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WEEKLY COMMENT: FRIDAY 31 MAY 2013

1. The *Taxation (Annual Rates, Foreign Superannuation, and Remedial Matters) Bill* ("the Bill") was introduced on 20 May 2013. Apart from the foreign superannuation and mining tax changes, which are the main focus of the Bill, there are some other changes that I believe are worth commenting on this week. I will comment on the foreign superannuation changes next week.

2. The changes in the Bill discussed this week are as follows:

   (a) Minimum special purpose reporting requirements: Following on from my *Weekly Comments* in recent weeks regarding the Financial Reporting Bill, I thought I would first mention that the Bill authorises the use of Orders in Council to determine minimum special purpose reporting requirements that will apply to companies and other specified classes of taxpayers.

   (b) Imputation credits on FIF income: A proposed amendment addresses a mismatch arising under the tax rules when imputation credits are calculated on the basis of the dividend paid but income tax arises only on the foreign investment fund (FIF) income (which could be lower than the amount of the dividend).

   (c) Bad debt deductions: The bill proposes 2 changes to the tax rules regarding bad debt deductions for holders of debt:

      (i) Bad debt deductions permitted: Bad debt deductions will be where the debt has been remitted by law (for instance, following liquidation or bankruptcy of the debtor), or where a debtor company entered into a composition with its creditors; and

      (ii) Bad debt deductions limited: Bad debt deductions of holders or dealers in financial arrangements will be limited to the purchase price paid for a debt that was purchased.

   (d) Notional interest under IFRS: A change is proposed to clarify that taxpayers with interest-free and low-interest loans should not be able to claim tax deductions on notional interest amounts that can arise under IFRS financial accounting.

Financial reporting requirements for tax purposes

3. Effective from the income year after the year in which the Financial Reporting Act 1993 is repealed (expected to be the tax year commencing 1 April 2014 or equivalent), clause 110 of the Bill proposes inserting new sections 21B and 21C into the *Tax Administration Act 1994*, which will require:

(a) Companies to prepare financial statements in accordance with applicable minimum requirements prescribed in an Order in Council made under section 21C; and

(b) Other classes of taxpayers who are specified in an Order in Council under section 21C to prepare financial statements in accordance with applicable minimum requirements prescribed in an Order in Council made under section 21C; and

(c) Companies or other taxpayers who are required by other enactments to use other applicable minimum requirements for preparing financial statements, to prepare financial statements in accordance with those other minimum requirements.

4. The retention of records rules in section 22 will apply to financial statements prepared under the new minimum requirements, and section 17(2), which requires companies to produce a form of financial statements is being repealed.

5. New section 21C(2) requires the Minister of Revenue to consult with "professional accounting bodies that the Minister decides it is reasonable to consult" before recommending the making or amending an Order in Council under section 21C.

6. It is stated on page 49 of the *Commentary* on the Bill that:

   "While nothing has been finalised, the intention is that the financial statements will be simple and based on double entry and accrual concepts, using where possible tax-related figures. Certain notes are likely to be required, including a statement of accounting policies, disclosure of related-party transactions and where necessary, a book-to-tax reconciliation. All of this detail will be subject to full consultation later this year."

Imputation credits and Australian dividends

7. Amendments, which will come into force on 1 April 2014, are proposed to limit the imputation credit received by a shareholder under the trans-Tasman imputation rules to the imputation credit that could be attached if the dividend paid was equal to the FIF income that arises. In the *Commentary* on the Bill, the background to the amendment is stated on pages 42 to 43 as follows:

   "The trans-Tasman imputation rules permit an Australian company to operate an imputation credit account (ICA). An Australian ICA company that has paid New Zealand tax can attach imputation credits to dividends paid to New Zealand shareholders. Wholly owned Australian and New Zealand companies can also form a trans-Tasman imputation group. New Zealand tax paid by a member of the group will generate imputation credits that can be distributed to a New Zealand shareholder. *The amount of imputation credits that a particular shareholder receives is determined with reference to the actual dividend paid by the company*. In the domestic context, this works as intended. (emphasis added)

   However, an issue arises when a New Zealand-resident shareholder receives a dividend with imputation credits attached that is paid from *a closely held Australian company. The New Zealand resident's investment in that company will generally be an attributing interest under the FIF rules*. Under the FIF rules, a New Zealand resident is taxed only on the deemed FIF income; the actual dividend is disregarded. (emphasis added)

   A mismatch therefore arises, with imputation credits being calculated on the actual dividend paid but income tax arising only on the FIF income. If the dividend is of greater value than the amount of FIF income, the shareholder will receive excess imputation credits, which they can use against the tax on their other income, such as salary and wage income. This is inconsistent with the policy intent. The amendment is intended to address this mismatch."

8. Section LE 1 deals with tax credits for imputation credits. Section LE 1(1) states that a person whose assessable income for an income year includes an imputation credit has a tax credit for the year equal to the imputation credit.

9. Section LE 1(4B) deals with FIF income, and provides that, for the purposes of section LE 1, an amount that would be income of a person from an attributing interest in a FIF, if the "no income other than FIF income" limitation in section EX 59 did not apply, is treated as if it were assessable income of the person.

10. The combination of sections LE 1(4B) and LE 1(1) mean that an imputation credit attached to a dividend under the trans-Tasman imputation rules, from an interest in an Australian company that is a FIF interest, is treated as a tax credit.

11. Clause 86 of the Bill proposes inserting a new section LE 8B, which will apply when a person has assessable income for the purposes of section LE 1, because section LE 1(4B) applies, and the LE 1(4B) income includes an imputation credit. The tax credit will be limited to the lesser of the actual credit, or an amount calculated as: *(imputation ratio x FIF income)*. The "imputation ratio" will be calculated treating the section LE 1(4B) income as a net dividend to which the imputation credits are attached.

12. In addition, clause 15 inserts new section CV 18 which is designed to ensure that the tax credit calculated under section LE 8B is included in the person's income.

Bad debt deductions for holders of debt

13. Under existing section DB 31(1)(a), a deduction for a bad debt is denied unless the debt is written off as bad in the income year. Clause 29 of the Bill contains a proposed amendment to this subsection, which will allow a person a deduction for a bad debt if either:

    (a) The debt is written off as bad in the income year; or

    (b) The debtor is released from making all remaining payments under the *Insolvency Act 2006* (excluding Part 5, subparts 1 and 2), or under the *Companies Act 1993*, or under the laws of a foreign country and the person is required, under section EW 29, to calculate a base price adjustment for the debt for the income year; or

    (c) The debtor is a company that is released from making all remaining payments by a deed or agreement of composition, and the person is required, under section EW 29, to calculate a base price adjustment for the debt for the income year.

14. This amendment will apply to a debt that goes bad on or after the date of assent of the Bill if a tax return has been already filed for the year in which the debt went bad. Otherwise, it will apply retrospectively to a debt that went bad in the 2008-09 income year or later.

15. The proposed amendment will mean that a creditor can take a deduction for a debt that is a bad debt, without having written the debt off, if a debtor goes into liquidation or bankruptcy, or when a debtor company has entered into a composition with them. The stated background to this amendment in the *Commentary* is that the requirement to write off a debt as bad can be unnecessarily onerous for example, for "mum and dad" investors in failed finance companies, who may not have up-to-date knowledge of the financial state of the debtor.

16. Note that a requirement for the deduction is that a base price adjustment must be performed.

17. Other proposed amendments relating to bad debt deductions for dealers in financial arrangements are to apply from the date of introduction of the Bill: 20 May 2013:

    (a) Clause 29 contains:

    (i) New section DB 31(4B), under which a dealer will be allowed a deduction, for a debt acquired for less than its face value, only to the extent of the consideration the dealer pays for acquiring the debt.

    (ii) New section DB 31(4C), under which a dealer will be allowed a deduction, for a debt that a *limited recourse arrangement* relates to, only to the extent to which the limited recourse arrangement does not relate to the debt.

    (b) Clause 26 contains new section CZ 27 which provides for a clawback of previous bad debt deductions to the level proposed under new sections DB 31(4B) and (4C), for a dealer who still holds, on the first day of the 2014-15 income year, a debt which arose before the introduction date of the Bill and for which a bad debt deduction has been taken in a tax return for an income year that started before the date of introduction of the Bill.

18. A *limited recourse arrangement* is defined for this purpose, in relation to a debt, as an arrangement:

    (a) That is for the person's business of dealing in or holding financial arrangements; and

    (b) That requires repayment or no repayment of an amount under the arrangement contingent upon payment or no payment, in whole or in part, of the debt.

19. This amendment is explained in the *Commentary* to the Bill on page 47 as follows:

    "Both original and subsequent holders of debt who carry on a business of dealing in or holding the same or similar financial arrangements will be limited to taking bad debt deductions up to the true economic loss. This means original holders will be able to take bad debt deductions up to the amount lent, and subsequent holders will be able to take bad debt deductions up to the purchase price.

    Deductions for amounts greater than the economic loss will be allowed if the amounts have previously been returned as income.

    As an anti-avoidance measure, a holder of debt who deals in or holds the same or similar financial arrangements will only be able to take bad debt deductions for the true money at risk. This means that if the purchase of a debt was funded by a limited recourse arrangement, a bad debt deduction will only be allowed to the extent to which the limited recourse arrangement does not relate to the debt."

Notional interest adjustments under IFRS will not have a tax effect

20. Effective from the 2013-14 income year onwards, further modifications to the IFRS rules, when the IFRS financial reporting method under section EW 15D is used, will prevent notional interest or adjustments to a loan's fair value from being recognised for tax purposes:

    (a) Under clause 38:

    (i) New section EW 15D(2)(ac) will mean that no interest can be recognised for tax purposes in relation to an interest-free loan; and

(ii) New section EW 15D(2)(ad) will mean that a reduction in the recognised value of a loan, due to a concessional interest rate, below the consideration actually provided, will not be recognised for tax purposes.

(b) Under clause 55, new section EZ 64 will mean that a change of spreading method adjustment under section EW 26(2) will apply to a loan for which notional interest was recognised in the 2012-13 income year, and for which notional interest is not allowed to be recognised from the 2013-14 income year under new section EW 15D(2)(ac). The change of spreading method adjustment must be undertaken in the 2014-15 income year.

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