NEW ZEALAND
LAW SOCIETY

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Taxation (Annual Rates for 2019-20, GST Offshore Supplier Registration, and Remedial Matters) Bill

28/02/2019

Submission on the Taxation (Annual Rates for 2019-20, GST Offshore Supplier Registration, and Remedial Matters) Bill

1 Introduction

1.1 The New Zealand Law Society welcomes the opportunity to comment on the Taxation (Annual Rates for 2019-20, GST Offshore Supplier Registration, and Remedial Matters) Bill 2019 (Bill).

1.2 All statutory references in this submission are to the Income Tax Act 2007 (Income Tax Act), the Goods and Services Tax Act 1985 (GST Act) or the Tax Administration Act 1994 (TAA).

1.3 The submission provides drafting comments relating to ring-fencing rental losses (clause 49), and then more general comments about trust beneficiaries as settlors (clause 56).

1.4 The Law Society does not seek to be heard but is happy to discuss its submission with the Committee or officials if that would be of assistance.

2 Ring-fencing rental losses (Commentary, page 5)

Portfolio and/or "property by property" approach? (clause 49)

2.1 Some of the provisions in clause 49 suggest that a taxpayer may take a portfolio approach to some residential rental property owned but a "property by property" approach to other residential rental property owned at the same time. For example, section DB 18AC (concerning a portfolio of "*residential rental property*") excludes from the subsection (12) the meaning of "*residential rental property*", any particular piece of residential rental property for which the person has elected to be governed by section DB 18AG. Further, section DB 18AH provides that ring-fenced disposal deductions, relating to a piece of residential rental property disposed of during an income year (in a non-taxable disposition), for which the person elected to take a non-portfolio approach, may be allocated in a later income year to other property if in the later year the person owns portfolio property and/or another piece of non-portfolio property, "and/or" being the meaning of a colon, rather than the disjunctive meaning conveyed by a semi-colon (as explained in Tax Information Bulletin 17.1, February 2005).

2.2 On the other hand, section DB 18AD(1), with its requirement that the person owns no land that was residential rental property in the divestment year, seems inconsistent with the notion of a taxpayer being able to take a portfolio approach to some property and a property by property approach to other property owned.

2.3 The legislation should make it clear that a ring-fenced deductions approach to one or more pieces of property does not preclude a portfolio approach to other pieces of property for which a non-portfolio election is not made. If, however, it is only either a portfolio or a property by property approach that is to be permitted, then this should be expressly stated in the legislation.

DB 18AC

2.4 The intention of section DB 18AC(5) is to remove the ring-fencing of deductions relating to residential rental property to which the portfolio approach applies, if all the property has been disposed of and assessable income was derived from each disposal. The reference to "*an income year*" in the opening lines of subsection (5) and the reference to "*the income year*" in subparagraphs (a) and (b) are presumably all to the same income year. If so, it seems to follow that any excess deductions are allowed to be offset against other income in the income year in which the person ceases to own the last property in the portfolio. However, section DB 18AC(5)(c), which is difficult to interpret, appears to require the last disposal to occur before the start of the income year in which the deduction is released, if the last disposal occurs after the 2019-20 income year. If that is the intended meaning of section DB 18AC(5)(c), the Law Society submits that a preferable approach would be that the deduction is released in the income year of the final taxable disposal.

2.5 It is also submitted that the drafting of subsections (5)(a), (b) and (c) could be simplified as follows:

(a) at the start of the income year, the person owns land that is or was residential rental property at some time during their ownership (**RRP land**):

(b) at the end of the income year, the person does not own RRP land; and

(c) the person derived assessable income from each disposal they made of such RRP land on or after 1 April 2019.

2.6 The Law Society suggests the defined term "RRP land" to reduce repetition.

2.7 Section DB 18AC(5)(d) contains a further precondition for the release of ring-fenced deductions relating to portfolio property, namely that the person has not treated any excess deductions as deductions that relate to RRP land under sections DB 18AD or DB 18AH. It is unclear how sections DB 18AD or DB 18AH could apply, since section DB 18AC(5) applies only to taxable disposals, whereas sections DB 18AD and DB 18AH apply to excess deductions where there have been one or more non-taxable disposals of land in the portfolio. Accordingly, the Law Society recommends that section DB 18AC(5)(d) is deleted, or redrafted so that the purpose of the provision is clearer (if there is a reason to retain it).

DB 18AD

2.8 The drafting of section DB 18AD(1) could also be simplified in a similar way to that suggested above in relation to section DB 18AC(5).

2.9 Above we have submitted that a taxpayer should be able to take a portfolio approach to some property and a property by property approach to other property owned. On this approach, a further amendment to draft section DB 18AD would be required, so that section DB 18AD applies regardless of whether the taxpayer owns any other residential rental property which was <u>not</u> included in the portfolio (i.e. for which the taxpayer has made an election under section DB 18AG to ring-fence deductions to that property while it is owned).

DB *18AJ*

2.10 It is submitted that, in section DB 18AJ(4), the applicable point in time needs to be specified for determining the "*applied capital percentage*". Presumably the intention is that this is determined at the end of each income year.

Further drafting comments on clause 49

"allocated"

2.11 Section DB 18AC(2) limits the amount of residential rental deductions "*allocated*" to an income year to no more than the sum of residential rental property income and any net income from the disposal of applicable property in that income year. Deductions are also allocated under subsection (5), in certain circumstances. However, subsection (4) also uses the word "*allocated*" and provides that excess deductions are "*allocated to the next income year*". It is submitted that subsection (4) should only provide that excess deductions are carried forward to the next income year, as their allocation to any year will be determined by subsection (2) or (5) or (8). Accordingly, it is submitted that subsection (4) should be shortened by deleting sub-paragraphs (a) and (b) and ending the subsection with "… *any excess deductions not allocated to the income year because of subsection (2) are carried forward to the next income year*." The same change should be made to section DB 18AD(4). A similar change should be made to sections DB 18AG(5) and DB 18AH(4), but with the subsections ending "*carried forward to the later income year*".

2.12 Relatedly, sections DB 18AC(2), (5), (7) and (8) and sections DB 18AG(4), (6), (8)(b) and (9) should be amended by deleting "*and allocated*" (from the phrase "*carried forward and allocated*").

2.13 Subsections DB 18AC(11), DB 18AD(5) , DB 18AG(12) and DB 18AH(5) should all be amended by changing "*not allocated*" (in the first line) to "*not carried forward*".

2.14 The reference in the headings of DB 18AC(11), DB 18AD(5), DB 18AG(12) and DB 18AH(5) to "*reinstating excess allocations*" should be changed to "*allocating excess deductions*". It also seems unnecessary for these subsections to contain the phrase "*allowed or allocated*", as "*allocated*" is sufficient and "*allowed … to any income year*" is not well-phrased.

"*Excess deductions*"

2.15 The term "excess deductions" is not defined in sections DB 18AC(3), (4), (5) or (8) or DB 18AD. The concept of "*excess deductions*" could be introduced and defined in subsection (4) as follows: "… *any ~~excess~~ deductions not allocated to the income year because of subsection (2)* ***(excess deductions)*** *are carried forward*…". The order of subsections (3) and (4) could then be switched, so that the "*excess deductions*" is defined in what would become subsection (3) before the term is used in defining "*net disposal income*" in what would become subsection (4).

2.16 In sections DB 18AC(11) and DB 18AD(5), the references to "*excess*" should be changed to "*excess deductions*".

2.17 The term "*excess deductions*" is also used, without being defined, in section DB 18AG. Section DB 18AG(5) could be amended to read "*If the person does not dispose of the piece of property during the income year, any ~~excess~~ deductions not allocated to the income year because of subsection (4)* ***(excess deductions)*** *are carried forward* …". Section DB 18AG(6) could then be rephrased by replacing "*an amount that*" in the second line with "*any excess deductions*".

2.18 In section DB 18AG(12), the references to "*excess*" should be changed to "*excess deductions*".

2.19 In section DB 18AH(1)(c), the phrase "*ring-fenced disposal deductions*" is used instead of "*excess deductions*". For consistency, the phrase "*ring-fenced disposal deductions*" should replace "*excess deductions*" in section DB 18AH(4) and should replace "*excess*" in subsection (5).

"*Residential rental property*"

2.20 Draft sections DB 18AC and DB 18AD concern "*residential rental property"* to which a portfolio approach applies. Consequently, the meaning of "*residential rental property"* in these sections excludes residential rental property for which a non-portfolio approach is elected, but this is not made clear within sections DB 18AC and DB 18AD (except for the heading) until subsection (12). The application of these sections only to portfolio property would be clearer if subsection (1) of both sections DB 18AC and DB 18AD expressly provided that they relate to "*<u>a portfolio of</u> residential rental property <u>(as defined in subsection (12) and section YA 1)</u>*". Subsection (12) could then be extended by providing that "… *and a* ***portfolio of residential rental property*** *is all such residential rental property owned by the person at any time*".

2.21 In section DB 18AC(4), the natural meaning of the words "*<u>at some time when they owned the land</u>"* is that the person no longer owns the land. However, subsection (4) is clearly intended to apply when the land is still owned, although it is no longer residential rental property. The subsection would be clearer if it was rephrased as "*the person owns residential rental property or land that was<u>, in a previous income year, residential rental property of the person</u>*".

"*Residential rental property income*"

2.22 Section DB 18AC defines "*residential rental property income*" identically in subsections (3) and (10). It is also defined in section DB 18AG(11), albeit with reference to a piece of property, while the general outline of the definition (ie "*income under sections CC 1 to CC 2 (which relate to income from land use)*" is used in sections DB 18AG(4), DB 18AJ(6)(b)(i) and DB 18AK(2)(a) and (5)(a). The draft ring-fencing provisions are lengthy (at more than 13 pages) and could be shortened by inserting a definition of "*residential rental property income*" into section YA 1 that could apply to all these provisions.

2.23 "*Residential rental property income*" could be defined as "*income under sections CC 1 to CC 2 (which relate to income from land use)*", being the phrase used in the ring-fencing provisions, although the words "*(which relate to income from land use)*" are unnecessary and could also be deleted.

2.24 Then, rather than defining "*residential rental property income*" in both section DB 18AC(3) and (10), it could be defined once in subsection (12) as "*residential property income as defined in section YA 1, in relation to residential rental property (as defined in this subsection) that is owned by the person*".

2.25 In section DB 18AG(11) "*residential rental property income*" could then be defined as "*residential property income as defined in section YA 1, that the person derives for the income year, that relates to the piece of property they disposed of*".

2.26 Relatedly, in section DB 18AG(4), the phrase "*income under sections CC 1 to CC 2 (which relate to income from land use)*" could be replaced with "*residential rental property income*". Subsection (11) could then be amended to begin: "*In the formula in subsection (10) <u>and in subsection (4)</u>*".

2.27 With the introduction of a section YA 1 definition of "*residential rental property income*", section DB 18AJ(6)(b)(i) could be redrafted as "*residential rental property income that relates to residential rental property owned by the residential land-rich entity*". Consequential amendments could also be made to sections DB 18AK(2)(a) and (5)(a).

3 Trust beneficiaries as settlors (Commentary, page 10)

3.1 Clause 56 proposes an amendment to the definition of settlor in section HC 27 of the Income Tax Act to provide that a beneficiary does not become a settlor of a trust solely as a result of being owed an amount by a trustee of the trust, provided that either the amount owing at the end of the income year does not exceed $25,000 or the trustee pays interest to the beneficiary on the amount owing at a rate not less than the prescribed rate of interest for FBT purposes. The Bill proposes that the amendment to the definition of settlor will come into effect on the date of the Royal assent.

3.2 Correctly identifying the settlors of a trust underpins a number of income tax and tax administration provisions, including determining whether the trustees are liable to New Zealand income tax on their worldwide income, determining the income tax treatment of distributions made by the trustees, determining who is liable to meet the trustees' income tax liability, determining whether the trustees are required to register the trust as a New Zealand foreign trust under section 59B of the TAA, calculating "family scheme income" for determining entitlements for Working for Families, and calculating "adjusted net income" for student loan purposes. In some instances, correctly identifying the settlors of a trust in a particular income year is critical (e.g. in calculating entitlements for Working for Families), but in other instances it is critical to identify who have been the settlors of a trust since the trust was first settled (e.g. in determining whether the trust is a foreign trust). For the above reasons, it is essential that the definition of settlor is clear and unequivocal, and that any uncertainties or overreach in that definition are resolved with retrospective effect.

3.3 Clause 56 deals with the uncertainty that has arisen in respect of whether a beneficiary of a trust will be treated as a settlor of a trust solely because that beneficiary is owed an amount by a trustee of the trust, and the trustee has not paid a market rate of interest on that amount. This situation commonly arises where the trustees of a trust vest an amount in a beneficiary of the trust absolutely in interest, or pay an amount to a beneficiary of the trust, and the amount is not transferred into the beneficiary's possession, and no interest is paid to the beneficiary on the amount.

3.4 Section HC 27 of the Income Tax Act sets out who is a settlor of a trust for income tax purposes, and provides that a settlor is a person who, at any time, transfers value to, for the benefit, or on the terms of the trust, or who provides financial assistance to the trust or for the benefit of the trust with an obligation to pay on demand, and the demand to pay is not exercised or is deferred. In draft public ruling PUB0209[a], which was issued in December 2014, Inland Revenue concluded that a beneficiary of a trust would not be treated as a settlor of the trust just because they had a credit balance in their beneficiary current account and no interest was paid on that credit balance (or interest was paid at a rate less than the market rate). The commentary to the draft ruling includes comprehensive analysis which explains why a beneficiary would not be treated as a settlor in this situation. In essence, this is because the beneficiary does not cause the settlement to be made, as it is the trustee, not the beneficiary, who decides to make the distribution and whether the distribution is actually paid out or credited to account. Further, the beneficiary does not have legal ownership of the money, and so cannot provide money to the trust or provide financial assistance. PUB0209[a] was never finalised, but was widely recognised as reflecting Inland Revenue's considered view on this issue.

3.5 Contrary to Inland Revenue's considered view in PUB0209[a], the Commentary to the Bill at p10 states that a beneficiary of a trust would be treated as a settlor of the trust if that beneficiary has a credit balance in their beneficiary current account and no interest is paid on that credit balance. The Commentary explains this is because “leaving money in the trust interest-free” constitutes a “transfer of value” by the beneficiary to the trust and, therefore, meets the definition of settlor in section HC 27 of the Income Tax Act. This conclusion is contrary to the detailed and considered analysis in PUB0209[a] and is also arguably contrary to the analysis set out in IS 18/01, *Taxation of Trusts - Income Tax* (28 June 2018).

3.6 While the proposed amendment in clause 56 resolves this uncertainty (at least where the balance of the beneficiary’s current account does not exceed $25,000 at the end of the income year), it does so only from the date the Bill is enacted. As such, it is still not clear whether a beneficiary with a credit current account balance would be treated as a settlor of the trust prior to the date of enactment. This could lead to absurd and presumably unintended outcomes, particularly under the settlor taxation regime. Take, for example, the relatively common situation where a beneficiary of a foreign trust (who is not a trustee of the trust and is not otherwise involved in the administration of the trust) migrates to New Zealand and receives a relatively small distribution from the trust which (without their knowledge) is credited to their beneficiary current account. Based on the Commentary (but not PUB0209[a]), the beneficiary will be treated as a settlor of the trust, with the result that the trust ceases to be a foreign trust for income tax purposes, the trust becomes liable to New Zealand income tax on its worldwide income (for each income year that the beneficiary remains New Zealand tax resident), and the beneficiary may be liable, as agent of the trustees, to meet the trustees’ New Zealand income tax liability under the settlor liability provisions in section HC 29 of the Income Tax Act. The Law Society does not consider this is an intended policy outcome, a point also acknowledged in the Explanatory Note to the Bill.[1]

3.7 The uncertainty concerning whether a beneficiary could be treated as a settlor of a trust solely because the beneficiary has a credit current account balance and no interest (or less than a market rate of interest) has been paid on that current account balance needs to be resolved with retrospective effect, so that situations such as that described in paragraph 3.6 above do not arise. This could be achieved by either making the proposed change to section HC 27 retrospective (but with a savings position for contrary tax positions taken prior to the date the Bill is enacted), or by allowing taxpayers to “pick and choose” whether a beneficiary of a trust with a credit current account balance is to be treated as a settlor of a trust solely by reason of that fact prior to the date the Bill is enacted (but with a transitional provision that prevents taxpayers who have taken a tax position prior to the date the Bill is enacted from changing that position). The Law Society notes there is a precedent for such a “pick and choose” approach in terms of the GST treatment of bodies corporate prior to the 2015 amendments.

3.8 Finally, limiting the proposed change in clause 56 to beneficiaries who are owed no more than $25,000 at the end of the income year is arbitrary and could be ineffective (as trustees could manipulate beneficiary current account balances at the end of each income year to fall below the $25,000 threshold). There does not appear to be a clear rationale for why a beneficiary who is owed, say, $24,000 at the end of an income year would not be treated as a settlor of the trust under the proposed amendment to section HC 27 but a beneficiary who is owed, say, $26,000 at the end of the income year would be (unless interest is charged on the credit current account balance at a rate not less than the prescribed rate of interest).

1 Taxation (Annual Rates for 2019–20, GST Offshore Supplier Registration, and Remedial Matters) Bill, Explanatory note, p 10.

The Law Society notes that the analysis set out in PUB0209[a] applies irrespective of the amount of the beneficiary's current account balance.

3.9 The Law Society therefore recommends that clause 56 is amended so that:

a. A beneficiary does not become a settlor of a trust solely because a trustee of the trust owes an amount to the beneficiary, irrespective of that amount;

b. A transitional position applies so that a beneficiary can choose whether or not they are treated as a settlor of the trust where a trustee of the trust owes an amount to the beneficiary before the date the Bill is enacted, but taxpayers who have taken a tax position which turns on whether such a beneficiary is a settlor of the trust prior to the date the Bill is enacted are prevented from changing that tax position.

Andrew Logan
President

28 February 2019