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WEEKLY COMMENT: FRIDAY 4 JANUARY 2013

1. The *Taxation (Annual Rates, Returns Filing, and Remedial Matters) Act 2012* ("the Annual Rates Tax Act") has been enacted with a date of assent of 2 November 2012. The key income tax amendments are:

   (a) New rules on the taxation of shares issued under a profit distribution plan;

   (b) Deductions for expenditure on unsuccessful software development;

   (c) Significant changes to the calculation of Net Attributable CFC Income and FIF income using Attributed FIF Income method, as well as the introduction of an election not to be a Non-attributing CFC or FIF;

   (d) A number of changes affecting LTCs and, to a lesser extent, limited partnerships;

   (e) A number of further tax relief measures relating to the Canterbury earthquakes;

   (f) Making the income of non-resident film renters subject to the tax rules on royalties;

   (g) The inclusion of an employee's future expenditure in the definition of "expenditure on account of an employee"; and

   (h) Tightening up the tax treatment of debt remission within a tax consolidated group.

2. I have already discussed some of these income tax changes in earlier *Weekly Comments*. I have discussed some other changes in separate sections of this website. This week I look at the changes that I have not previously discussed. Note that:

   - The CFC and FIF changes were discussed in *Weekly Comments: 24 and 31 August 2012*.
   - The amendments affecting LTCs and limited partnerships are covered in paragraphs 115 to 128 of the *Close Companies and Partnerships* section of this website.
   - The tax relief measures relating to the Canterbury earthquakes were discussed in *Weekly Comments: 19 and 26 November 2012*.
   - The amendments relating to the income of non-resident film renters are covered in paragraphs 53 to 60 of the *Non-residents* section of this website.

Taxation Of Shares Issued Under A Profit Distribution Plan

3. Under a profit distribution plan (PDP) a company issues bonus shares to all shareholders and offers to repurchase the shares immediately after the shareholder receives them. If the shareholder does not elect for the repurchase, the shareholder retains the bonus shares.

4. The previous tax treatment of PDP's was covered in Inland Revenue *Product Ruling BR PRD 05/09.* That ruling held that a distribution of shares under a PDP is a non-taxable bonus issue.

If the shares were repurchased, the cash amount received was treated as a taxable dividend and imputation credits could be attached.

5. In April 2009 the Government announced its intention to amend the law so that bonus issues under PDPs are taxed in the same way as shares issued under other dividend reinvestment plans. The new tax rules are contained in the Annual Rates Tax Act and apply from 1 October 2012. The full details of the new rules are contained in the attached PDF attachment *Profit Distribution Plans*.

(a) Definition of a PDP

6. There is a new definition of a PDP in section YA 1. Note that the Finance and Expenditure Committee changed the original definition by removing the requirement for a company to notify all of its shareholders. A PDP will mean a scheme comprising one or more steps undertaken by company by which it:

   (a) *Notifies some or all of its shareholders* that shares are to be issued on a particular date; and

   (b) Gives *the notified shareholders* an option to have some or all of the shares issued to them repurchased by the company.

(b) A share issued under a PDP will be a dividend

7. A share issued by company under a PDP will be a dividend. The amount of the dividend will be the money offered by the company for the repurchase of the share. [s. CD 7B(1) & (2)]

8. If a shareholder exercises the option to have a share that was issued under a PDP repurchased by the issuing company, any amount paid by the company to repurchase the share will not be a dividend. [s. CD 23B]

9. If the share is repurchased, s. CD 22, which contains the rules to determine the extent to which a payment by a company to a shareholder is a return of capital and not a dividend (the off-market share cancellation dividend rules), will not apply. [s. CD 7B(3)]

(c) Available Subscribed Capital (ASC) implications

10. The amount offered by the company for the repurchase will be a "subscription" for the purposes of determining ASC. Any amount paid on the repurchase of a share issued under a PDP will be a "return" for ASC purposes. [s. CD 43(6)(ab)]

(d) Tax accounting implications

11. The tax accounting entries will be as follows:

Upon issue of the share under a PDP:

Retained earnings	Dr	$XXX	
Available subscribed capital	Cr		$XXX

Upon repurchase of a share issued under a PDP:

Available subscribed capital	Dr	$XXX	
Bank	Cr		$XXX

(e) Bonus issue in lieu tax rules will apply

12. The definition of a "bonus issue" has changed so as to include the issue of shares under a PDP. The definition of a "taxable bonus issue" has also changed so as to include shares issued under PDP. [Amendments to section YA 1 definitions]

13. The same rules for the calculation of tax as those that apply to a bonus issue in lieu apply to shares issued under a PDP. This is:

    33% x (amount offered for repurchase + credit attached or tax paid)

    Credit attached or tax paid is: ICs or FDP credits attached or, if the share repurchase is offered by a foreign company, the foreign withholding tax paid. [Amendments to s. RE 14 and RE 15]

14. There is a corresponding amendment to the quantification of the dividend derived upon a bonus issue: the amount of the dividend arising on a bonus issue will include any resident withholding tax (RWT) payable on the dividend. [Amendment to section CD 7(2)]

(f) Treatment when non-residents are issued shares under a PDP

15. Shares issued under PDP to a non-resident will be treated as non-cash dividends subject to non-resident withholding tax (NRWT) and the rules that apply to the calculation of tax payable on a non-cash dividend to non-residents will apply. To the extent the dividend is not fully imputed or FDP credited, the pre-treaty rate of NRWT is 30%. To the extent the dividend is fully imputed or FDP credited, the NRWT rate is 15%. [Amendments to section RF 10(5)]

Deduction For Expenditure On Unsuccessful Software Development

16. An amendment contained in the Annual Rates Tax Act allows for an immediate deduction of expenses incurred on unsuccessful software development projects, in the year that the development of the software is abandoned. The deduction is set out in a new section DB 40B.

17. In order for a person to qualify for the deduction all the following requirements must be met:
    (a) The person must incur expenditure in the development of software for use in the person's business.
    (b) The development of the software must be abandoned when the software is not depreciable property of the person.
    (c) The software must have been depreciable property of the person if the development had been completed.

18. Note especially that the Finance and Expenditure Committee sought to make it clear that deduction is for expenditure on *software that would need further development to become depreciable property*. The deduction overrides the capital limitation and applies from the 2006–07 income year onwards (effected through the insertion of s. DB 31B into the Income Tax Act 2004).

Expenditure On Account Of An Employee To Include Future Expenditure

19. The meaning of "expenditure on account of an employee" in s. CE 5(1) has been amended. Expenditure on account of an employee means a payment made by an employer relating to expenditure incurred by an employee *or to be incurred by an employee*. A payment of expenditure on account of an employee is included in their salary and wages. The amendment

means that expenditure on account of an employee's future expenditure will be included in an employee's taxable income. The amendment applies for the 2008-09 and later income years. [Amendment to s. CE 5(1) by s. 11 of the Annual Rates Tax Act]

20. Under s. CW 17(1), expenditure on account of an employee incurred by an employer in connection with the employee's employment or service is exempt income of the employee to the extent to which, if the employee had incurred the expenditure, the employee would be allowed a deduction for the expenditure if the employment limitation did not exist. Section CW 17(1) has been amended so that the reference to "expenditure on account of an employee" is now a reference to "expenditure on account of an employee, being a payment to which section CE 5(1) applies". This means that the exemption in s. CW 17(1) also applies to expenditure on account of an employee relating to expenditure to be incurred by an employee.

Tightening Up Debt Remission Within A Consolidated Group

21. Remission of a financial arrangement within a consolidated group now results in income unless the parties were *within the consolidated group* for the whole term of the arrangement.

22. Under the previous rules in section FM 8, income from the remission of a financial arrangement within a consolidated group is excluded income if the parties were *a group of companies* for the whole term of the arrangement. Under the amended s. FM 8 the parties will have to have been *consolidated group companies* for the whole term of the arrangement.

23. The amendment applies from the 2008-09 income year except for a tax position that is inconsistent with the change and is taken in a tax return filed before 14 September 2011.

[Amendment to s. FM 8(3)(b)(ii) in s. 72 of the Annual Rates Tax Act]

Arun David, Director

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