exclusion with the bright-line test period.

Comment

The main home exclusion should be based on the period that the home would ordinarily be available for use.

We agree that the period from which a mere equitable interest in the property is acquired, to when settlement occurs, should be excluded from the test. Ordinarily the owner does not have occupancy rights during the period prior to settlement and as such it would not be appropriate to apply a use test to this period, as the property is not available for any tangible use.

However, the bright-line test period also artificially curtails the period of use in that the relevant test period ceases where the property is subject to a sale and purchase agreement.

Where a bright-line property is subject to an extended settlement period and the owners continue to reside in the property it would be inappropriate to exclude this period from the test.

Submission

The wording in clause 60 of the Bill should be replaced with *"if, for most of the period starting with the relevant date described in section CB 6A(1) to (4B)* ***and ending at the time the person ceases to own the land****, the land has been used predominantly for a dwelling"*.

Taxation of trusts

We note that "trust" is used in our submission as short-hand for the trust relationship. Although a "trust" is not an entity, it is generally simpler to use "trust" in this way as a separate taxpayer (from its trustees and beneficiaries.)

Issue: Generic tax policy process not followed

Despite the general policy statement to the Bill, we are not aware of the generic tax policy process being followed for the proposed trust measures.

There has been a detailed review of Inland Revenue's statement on the taxation of trusts resulting in *Interpretation Statement: IS 18/01*. There has been limited discussion of possible legislative changes – for example the amendment to include section HC 27(6) in the Taxation (Annual Rates 2019-20, GST Offshore Supplier Registration and Remedial Matters) Act 2019 – but no detailed consultation on the measures proposed in the Bill.

Submission

Only matters which are properly clarifications should proceed. Other proposals should be deferred for proper consideration through the generic tax policy process.

Comment

The Trust rules are complex but potentially apply to many. We agree that the genesis of the rules, and the policy, is to ensure that New Zealand tax is properly payable for income derived by a trustee. However, this does not mean that the detailed rules are appropriate. They assume that trust tax effects arise from tax planning rather than the messy reality of how family and commercial life is lived. (We refer the Select Committee to draft *PUB00345: Income Tax – distributions from foreign trusts,* for examples.)

Some of the amendments proposed have a potentially wide affect. They require closer and further consideration.

Issue: Alignment with IS 18/01

Some of the measures are described as "aligning the legislation with *IS 18/01*" as justification for the amendment.

Submission

This should not be accepted as justification for any proposed amendment.

Comment

IS 18/01 should be aligned with the legislation as it is now. The proposal has the reverse effect. The proposal changes the law without the detailed scrutiny that should be provided.

Issue: Clause 87 – trust residency

A tax residency rule for the deemed single notion person is to be included in section HC 2 with effect from Royal Assent. (Despite the trust not actually being a person, it is deemed to be so that the residency status of the deemed person arises.)

Submission

Our submission are:

- The relevant provision should be reconsidered for whether it applies the correct test of residency;
- It should be included in Part YD rather than in Part HC;
- The commencement date should be deferred; and
- The consequential impacts should be considered.

Comment

The proposed change relies on the Commissioner's view of the law as stated in *IS 16/03* (tax residence) and *IS 18/03*.

Correct test

As well as residency of the trustees, the location of central management and control of a trust is used by other countries as an indicator of the tax residency of a trust. At a minimum, this test should be included.

Location of the rule

As is clear from *IS 18/03* and also the table at page 71 of *IS 16/03*, the residence of the trust and trustees has limited impact on the taxation of the income derived by the trust. The key drivers are the source of the income, the residency of the settlor and the residency of the beneficiary. The residency of the trustee only impacts whether, for a foreign settled trust, foreign income is treated as exempt income or not within the scope of the trust rules.

As the IS also states, residency would affect the application of withholding taxes (such as RWT and NRWT). This means that the residency of the trust is important for payers of income which are subject to those rules.

The residency test for the trust "single notional person" should be located with the other residency tests so that it is more readily found by such payers.

Deferral of effective date

Although *IS 16/03* states the Commissioner's view of residency of a trust, it has been more common to state that the residency of a trust is undefined for New Zealand income tax purposes. (This has necessitated the agreed trust residency tests for FATCA and Common Reporting Standard purposes, for example.) It is therefore unclear to what extent a definition of trust tax residency will alter existing practice and positions.

Trustees and payers of withholding income should be given time to implement the rule rather than having it apply from the date of Royal Assent.

Consequential impacts

We have not had time to consider the consequential impacts of a deemed tax residency for trusts. For example, whether it is clear that the appropriate outcomes apply if the trust is treated as non-resident, but the beneficiaries are resident, and vice versa. Although in practice,

positions are taken that NRWT or RWT can be used as credits or that the beneficiary's tax position is what should apply (so that shortfalls are made up or refunds claimed), the proposed amendment may place this in doubt.

Issue: Clause 88 – corpus

The definition of corpus is to be amended to confirm property must be capable of distribution and to specify the value of corpus.

Submission

That the definition of corpus be reconsidered.

Comment

Arguably, clause 88(1) is not required. *IS 18/03* already states that property must be capable of distribution for it to be corpus.

However, the Bill raises the question of whether this is the correct policy outcome. Limiting corpus to distributable property potentially means that distributions are double taxed or are taxed inappropriately. (This is because the definition of corpus would be narrower than the definition of settlement, which simply requires a transfer of value).

The lack of a full generic tax policy process for this proposal has not allowed time for this to be considered.

Issue: Clause 90 – election to be a complying trust and clause 97 - satisfying trustee liability

A clear effective date for an election to be made to be a complying trust and clarifications of the status of a trust are proposed.

Submission

Retrospective elections should be allowed.

Comment

In our general submission, we note that the reality of family and commercial arrangements is that the tax status of a trust, its trustees and beneficiaries may be fluid. Examples of this are in *IS 18/03* and in draft *PUB00345*. The tax effects will change accordingly. Importantly, this often occurs accidentally, not deliberately, and it is unusual for these effects to be found in sufficient time for elections to be made.

We understand there may be concerns that allowing retrospective elections may support tax planning. However, we do not see it that way. Retrospective elections would allow appropriate treatment of trusts and beneficiaries by bringing the trust into the New Zealand tax net. (We note that we have assumed that an appropriate interest regime would apply so that any incentive to defer an election would be addressed.)

Consequential changes to clause 97 would be required.

Issue: Clause 91 – source of capital gain

The existing source of income rule is modified to apply to capital gains so that the source of a capital gain can be determined.

Submission

The efficacy of the rule should be confirmed and consideration given to whether an equivalent rule is required for capital losses

Comment

The clause requires section YD 4 to be read *"as if the capital gain were an amount of income"*. This provides no guidance on which subsection in YD 4 is relevant. For example, a capital gain made on a bond is not an amount of interest but presumably, it is the interest source rules which should be the appropriate provision applied to determine the source of the capital gain.

The trust distribution rules also require capital losses to be taken into account. We have not confirmed that defining the source of a capital gain but not capital losses will produce appropriate outcomes. This should be tested and further amendments proposed.

Issue: Clause 93(1) – foreign sourced income of a resident trustee

Beneficiary income will be excluded from section HC 26(1).

Submission

The treatment of the beneficiary income should be confirmed in a Tax Information Bulletin item.

Comment

The broad policy is that a non-resident beneficiary is not taxed on foreign sourced income. The amendment may raise the question of whether it affects that policy. In our view, it does not but it would be useful to have this confirmed.

Issue: Clause 94 – settlement by acts of associates

The current direct or indirect settlement rule is being rewritten.

Submission

The proposal does not clearly meet the objective and it may expand the definition of settlor significantly and inappropriately.

Comment

The current settlement rules deem a settlor to be someone who transfer value to a trust directly or indirectly. Indirectly is understood to include actions caused by the person.

The Bill, by replacing subsection (4), potentially broadens the definition of settlor to include any action of a person.

For example, if a person's sister settles her own family trust, the person appears to be deemed a settlor of her sister's family trust.

This position may be clarified by making proposed subsection (4), subsection (4A) and referring to existing subsection (4) and being modified appropriately.

Issue: Clause 96 – value of deferral and non-exercise

The value of deferrals and the non-exercise of powers will be determined by reference to the prescribed interest rate.

Submission

The relevant rate should be reconsidered.

Comment

The prescribed interest rate may not be relevant for, for example, loans in foreign currency.

Issue: Trust Act 2019 – issue not in the Bill

The Trusts Act 2019 amends the definition of "trust" and "trustee" in the Income Tax Act.

Submission

The effect of this amendment should be considered for whether amendments are required.

Comment

The definition of "trust" in the Income Tax Act is specified only for unit trusts and superannuation schemes. "Trustee" has an extended meaning.

The Trusts Act 2019 amended the definition of "trust" and specifies the definition of trustee for that definition without it being clear whether the existing definition of trustee is replaced.

The policy intent of the amendment is not clear. For example, it includes in the definition of trust, apparently for the definitions of unit trust and superannuation scheme, actions and facts which would not generally be thought to apply to unit trusts and superannuation schemes.

This raises the question of whether the amendment is intended to be a general definition of a trust.

The Trusts Act amendment should be reconsidered.