SPEAKMAN LAW

March 2018 – Tax Edition

Issue 25

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Briefly – Special Interest/Sport

- CBL placed in liquidation by Reserve Bank; market capitalisation had been north of $750m
- MH370 – the reinstated search for missing plane so far unfruitful, to end in June
- Ireland undefeated in 6 nations, England lost one (Scotland)
- Phil Mickelson wins World Golf Championship, now has 43(!) PGA victories
- Steve Smith, Australian cricket captain, reportedly will earn nearly US$1.5m this year
- Can you name where Commonwealth Games are to be held? They start on April 4.

Briefly – Law

- Cartel criminalisation – criminal penalties are proposed for cartel conduct that is essentially anti-competitive (maximum penalties are a term of imprisonment of 7 years for individuals or a fine of $500,000)
- Trust Law Bill before Parliament – period of trusts to be extended to 125 years, trustees responsibilities to beneficiaries expanded, mandatory and default provisions introduced for trust deeds
- Taxpayer (Chatfield & Co, Accountants) wins judicial review case against Revenue on scope of Revenue's powers to access information from NZ residents on request from a foreign Government

A change of seasons

Then as it was, then again it will be
Though the course may change some times
Rivers always reach the sea
Flying the skies of fortune
Each our separate ways
On the wings of maybe…

I've always liked these lyrics, can you name the song? Perhaps it is just because I like the song; somehow with Summer ending and the onset of Autumn they seem apt to encompass the changes ahead and attitudes towards them.

Welcome to my first newsletter for 2018. So much is happening in the legal front, so much to keep up with, busy times had and busy times lie ahead. I have tried to capture the most pertinent here. As always I trust and hope you find it an enjoyable and pertinent read.

Brightline Test Extended to 5 Years/Loss Ring Fencing…

The Brightline test for residential property is to be extended from 2 to 5 years from later this month. The current 2 year period was criticised from inception as potentially too short and relatively easy to work around. With the extension, the ability to work the system, by sitting out the 2 year period will have gone.

The extended period will not apply to properties that have already been acquired; it will only apply to properties acquired after the law is enacted. The 2 year period will continue to apply to properties acquired before then.

Significantly the focus on residential property remains. The Brightline test will continue to apply only to residential property and not also to commercial property. Investors may be encouraged therefore to shift their focus to commercial property. Similarly, the exemption for the private family home remains.

As a broad statement, the rules can be summarised by saying that any gains from the sale of residential property, other than the family home, will be taxable where bought and sold within 5 years.

Coupled with the Brightline extension is proposed ring fencing of residential rental losses. Proposals have been announced to this effect with the result that investors will no longer be able to offset tax losses from their residential investment properties against their other income.

Losses result from excessive gearing and interest deductions exceeding rental income, with those losses essentially recouped by capital appreciation in the value of the property and gain on sale.

The Brightline test already addresses taxation of such gains; ring fencing of losses will curb residential investment activity even further by limiting the benefits of residential property investment.

Land Rich Companies…

The Brightline test must be read hand in hand with anti-avoidance rules targeting residential properties held by companies and trusts. These anti-avoidance rules apply where residential property is owned by a company or by a trust and the shares or equity interests in the trust are traded within the Brightline period.

These rules apply to a company (a land rich company) where residential land owned directly or indirectly by the company makes up 50% or more, by market value, of the assets of the company.

Similarly, these rules apply to a trust where residential land makes up 50% or more, by market value, of the assets of the trust.

In the case of company residential land, these provisions will yield a tax result where 50% or more of the shares in the company, by market value, are disposed of within a 12 month period, with a purpose or effect of defeating the intention and application of the Brightline test. The tax yielded is in proportion to the percentage shareholding of the exiting shareholder.

In the case of trust residential land, these provisions will yield a tax result where the trust's trust deed changes, a decision-maker under the trust deed changes, or an arrangement under the trust changes, with a purpose or effect of defeating the intent and application of the Brightline test.

Taxation of Employee Share Schemes…

Nearly 2 years ago, Inland Revenue heralded introduction of new rules for employee share schemes. These rules target tax-free capital gains on shares issued by a company to its employees.

Historically it has been a straight forward matter to structure employee share benefits in a way that has provided a tax shelter on the uplift in value of employee shares during all or part of the employee's term of employment. That has been possible through an employee share trust with the shares held in the trust on behalf of the employee. Under such arrangements, shares are transferred to the employee share trust at market value financed by a loan from the issuing company to the trustees. The shares are ultimately transferred to the employee at a pre-agreed time some years later upon payment by the employee of the market value of the shares at the outset (when they were first transferred to the trust). The entire uplift in value of the shares whilst they remain in trust has, under existing tax rules, been tax free.

This tax result has created a tax incentive for creating an employee share scheme. The new rules will remove that incentive. They do so by shifting the taxing point. To explain, under the existing rules (soon to be the old rules), the taxing point is at the time the shares are placed in the employee share trust. Under the new rules the taxing point will shift to a later time that will bring to tax the uplift in value of the shares

These tax results hinge on the timing of the taxing point and precisely what gives rise to that. Essentially, this is the point of time that the employee holds the shares in the same way as any other shareholder. Amongst other things this will deny the ability for an employer wishing to incentivise its employees to protect employees against a fall in the value of the shares. Under existing schemes, where shares are transferred to an employee share trust at say $1 per share (requiring the employee to likewise pay $1 for the shares some years later) it has been possible to protect the employee from loss where the shares fall in value to say, $0.50c per share. Under the new rules it will no longer be possible to structure employee share schemes that both provide that protection and shelter the employee from tax on any uplift in value.

In substance the new rules will mirror the rules for taxing employee options; the employee is taxed by reference to the value of the underlying shares at the time he or she exercises the options, that being the time when protection against risks in full in value of the shares is lost.

Noteworthy are the transitional provisions for existing schemes. The new rules are to apply from 6 months after enactment. From that date, care will need to be taken for shares held in an employee share trust. For

shares held in such a trust, there is potential for the taxing point to be delayed. If it is delayed beyond 1 April 2022, the new rules will apply. This would greatly alter the basis on which an existing employee share scheme has been established. It might also mean that employee share benefits are taxed both under the old rules and the new rules, in which case credit will be available for tax already paid against future tax payable under the new rules.

Cross Border Tax Avoidance Measures…

I have previously written about the likes of Google paying little tax anywhere in the world despite deriving bountiful profits.

The tax savings of multinationals have been prolific. Those tax savings have been achieved through a mixture of positing intellectual property rights in tax havens and limiting tax liabilities in trading countries with high tax rates.

For many years the OECD has been battling the issue of how to address tax planning that delivers these results. The OECD's work has crystallised into a series of anti-base erosion and profit shifting (BEPS) measures – NZ has now developed these anti BEPS measures into a Tax Bill that is presently before Parliament.

The NZ proposed anti BEPS measures are in 4 main areas:

1. Countering cross border tax advantages from use of hybrid entities (eg limited partnerships) and hybrid instruments (eg convertible notes).

2. Curtailing excessive interest rates on borrowings by a NZ subsidiary from its parent.

3. Further tightening our thin capitalisation rules which disallow tax deductions for interest on excessively geared NZ subsidiaries.

4. Targeting commissionaire and sales agent type arrangements that in substance entail an income generating activity in NZ whilst circumventing a tax liability here on that income.

Of these measures, the one that I commonly strike in my practice concerns cross border limited partnerships. They are a most convenient form of cross border tax planning because they will generally result in tax being payable only in one country and not also in the other, ie they avoid jurisdictional double taxation. Please see my November 2017 newsletter for further detail.

They have also been used mischievously. The mischief has been to take advantage of their look through (transparent) tax treatment here in contrast to their opaque tax treatment in some other countries. Take for example a limited partnership (LP) with interest bearing borrowings in Australia. The LP is treated as a corporate non-look through vehicle there meaning that the LP itself obtains a tax deduction for the interest in Australia. It is then able to offset those deductions against related company profits. NZ, however, treats the LP as transparent and therefore confers the interest deductions on the NZ partners. Consequently, a tax deduction for the interest is available twice, both in Australia and in NZ, to different taxpayers.

The anti BEPS measures will arrest use of LPs in this way. They will broadly apply to any use of LPs across borders that result in double deductions or a deduction in one country and no recognised income in the other. Similarly, the new rules will apply to cross border financial instruments (eg convertible notes) that deliver the same result.

The new rules are to apply to income years commencing on or after 1 July 2018.

Tax Working Group…

As you will know, the Labour Party campaigned heavily last year on tax issues. As heralded, a Tax Working Group has been established. Scope of that group's objectives has been published and is illuminating, a capital gains tax being foremost in their thinking.

Primarily their focus is whether taxing capital gains or land or other housing tax measures would improve the tax system, the possibility of a progressive company tax system and what role tax has in delivering positive environmental and ecological outcomes.

Excluded from their consideration is inheritance taxes, increases in rates of income tax or GST, imposition of a capital gains tax to the family home or land underneath it, adequacy of the personal tax system

and the anti BEPS measures discussed separately in this newsletter.

Their target is to produce a final report to the Ministers of Finance and Revenue by February 2019.

There is nothing surer that new taxes are on their way. Possibilities are financial transaction taxes, wealth taxes, a general capital gains tax (or targeted form of it), land tax and environmental taxes. For what its worth my pick is a mixture of all of the above, least likely being land tax and wealth taxes.

Our Website…

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