SPEAKMAN LAW

September 2016

Issue 19

What's inside
- Debt Remission
- Inbound Investment
- Pre-Emptive Rights
- Zoning Changes – Taxation Effects
- Overseas Investment Office (**OIO**) – Associates
- Warranties: Material Adverse Change (**MAC**)

Briefly - sport
- ABs extend Bledisloe Cup hold to 15 years
- Black Caps under perform again versus South Africa
- Justin Rose becomes first man to win Olympic gold in golf
- Usain Bolt completes perfect sweep; 3 golds at each of the last 3 Olympics

Briefly – Law/Special Interest
- Gene Wilder (the original Willy Wonka) 1933 - 2016
- Deutschebank (American unit) has again failed US Federal Govt stress test; nominal value of its derivates risk stated as $72.8 trillion with market cap less than $20 billion. This exposure is higher than the World's GDP. Cause for alarm? Many commentators think so.
- New foreign trust disclosure rules now in Bill form.

Well, if the sun shines so bright, or our way is darkest night, the road we choose is always right…

Can anyone guess where this comes from?

I hope you enjoy the newsletter items that follow. As with earlier newsletters, each of these items have hit my desk in the last 2 or 3 months, perhaps that makes them topical? As always if any questions spring to mind, just give me a call or drop me an email.

Debt Remission…

An age old problem is the current asymmetric tax outcome when debt is remitted (forgiven) between related or associated parties. Current law results in the debtor being fully taxed on the amount forgiven whilst the creditor is denied a tax deduction. Legislative amendments are proposed to remove this treatment. These amendments will negate steps customarily taken to circumvent remission income, notably capitalisation of the debt.

Relief from remission income will, however, be within confined parameters. The debtor and creditor must be within the same economic group and the debt must be forgiven pari passu. What does that mean?

It means that the debtor must be a company or a partnership (including a look through company or limited partnership). The creditor must be a member of a "creditor group", ie a company in the same wholly owned group as the debtor or an owner or associate of an owner. Pari passu debt means debt that is held and forgiven in proportion to ownership, eg three shareholders each holding a third of the debt. Reduction (or elimination) of their debt in equal proportions is not seen as problematic because it results in no overall economic change.

Particular care must be taken with the proposed debt remission rules in relation to look through companies (LTCs). The proposed amendments introduce a new term, "self remission". These amendments will result in no income tax for a shareholder who forgives debt owed by a LTC to him or her (ie self-remission). It will however result in income tax for other shareholders, who indirectly benefit from the forgiveness of debt made by the first shareholder.

Regardless, the amendments and the relief they afford are most welcome.

Inbound Investment…

New Zealand's taxation framework for inbound investment has been extensively reviewed and helpfully summarised in a paper recently issued by Inland Revenue. It is an excellent summary and is set in the context of challenges facing all western governments at securing a fair and proper collection of tax from local operations. The Irish revenue authorities, for example, just this week concluded that Ireland was not securing for itself a fair tax collect on Apple's earnings, resulting in a $20 billion tax assessment against Apple. So, establishing an appropriate and robust taxation framework for inbound investment is critically important.

The Inland Revenue paper concludes that New Zealand's tax rules for inbound investment are appropriate and for the most part they are robust. The principal means of taxing foreign capital invested here is via company tax. While taxing foreign investment at all is observed to have negative effects on economic investment here, the alternative of not taxing it at all is less desirable. The trick is to strike an appropriate balance and that requires both our company tax rate and our tax settings to fit within international norms. Our tax rate and our tax rules in this area do that.

A robust tax system requires limitations on the ability to erode New Zealand profit by excessive deductions. Historically, excessive deductions have been witnessed in the form of above market interest costs or related party management fees. Transfer pricing, thin capitalisation and non-resident, withholding tax (NRWT) rules all play their part in negating them and in buttressing our tax system. All 3 components are essential; New Zealand's tax system is presently weak in the case of the latter.

Accordingly, proposals are afoot to bolster New Zealand's NRWT rules. Specifically the strengthening of the rules will be in the area of related party lending. Accessibility to the approved issuer levy rules will also be tightened, preventing use of them by associated persons who are associated with the borrower.

The key change in relation to NRWT is to avoid a mismatch in timing between the local borrower obtaining an interest deduction on the one hand, and incurring a NRWT liability on that interest on the other hand. Essentially, whenever a New Zealand borrower obtains a deduction for interest on a foreign related party loan, a corresponding NRWT liability is to be triggered. This will overcome this mismatch.

New anti-avoidance rules are also to be introduced to overcome back to back loans and other arrangements that have as their design evasion of NRWT. Moreover, accessibility to the AIL regime is to be limited to circumstances where 75% of the total borrowing is from non-associated persons who use financial institutions, widely held companies or other approved organisations. These changes are welcomed. Please contact me for more information.

Pre-emptive Rights…

These are common amongst private companies, particularly closely held companies. They serve to protect existing shareholders from having unwanted bed partners. The protection is in the form of a first right of refusal to acquire shares of a co-shareholder who wishes to leave.

They do, however, require great care in drafting. Take for example a shareholder who wishes to exit the company. The other existing shareholders are not compelled to buy the existing shareholder's shares, thus he or she is "locked in" unless he or she can attract a third party interest.

Here is the rub. How might an existing shareholder attract a third party buyer? The existing shareholder will be able to provide only limited information about the company to the third party. Most company information will be in the hands of the company, or its board, and will be confidential. Consequently, without support of the company, the existing shareholder has his or her hands tied and will be denied the ability to introduce a third party buyer.

There is a solution to this conundrum. The solution is to insert into the company's pre-emptive rights (either in the constitution or a shareholders agreement) provisions requiring the company to assist a shareholder upon an intended exit. Degrees of assistance are varied; the essential point is to turn your mind to the need for it in crafting the pre-emptive rights in the first place.

If you believe your own company's pre-emptive rights are or may be defective in these respects, I would welcome hearing from you and correct them for you.

Zoning Changes – Taxation Effects…

The zoning changes predominating the Auckland landscape highlight and attract a longstanding and little heralded tax result. Land that is "untouched" and not bought with an intention of resale generally attracts a capital characterisation. Consequently, any gain realised on sale is generally not taxable, courtesy of there being no capital gains tax regime in New Zealand's tax system.

Many landowners presently reaping the rewards of an uplift in the value of their property as a result of zoning changes will beg to differ. Those landowners do indeed suffer a tax liability on sale of their property and may argue that NZ does have capital gains tax. This is because a little known section in our land taxing provisions brings to tax gains on the sale of a property where 20% or more of the gain is attributable to a zoning change or the likelihood of a zoning change. These provisions apply where the land is sold within 10 years. There are exceptions for residential properties and farm land.

In the present Auckland (and elsewhere) housing climate, the 20% threshold of attribution to a zoning change is easily triggered, or at least difficult to refute. Consequently, an unintended side bar to the unitary plan and other zoning changes is a windfall for the IRD, converting what would otherwise have been capital around property (non taxable) to revenue account property (taxable).

Against this, helpfully, there is a reduction in the tax amount available that escalates by 10% for every year of ownership. Where land is sold after only 1 year of ownership, the taxable amount is reduced by 10%. Where land is sold after 2 years of ownership, the taxable amount is reduced by 20% and so forth.

As always when buying or selling land, be well advised.

Overseas Investment Office (OIO) - Associates…

OIO consent is needed whenever an overseas party wishes to acquire a 25% or greater stake in a New Zealand company that holds "sensitive land" or where stipulated monetary thresholds are exceeded. That much is well known. Less known is the potential for the 25% overseas ownership threshold to be triggered by actions or holdings of an "associate".

Just who is an "associate" for these purposes is as unclear as it is broad. Under one test, two parties will be regarded as associates where they act jointly or in concert. For example, a local shareholder may acquire shares in a New Zealand company on the condition that a foreign party with which it has commercial links also acquires shares in the company. Notwithstanding that the foreign party remains below 25%, if that percentage is exceeded where the New Zealand associate's holding is aggregated, OIO consent will be required.

That is an obvious example. Under a separate test, persons are deemed to be associates where a first person participates in the overseas investment through an arrangement or understanding with a second person. Just what is an arrangement in this context is vague. Clearly a meeting of minds is required that creates an expectation that one or other of them will act or refrain from acting in a particular manner. This was demonstrated recently in a case concerning Carbon Conscious NZ Limited (CCNZ), being Australian owned. CCNZ arranged for a third party to acquire certain land in circumstances where OIO consent would have been required had CCNZ acquired the land, it being sensitive land. The purchaser and CCNZ were found to be associates. Consequently CCNZ suffered a $400,000 penalty awarded against it.

Take care when dealing with OIO issues… and seek advice.

Warranties: Material Adverse Change (MAC)…

A frequently sought and often provided warranty on a share sale is a vendor warranty that since the last Accounts Date there has been no Material Adverse Change in the assets, liabilities, turnover, earnings, financial condition, trading position, affairs or prospects of the Target Company. Sometimes the expression "Material Adverse Change" is defined and sometimes it won't be. An example of the definition is "an event or change in circumstances that results in a 10% (or greater) reduction in the maintainable earnings of the business in any financial year or a material adverse effect on the operation, property, assets, condition (financial, trading or otherwise), profits or prospects of the Business".

A purchaser will want to retain wording that is as broad as possible thereby facilitating a claim for

materially reduced performance in the period under watch without needing to establish the causes of that poor performance. A vendor on the other hand will want to limit the basis for a claim to defined events or circumstances. For example, from a vendor's perspective it is not sufficient for a claim to be brought merely on account of reduced EBITDA (earnings result). The cause should be identified and the wording of the warranty drafted to match so that a claim is possible only where an express cause can be pointed to (for example, a lost customer or third party claim). Focus from the vendor's perspective should also be to "maintainable" earnings, not actual earnings (which is essentially a guarantee that a certain level of earnings will be achieved).

Many MAC warranties that I see are deficient in their drafting. Most suit the purchaser and "over-reach". The consequences for the vendor can be expensive and unfair. As always with warranties, take great care over them and do not take short cuts over the wording.

Our Website…

Read our newsletters online at www.speakmanlaw.co.nz.

Come visit…

Please feel free to pop in for a visit at Suite B, Level 1, 7 Windsor Street, Parnell.

Contact details

Peter Speakman
Principal
T: +64 9 973 0577
M: 021 854 642
www.speakmanlaw.co.nz