SPEAKMAN LAW

November 2017 – Tax Edition

Issue 24

Welcome to the last edition of Speakman Law Newsletter for 2017. A pot pourri of selected topical (hopefully also interesting!) issues follows. As with the last newsletter, I have written a tax edition and separately a commercial edition. Whilst both may be of interest, inevitably one will appeal to you more than the other.

And because it is nearing Christmas there is a bottle of pinot noir and a pinot gris for the first of you who can pick these lyrics.

"I've been to London, seen seven wonders. I know to trip is just to fall. I used to rock it, sometimes I'd roll it. I always knew what it was for."

All the best for the holiday season ahead!

What's inside

- Voluntary Disclosure
- Limited Partnerships – cross border considerations
- Business Sales – Allocation Purchase Price
- Pre-Completion Dividends

Briefly - sport

- ABs v France this weekend leaving me feeling uneasy (Battle of Nantes, the 2007 Cardiff collapse and the 1999 World Cup semi-final ambush feature large still)
- Virat Kohli enters list of top 10 highest century makers of all time (he is only 28!)
- Colin Munro now has 2 (of only 5) International T20 centuries for NZ (McCullum has 2, Guptill 1)
- US has 1, 2 and 3 in world golf rankings (1st time in a long time)

Briefly – Law/Special Interest

- Tax focal point of Labour led govt. Tax Working Group to be established and a 100 day plan. My pick is wide sweeping changes in the international tax arena and a return to targeted (ie housing) tax provisions
- Trust Bill still making its way through Parliament
- New Anti-cartel laws coming into effect, much broader and addressing output restrictions and allocating customers
- Severe penalties imposed in first case involving breach of anti-money laundering rules
- Stephen Hawking says artificial intelligence becoming smarter than us "If people design computer viruses, someone will design AI that improves and replicates itself. This will be a new form of life that out performs humans". My response, Trump will be our saviour, his obvious solution will be to sanction all computers.

Voluntary Disclosure…

Relief from tax penalties accompanies making voluntary disclosure. In most cases, making voluntary disclosure is both a sensible and a pragmatic solution to managing tax errors. There are, however, issues to be aware of regarding them.

First, the earlier disclosure is made the better. That will minimise interest and late payment penalties. It will also maximise the relief that is available from civil (shortfall) penalties; relief accompanying disclosure reduces where an Inland Revenue audit or investigation has already commenced by the time disclosure is made.

Secondly, disclosure provides relief against civil (financial) penalties only. It does not offer relief against penalties for knowledge offences. If there is a risk of suffering penalty for taking a tax position knowing it to be wrong, you need to balance that risk against the advantage of making voluntary disclosure. Such disclosure can be expected to produce leniency against Inland Revenue seeking to impose a criminal penalty, but it does not guarantee it. By making voluntary disclosure a taxpayer admits the offence. Consequently, if Inland Revenue is minded to impose a criminal penalty it becomes that much easier for it to do so following that admission. This potential consequence needs to be carefully considered.

Voluntary disclosure is effective only where there is a tax shortfall. In relation to GST, for example, it may be that underpaid output tax has a corresponding input tax effect, which if claimed would result in the correct amount of GST having been collected, thereby resulting in no tax shortfall and no penalty against which disclosure may operate. In those circumstances an appropriate action may be a section 113 application rather than a voluntary disclosure in order to achieve the result that there is no tax shortfall. Whichever action is best will depend on the circumstances. All grist to the mill for a tax specialist.

Limited Partnerships: Cross Border Considerations…

Limited partnerships lend themselves to cross border investment on account of the tax look through treatment afforded to them in New Zealand. This overcomes potential for economic or jurisdictional double taxation with corporate structures and repatriation of profit by way of dividend, with accompanying withholding taxes in many cases.

Nevertheless cross border issues for limited partnership remain and care is needed regarding them.

One issue is whether or not interest paid to a non-resident lending partner in the LP may attract the 2% approved issuer levy (**AIL**) or whether it is subject to NRWT (either at 10% or 15% depending on any applicable double tax treaty).

The first hurdle to obtain the 2% AIL rate is to overcome application of the associated person rules between the non-resident partner and the LP. Association between them will be triggered where the partner has a 25% or greater percentage interest in the LP. There is argument that association is triggered below that level but that argument is not preferred. Secondly, AIL will not be available where the interest is jointly derived by NZ partners along with non-resident partners. Where, for example, the LP itself carries on a lending activity from which it derives interest income, AIL will not be available if the LP has both NZ and foreign partners. Consequently, it may be advisable to establish a separate LP for the lending activity with the partners in that LP being either solely the NZ partners or solely the foreign partners.

Interest issues aside, the tax position for non-residents in a NZ LP will turn on whether the LP has a permanent establishment (PE) in New Zealand. The issue here is whether the activities of the LP undertaken on its behalf by the general partner create a PE for the individual partners in the LP. If so, the partners will be taxable in NZ on their share of the LP's income. In that event the partners will look to any applicable double tax treaty (or their home domestic tax rules) for tax relief against jurisdictional double tax arising. The question whether the LP has a PE is a complicated one; an office may be enough to constitute a PE, it is fairly easy to inadvertently create one.

Cross border tax consequences can also arise on account of differing tax treatment accorded limited partnerships from country to country. Australia, for example, treats LPs as companies for tax purposes (whereas NZ does not). This has led to an arrangement creating a double deduction for the same expense. NZ partners in an Australian LP have, under that arrangement, benefitted from a deduction for interest paid by the LP in Australia. That interest has triggered a deduction at the level of the LP (because it is treated as a company for tax purposes in Australia) and a deduction for the NZ partners (because NZ tax law treats the LP as look through). The Australian LP is then able to offset the interest expense against group profits, resulting in the same expense being used twice. This is one of many issues involving hybrid vehicles being addressed by Inland Revenue as part of the BEPS (Base Erosion Profit Sharing) initiatives now underway.

For more information don't hesitate to contact me.

Business Sales: Allocation Purchase Price…

Sellers of businesses have a motivation to allocate as much of the purchase price as possible to goodwill, thereby obtaining a tax free return. Are they freely able to do that? How does this affect the purchaser?

In answer to the first question there are statutory rules in the tax legislation that limit the extent to which the purchase price can be allocated to goodwill. Those rules require that trading stock that is sold in the course of a business must be sold at market value. Other revenue account assets that are sold for inadequate consideration, similarly, must also be ascribed market value. There are no market value rules for capital assets.

In answer to the second question, any tax benefit that a seller obtains from a chosen allocation of purchase

price amongst the transferred assets ordinarily results in a corresponding tax cost for the purchaser. The seller's preference for putting much of the purchase price to goodwill denies the purchaser a tax deduction which would otherwise be available for amounts allocated to trading stock or other revenue account assets. Similarly, to the extent the purchase price is allocated to depreciation assets, the purchaser will obtain a tax benefit by way of depreciation allowances.

Unsurprisingly then, allocating the purchase price amongst the transferred assets is often contentious as between seller and purchaser. What if they cannot agree?

That is in fact not uncommon. In some cases, the response is for the parties to proceed with their sale and purchase agreement without making any allocation of the purchase price amongst the transferred assets, leaving the parties to make their own allocation to suit themselves when filing their tax returns. Obviously that creates potential for them to each take wildly different tax positions and for Inland Revenue to question it. Another response is for the parties to file their tax returns using different allocations to those recorded in their sale and purchase agreement. Here again, it can be expected that Inland Revenue will be in question mode.

Another issue is whether Inland Revenue is bound to accept the allocations agreed between the parties (assuming they do reach agreement). Argument in favour of this is that the agreement between the parties best represents market value. No, Inland Revenue is not compelled to accept the parties agreement; if the parties decide for their purposes that something is green when in fact it is yellow, there is no good reason why Inland Revenue cannot assert it is yellow.

Risks in all these respects are reduced where positions taken are both reasonable and supportive by independent valuation.

Pre-Completion Dividends…

Upon a sale of more than 34% of a company's shares, any imputation credits for the company are lost. Hence it is common to clear out imputation credits prior to a share sale by way of a pre-completion dividend. The dividend must be declared prior to the share sale agreement becoming unconditional in order for it to achieve its purpose.

More often than not the dividend is declared and unpaid until settlement. How does this affect each of the vendor and purchaser respectively?

For the vendor, the dividend will be taxable, but sheltered as to 28% by the imputation credits attached to the dividend. The dividend will trigger a resident withholding tax liability of 5% (on current marginal tax rates) in most cases. The dividend will reduce the company's retained earnings balance that would otherwise be tax problematic.

The amount the vendor will receive on settlement of the share sale transaction for sale of the shares will reduce by the size of the dividend. Thus the vendor will receive two components, being firstly the proceeds on sale of the shares and secondly the dividend.

For the purchaser, it will inherit a company that has a "clean start". The pre-completion dividend will reduce the company's retained earnings balance so that at settlement, the purchaser will not inherit a company that is pregnant with a tax liability, in the form of a retained earnings balance without the shelter of imputation credits.

Commercial reality, however, does not make the payment of a pre-completion dividend straight forward. That is for two reasons. First, the timing of settlement of a share sale will only rarely fall around a company's provisional tax date. Where it does not, there will be the need to estimate the company's tax liability based on trading for the period from the previous provisional tax payment up to settlement and to pay tax on that estimated position. Only in that way will profits for the period to settlement (and, by extension, the company's retained earnings balance) be best managed, tax wise.

The second complication is the purchaser's commercial need for the target company to have working capital on hand sufficient to ensure the company can continue to meet its expenses in the immediate period following settlement.

A pre-completion dividend will invariably be at odds with this. This matrix usually resolves itself by the parties agreeing a Target Working Capital as at settlement. A pre-completion dividend will be permitted, and actioned, to the extent the company remains able to achieve the Target Working Capital at settlement.

In summary, whilst pre-completion dividends are common to share sale transactions they do require careful management. Where cash is an obstacle to them, a solution is to declare a taxable bonus issue. Again, these are relatively common.

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