SPEAKMAN LAW

Welcome to our final tax newsletter for 2018. Some of you may know that I have assisted the Law Society with submissions to the Tax Working Group (**TWG**). As a consequence of that I have become privy to a poll organised by the TWG on various of the proposals. The results of the poll may surprise you. Please see the last article for details.

As always I hope you find the newsletter of interest. Wishing you a very Merry Christmas and prosperous New Year.

LTC/Debt Remission Mismatches

In 2017, rules conferring relief from debt remission income were introduced. There are, however, restrictions on their applicability. Where those restrictions deny relief, remission income will result. In most cases that will simply serve to eliminate the tax losses that will inevitably have flown from the losses.

A recent example illustrates the care that is needed here, however. The debt had been owed by a company to one of its shareholders. The company was a LTC and the losses had passed through to the shareholders who had claimed the losses in their personal tax returns. By the time the debt was forgiven however, the company had elected out of the LTC regime. As a result, the remission income that arose on forgiving the debt fell on the company, whilst the losses were elsewhere (with the shareholders). The losses could not therefore be offset against the income – a big problem!

If you find yourself in this situation the best solution is to seek Inland Revenue agreement to reverse the election to opt out of the LTC regime.

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What's inside

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- Frucor Holdings Limited v CIR
- NZ Ratifies OECD's MLI
- Residence
- Tax Working Group Results of Poll

Briefly – Special Interest/Law

- David Tauber, tax adviser, found guilty of tax evasion, sentenced to 3 years and 3 months imprisonment.
- Trust Bill reaches second reading in Parliament.
- Charities Act being reviewed.
- $1.885m fine imposed on Steel & Tube for false and misleading statements.
- Long lost guitar signed by Jimmy Page, Eric Clapton, Bill Wyman and Gary Moore recovered.
- Theresa May's government becomes the first to be found in contempt of Parliament.

Briefly – Sport

- Woods & Mickelson showdown. The match decided at the 22nd hole in favour of Mickelson.
- Ireland serve up warning to All Blacks for 2019 RWC.
- Black Caps win over Pakistan in 1st test, by 4 runs, our closest ever result. Series delicately poised at time of writing with 3rd and deciding test in the balance.
- St Kents 1st XV facing exclusions from 2019 competition for poaching.

Frucor Holdings Limited v CIR

This is one of the most significant tax avoidance and tax structuring cases in recent times.

In issue were deductions of $10,827,606 and $11,665,323 which Frucor had claimed and which Inland Revenue had disallowed in the 2006 and 2007 income tax years respectively. These deductions relate to a convertible note (Note) issued by Frucor to Deutsche Bank (DBNZ) and a forward purchase of shares that DBNZ could call for under the Note by Frucor's Singapore based parent, Danone.

The Note was for $204m and carried an interest rate of 6.5% pa. Frucor paid DBNZ $66m interest under the Note which Frucor claimed as deductible. Inland Revenue argued that $55m was in fact non-deductible repayment of principal and the arrangement was a tax avoidance arrangement.

The forward agreement was for the shares in Frucor that DBNZ would acquire if it elected to convert the Note into shares. The purchaser was Frucor's ultimate parent (DAP). Under this agreement, DAP agreed to pay DBNZ $149m; in exchange DBNZ agreed that, if it did elect to convert the Note into shares, it would transfer the shares to DAP. If it did not elect to convert the Note into shares, it agreed to pay DAP $204m, tax adjusted. DBNZ claimed an interest deduction equal to the difference between $149m received from DAP and the $204m, being the acknowledged lowest price of the shares it was to transfer to DAP at maturity.

Inland Revenue argued that because the $204m paid by DBNZ for the Note was funded as to $149m by DAP's forward purchase of the shares, DBNZ's true advance was only $55m and the $66m paid actually was repayment of principal as to $55m and $11m interest. In summary, Inland Revenue's argument was that from DBNZ's perspective, its economic outlay was $55m only and in return for that, it received $66m. From Frucor's perspective, it received $204m, paid out $66m and issued shares to DBNZ for a value equal to the balance.

Inland Revenue's arguments in large part relied on there being no cost to Frucor in issuing the shares. Some points about that:

a. this position is inconsistent with the approach under the financial arrangement rules which do not treat the borrower as having paid no or inadequate consideration upon issuing shares;

b. this argument presupposes it is possible to have one rule for share issues to parent companies and another to third parties; that is not possible because the question is whether it is a cost to the company issuing the shares and the recipient is irrelevant in that context;

c. there was an opportunity cost associated with issue of the shares evidenced by the fact that when Frucor was acquired it would never have contemplated the relevant parcel of shares not being included in the acquisition.

The Commissioner of Inland Revenue argued that the law requires a focus on the economic and commercial effect of the transaction and that in reality there was no expenditure or economic cost associated with the issue of the shares. The Judge saw as relevant, not whether the shares had a cost, but whether it was consistent with Parliament's intention that Frucor should be able to deduct interest for a debt which was always going to be repaid by the issue of shares (which would themselves simultaneously be transferred to its parent).

The crucial paragraph in the judgment is in the context of whether a parent-subsidiary relationship trumps economics. That paragraph in the judgment cites the following example. "Assume an optional convertible note with a coupon rate of 6.5%, issued by a New Zealand subsidiary to its 100% offshore parent, in exchange for upfront funding. It may be satisfied by the issue of shares or repayment of cash. If by shares, the Commissioner's experts would say the debt had been satisfied at no economic cost to the subsidiary, should that result in non-deductibility of the coupon payments? I can find no suggestion in the financial arrangements rules that it would… apart from constituting good consideration, the shares must be taken as having had real value… the "no cost" proposition which underpinned the Commissioner's expert evidence does not in my view establish avoidance"..

The High Court found the transaction had real and (from a New Zealand taxpayer perspective) legitimate economic drivers, primary among them offshore tax minimisation.

It is a significant win for the taxpayer, however, given the size of the transaction, it will almost certainly be appealed.

NZ Ratifies OECD's MLI

NZ has ratified the multilateral Instrument (MLI). What does that mean? It means that NZ has done its part to adopt into our double tax agreements (DTAs) the amendments proposed by the OECD to address cross border tax avoidance. These amendments will become binding as and when each other country with which we have our DTAs likewise adopts the amendments.

Until that happens, these amendments are of no effect, but as time goes by each of our treaty partners will catch up and the amendments will become binding.

What are the amendments? The answer to that depends whether our treaty partners adopt (as NZ has) the OECD proposals in full. Countries have the option of adopting them in part only (US, Samoa and Taiwan have indicated they do not intend to adopt them at all, hence our DTA's with those countries will remain unchanged notwithstanding our adoption of the MLI). Where our treaty partners adopt the OECD measures in full, as NZ has, these amendments include provisions that:

a. neutralise the effects of hybrid mismatch arrangements in fiscally transparent entities (eg limited partnerships) and dual resident entities (branches);

b. prevent the grant of treaty benefits in appropriate circumstances and retrench DTA withholding tax rates on dividends, also strengthening taxation of gains on sale of shares in "land rich" companies;

c. target commissionaire arrangements by introducing an anti-avoidance rule regarding permanent establishments;

d. allow a taxpayer to apply for mandatory binding arbitration.

It will be evident that to identify what form of DTA with a treaty partner is applicable, you first have to ascertain whether our treaty partner has adopted the MLI in any way. The state of play with our treaty partners in these respects can be ascertained by reference to the OECD website (www.oecd.org/tax/treaties/mlimatchingdatabase.htm).

Residence

Tax residency rules are a critical component of our tax system; NZ tax residents are taxed here on the income wherever in the world that income arises. Consequently, each time residence is addressed by the court is a significant event, hence so is the recent Court of Appeal decision involving a ship's captain (Mr Van Uden) and the Court's finding that he was a New Zealand tax resident.

Mr Van Uden had been at sea for approximately 8 months every year for about 40 years. Despite being outside the country so extensively, Inland Revenue assessed him on his income from outside New Zealand as a New Zealand tax resident on the basis that he had a "permanent place of abode" here. This was due to a property in New Zealand in which he resided habitually when he was not at sea and in New Zealand. The property had been transferred to a family trust established by his wife following transfer of the property to her as a matrimonial settlement.

Mr Van Uden argued that whilst it was true that he regularly stayed there, the property was not legally his, his connections with the property were merely of the nature of a "sojourner" and both his and his wife's emotional and business ties had shifted to Europe.

Those arguments were dismissed on the basis that Mr Van Uden and his wife were beneficiaries of the trust that owned the property, in fact he did reside at the property whilst in New Zealand, it was indefinitely available to him and he retained ties with it.

In coming to the conclusion that Mr Van Uden at all times continued to have NZ tax residence courtesy of his ties to the NZ property, 2 items are noteworthy:

a. first the Court was influenced by Mr Van Uden's retention of a Sky TV account throughout the years in question; and

b. the property was at no time formally rented out to third parties.

The decision reinforces the elements that are relevant to establishing whether a person has a permanent place of abode in New Zealand, and by extension, NZ tax residence. These are:

a. continuity or otherwise of the taxpayer's presence in NZ and in the dwelling;

b. The duration of that presence;

c. The durability of the taxpayer's association with the particular place; and

d. The closeness or otherwise of the taxpayer's connection with the dwelling.

TWG: Results of Poll

Do you think that the Government should expand the taxation of capital

Yes	73%
No	22%

Do you support taxation of gains on the sale of family homes with a value of more than (say) $4m

Yes	70%
No	30%

Should capital losses be ring-fenced?

Yes - Contained in the Capital Gains Tax base	39%
No – full offset available	55%

On what basis should assets be brought into the tax base?

Grandparenting	31%
Valuation on start date	69%

These results show that a large majority favour introduction of a capital gains tax and, surprisingly, do not favour exclusion of the family home.

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