September 2019 – Tax Edition

Issue 33

What's inside

- Hybrid Mismatch Rules
- LPs and the Permanent Establishment Rule
- Non-complying trust scenario
- Recent tax changes/tax cases

Briefly – Special Interest/Law

- Trust Act passed, triggering the transitional period for updating your trust deed.
- Tax Working Group – not all lost, as much of their work now appears in the Government tax policy work programme. This includes reviewing the land rules, particularly in relation to investment property (likely resulting in a capital gains tax restricted to property investors).
- 45 Bills are currently before Parliament. Of these, relevant to me are the Partnership Law Bill and the Venture Capital Land Bill. Less relevant is the Veterans Support Amendment Bill!
- Claire Curran, sacked from cabinet, to retire from Parliament at next election.
- Donald Trump's latest brainstorm is to nuke hurricanes before they make landfall – Brilliant or fake news?

Briefly – Sport

- RWC team announced. Gone is a great All Black Owen Franks; included is a future great All Black in the McCaw/Michael Jones class, in Luke Jacobson.
- Black Caps share lead on new test championship with brilliant win over Sri Lanka.
- Rory McIlroy wins Fedex. Would have been nice if someone likeable had won it.
- CWC final: was the 4 overthrows off Ben Stokes bat (and umpiring error to compound it) the most unlikely and unlucky moment in sport?

While the news has been monopolised by the China/US trade war, Hong Kong democratic protests (really quite worrying with Chinese tanks at the border), and locally the Ihumatao protests and Jacinda Adern's travels to the Pacific Islands much has been going on in the legal world.

Dominating the tax scene this year has been the Government's back track on introducing capital gains tax. There has been plenty of other tax business going on and this newsletter encapsulates some recent activity here. I hope you find it interesting.

Hybrid Mismatch Rules

Hybrid mismatch rules were introduced last year and will apply to many cross border financing arrangements. They are not limited to group or related companies. They apply more broadly than that wherever there is a structuring element and a tax advantage that springs from treatment of a financing instrument as debt under New Zealand tax laws and as equity under foreign laws.

A convertible note is an example. Interest paid under the note will ordinarily be deductible in New Zealand. If, however, the country in which the holder of the note is resident treats a convertible note as equity, then that country will characterise the returns on the note as dividends. Many countries grant tax exemption for foreign sourced dividends. Where that is the case the note creates a tax mismatch. It is these mismatches in tax treatment that the hybrid mismatch rules target. New Zealand now responds to them by disallowing the interest deduction.

Notably, these rules only apply where there is an interest payment made under the financing instrument. They do not apply to the zero coupon convertible note instrument that was at the heart of the Alesco case. That is notwithstanding the fact that instruments of the type in the Alesco case also produce a tax mismatch (New Zealand tax rules mandate a deduction upon application of our financial arrangement rules, notwithstanding the absence of an interest payment).

Many types of financial structures are caught by the hybrid rules. One such type is reverse hybrids. New Zealand foreign trusts are an example. They fit that description because of the inherent facility for a New Zealand foreign trust to be used by a foreign person to generate income (that is, sourced outside their own country and so is "foreign sourced income" from their perspective) whilst New Zealand does not tax the income either, where the income is not sourced in New Zealand.

Often, use of a New Zealand foreign trust is accompanied by investment by the trust in an offshore company, and a return that is deductible in that offshore country and which is not taxable in New Zealand (or anywhere else). There had been discussion amongst Inland Revenue officials, so I believe, of the idea of taxing this income here despite the fact it fails both our residence or source basis for taxation.

Fortunately the rules do not extend that far. They will only extend, in the case of reverse hybrids where New Zealand is the country in which the deduction is created.

The breadth of arrangements that fall within the scope of the hybrid mismatch rules is immense and include, convertible notes, repo arrangements, reverse hybrids, dual resident taxpayers, hybrid transfers and back to back hybrid lending. They also apply to hybrid entities, such as limited partnerships and branches. I will cover application of the hybrid rules to limited partnerships and branches in my next newsletter. For the moment I finish by saying that these rules should put an end to the tax avoidance arrangements entered into in recent times by many of the banks, which imperilled the New Zealand tax base to the tune of some billions of dollars. That has to be a good thing.

LPs and the Permanent Establishment Rule

Will the activities in New Zealand of a New Zealand limited partnership (LP) with foreign partners attribute those partners with a permanent establishment (PE) in New Zealand? If the answer is yes, those partners will be taxable in New Zealand on the business profits from the LP's activities. If the answer is no, those business profits will be taxable only in the partners' home country (or not taxed at all, depending on the taxation laws in their home country).

Many factors will automatically give rise to a PE in New Zealand. There are the obvious ones such as an office or fixed place of work here. A building or construction site will also constitute a PE where it spans 12 months or more (in the case of some countries, our double tax agreement reduces this period to 6 months, but mostly the 12 month threshold applies). Each of these are physical locality tests.

Is a PE that exists on account of physical locality, a PE only for the LP or is it attributed to the partners? The answer is the latter. That is because of the look through tax treatment accorded to a New Zealand limited partnership under our domestic tax laws. That means the LP is not itself a taxpayer and by extension does not meet the definition of resident in a double tax agreement (DTA). The result: the DTAs do not apply to limited partnerships. Instead, though unfortunately there is no case law to directly answer the point, a business that is carried on by a limited partnership should be treated for purposes of applying our DTAs, as having been carried on by the partners. OECD commentary on DTAs supports that view and it is consistent with our domestic tax law of LPs which treat the partners, and not the LP, as carrying on the partnership business.

The physical locality tests are not the sole criteria applied in determining whether a PE exists. There is also an agency test, the effect of which is that a New Zealand resident agent with power to habitually negotiate or conclude contracts for the LP will give it a PE here.

Lastly, large multinational groups are subject to their own rules, under the new section GB54 so be careful with them.

Non-Complying Trust Scenario

Distributions made by a non-complying trust (other than out of the "corpus" of the trust) are taxed at a penal 45% tax rate. So, you generally want to take care to ensure that your trust does not fall out of a complying status (good territory) and into non-complying status (bad territory).

Unfortunately it is terribly easy for that to happen, and for it to happen inadvertently. This is because of the rule that a trustee must not derive (and retain) foreign source interest or dividend income (ie passive income).

When a trust has a deposit in an overseas bank or share in an overseas company, inevitably the trust will derive foreign sourced interest or dividend income. An incongruous result is that this income can be problematic for the trust. It is not a problem if the trustees distribute the income (to the beneficiaries) in the year they receive it; there is a potential problem if they do not distribute it in that year. Many trusts will of course prefer to accumulate income rather than distribute it and this rule concerns them.

Unless an election is made to save the situation (section HC33 permits this) and the election is made in time, the trust will become a non-complying trust. It will face a 45% tax rate in the hands of its beneficiaries when it ultimately distributes the accumulated income (even if, as is often the case, the income was taxed at source in the same way as New Zealand imposes resident withholding tax on interest and dividends).

An example might entail any New Zealander with a family trust already established who chooses to live overseas for a while (to work or holiday, it makes no difference). Assume you stay overseas long enough to lose your New Zealand tax residence and whilst there you use your family trust as the means to invest in the country you have taken up. Assume also you have not made an election under section HC33, the miracle pill which would solve all your problems.

The trust is no longer a complying trust because of the foreign source interest/dividends retained by the trust. Nor is it a foreign trust because it once had a New Zealand resident settlor (you). So it is, by default, a non-complying trust. When you distribute the interest or dividends, be prepared for the beneficiary to be stung with a 45% tax rate on the distribution. You certainly won't have expected that when establishing a trust for your children and when you make a distribution to them. The same result will potentially affect non-residents coming to New Zealand with a trust already in place and who retain foreign investments. Planning can often solve these problems and I would be happy to assist you with that.

Recent tax changes/tax cases

Two recent tax remedial changes are noteworthy. The first is a rule determining the residence of the trustees of a trust, where there is more than one trustee, including a trustee resident here in New Zealand and another resident overseas. Where is the residence of the trustees? Why is that important?

Answer: Residence is in New Zealand if there is a New Zealand resident trustee, regardless of the existence of, or even a majority of, foreign trustees. This is on account of a recently introduced rule (consistent with Inland Revenue practice in any event) that treats all trustees as a single notional person. So, you only have to look at any one of them who is a New Zealand resident to establish New Zealand residence for the trustees.

This is relevant to the rules in sections HC25 and HC26 which relate to taxation of foreign source income derived by trustees. If a trust has a New Zealand resident settlor then it doesn't matter where the trustees are resident; the trust's income will be taxable in New Zealand. If on the other hand, there is no New Zealand resident settlor, residence of the trustees does become important. A trust with New Zealand resident trustees will need to satisfy the requirement in section HC26 to gain exemption on foreign source income (and if there was never a New Zealand resident settlor, the trust is a foreign trust and it must also comply with the new foreign disclosure rules).

Clarification of residence of multiple trustees is helpful in this context.

The second noteworthy tax change concerns the personal income attribution rules. These apply to contractors who establish a company to provide services that they would otherwise provide personally but for the lower tax rates for companies). The rules apply where the income predominantly comes from a single source.

There has been potential for double taxation under the dividend and attribution rules. First, the attribution rules might impose the tax liability on the company's earnings in the year it derives them and secondly, the owner might be taxable on those earnings when they are distributed as a dividend in a later year. The tax change is intended to remove any double taxation in these situations and it achieves that.

A recent tax case is also noteworthy. It is a GST case involving Provident Insurance, for whom Lindsay McKay was lead counsel.

Provident offered insurance including indemnification of risk for credit contracts on the purchase of motor vehicles, ie insurance against a borrower defaulting on a financing arrangement on purchasing a motor vehicle. The issue was whether the premia paid to Provident were subject to GST, or attracted the financial services exemption.

Mr McKay (for Provident) argued that the insurance product fell within the meaning of financial services, as it is closely related to the core financial service, being the loan to the borrowers to enable them to purchase the vehicles. The Commissioner argued that the nature of a supply for GST purposes turns on contractual arrangements between the supplier and the recipient and the supplies made by Provident did not assume the character of interest merely because the insured was insured for amounts of interest and principal between the borrower and its lender. The court found in favour of Inland Revenue.

The case helps confirm that a contract of insurance is not itself a credit contract and that the GST exemption for financial services was not intended to extend to services connected with the provision of financial services that are not themselves financial services.

Our Website…

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

Come visit…

Please feel free to pop in for a visit at Level 15, 36 Kitchener Street, Auckland.

Contact details

Peter Speakman

Principal

T: +64 9 973 0577

M: 021 854 642

www.speakmanlaw.co.nz