SPEAKMAN LAW

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A raft of tax proposals herald the new decade, including rules to allocate the proceeds received upon sale of a business across the transferred assets, continued targeting of land activities, extension of the permanent establishment rules and a bold new proposal to impose a global minimum tax to counter tax avoidance by multinationals. Read on to learn more about these proposals.

Two other scenarios that have recently hit my desk are discussed here. These are the effect of the mismatch rules in calculating branch income and the use of company funds to pay out an exiting shareholder. I hope you find the discussion here useful. Winston Churchill once said "to improve is to change, so to be perfect is to have changed often". I guess then these tax changes are a step towards perfection. But if these changes represent perfection, perhaps it is better to be imperfect…

What's inside

- Purchase price allocation rules
- Deductibility of holding costs for privately used land that is taxable on sale
- Global minimum tax proposal
- Selling your shares in a private company
- Branch mismatch rules and head office charges

Briefly

- Ross Taylor has now scored the most runs for NZ in both test matches (7238 runs, second is Stephen Fleming with 7172) and ODIs (8570 runs, second is Stephen Fleming with 8007). He is third highest scorer for NZ in T20s, behind Martin Guptill and Brendan McCullum.
- The Blues resurgence this year (3 out of 3 away wins) has been wonderful to see. Long overdue for a Blues supporter.
- Rory McIlroy goes into the Masters next month as World No.1 golfer. A win there will see him join an exclusive group of only 5 golfers who have won all four of the majors at some time in their career; Phil Mickelson is the nearest miss with no fewer than 6(!) second place finishes in the US open denying him the career grand slam.
- The Urban Development Bill is the latest Government attempt to boost the supply of housing.
- Name one industry that is not affected by Coronavirus….pest control?.

Purchase Price Allocation Rules

Inland Revenue has released an issues paper relating to all business sales. The paper proposes rules for allocating the purchase price amongst the assets that are being sold. These rules are expected to make their way into a bill in the first half of this year and become law from 1 April 2021.

These rules are best understood by way of example. Assume a sale price of $10m. The vendor allocates $2m to land and buildings, $3m to plant and machinery (being their book value and depreciation claims to date of $1m), $1m to stock and $4m to goodwill. The tax results for the vendor arising from the sale are:

a. Land and buildings – Nil;

b. Plant and machinery – Nil;

c. Trading stock – tax on profit;

d. Goodwill – Nil.

(note the land and buildings result assumes no land business is carried on by the vendor).

Want to know more about the new Trusts Act we can help

This is a perfect tax result for the vendor. It is far from perfect for the purchaser, however as it will obtain no deduction for the goodwill component and its depreciation base for the plant and equipment remains low. These competing tax results inevitably create tension between the vendor and purchaser.

Depending on the respective bargaining strengths of the vendor and the purchaser, they will commonly agree a lower allocation to goodwill and correspondingly increase the allocation to plant and equipment. In the example above, say the goodwill is reduced to $1 (I commonly see that) and the allocation of the purchase price to plant and equipment is increased by $4m (less $1).

The tax results arising on the sale are then:

a. for the vendor – increased tax liability of $280,000 (28% of the $1m depreciation claims that are recovered);

b. for the purchaser – a tax benefit of $1,120,000 (approximately), being 28% of the additional sum allocated to plant and equipment; the purchaser will yield this tax benefit over time, via the depreciation regime.

The overall tax result under this allocation is more tax advantageous. This begs the question, are the vendor and purchaser at liberty to agree these allocations themselves and consequently reduce the overall tax take in this way? Alternatively, the vendor and purchaser may take different tax positions to best suit themselves. Are they free to do so?

Presently, there are no explicit rules that require the vendor and purchaser to adopt the same purchase price allocation when filing their tax returns. Nor (except for trading stock), is there a requirement for either the vendor or the purchaser to adopt market values. Consequently, market practice is:

a. an express covenant in the sale and purchase agreement that both parties file their tax returns using the same asset allocations; and

b. agreement between the parties on the asset allocations, which may or may not resemble market values.

Underpinning this practice is the belief between the parties that whatever values they agree amongst themselves best represents market values (due to the doctrine of willing vendor, willing buyer on an arm's length basis) and so long as they both adopt the same tax position, Inland Revenue has no ability to challenge it.

Inland Revenue does in fact have the right to challenge asset allocations that depart from market value but it faces a string of hurdles in doing so. The proposed new purchase price allocation rules will remove these hurdles for Inland Revenue. These rules will do so by:

a. in all cases requiring allocations to be based on relative market values and expressly empowering Inland Revenue to adjust an allocation that it believes does not reflect market value; and

b. requiring both parties to adopt the same allocations when filing their tax returns.

The issues paper states this is to be achieved by requiring all allocations to be based on relative market values, and:

a. if the parties agree on an allocation, both must file their returns using that allocation;

b. If the parties do not agree on an allocation, then:

    i the purchaser must use the vendor's allocation when filing its tax return (in this case, the vendor will be required to disclose its allocation to the purchaser and to Inland Revenue within 3 months of sale);

    ii if the vendor fails to provide an allocation within that 3 month period, the purchaser may make the allocation, Inland Revenue and this becomes binding on the vendor.

As will be evident, these rules place significant bargaining power in the vendor. From a practical perspective, these rules will remove the flexibility that vendors and purchasers presently enjoy about asset allocations. That being the case, the issue of asset allocations is likely to become a potential deal breaker in the course of the sale negotiations. The parties will invariably need tax advice early on in the negotiation phase in order to understand the potential tax effects on them (which can swing wildly, depending on the nature of the assets being sold). Depending on the size of the transaction the new rules will also likely require vendors and purchasers to obtain market valuation of key assets, potentially incurring additional expense early on in the deal negotiations, in order to quantify the tax results for them and in turn, their appetite to continue the negotiations.

For low value transactions, the additional costs in order to comply with these rules are not warranted. Inland Revenue propose a de minimis threshold so as to exclude deductible or depreciable assets having an

allocation of below $50,000. My view is that this threshold should be considerably higher.

Intriguingly, the proposals do not extend to assets held by a partnership. The sale of a partnership interest is treated as a sale of the underlying assets of the partnership. These proposals do not extend to that scenario.

Deductibility of Holding Costs for privately used land that is taxable on sale

Assume you purchase a residential property in Queenstown. It might be bare land that you intend to build on or it might be an apartment or townhouse. You acquire it for private purposes. Circumstances result in you selling it sooner than you intend, say after 3-4 years.

Because you will have sold the property within the 5 year period under the "Brightline" test (assuming you bought it post the Brightline period increasing from 2 to 5 years) you are taxable on any gain made on sale. Are you entitled to a deduction for rates, insurance and other holding costs incurred during your period of ownership?

Where the property has been rented out and you have received rental income on which you are taxed, these costs are clearly deductible. Tax law says nothing, however, about their deductibility where no rental or other taxable income is received prior to sale.

Inland Revenue is presently consulting on whether these costs should be deductible. Their view is that they should not be. They base that view on the premise that costs of a private or domestic nature are not deductible. If that view is followed, however, the Brightline test creates a tax mismatch whereby gains on sale or privately held land are taxable but costs incurred upon that land are not deductible. Non-deductibility could potentially extend to the cost of acquiring the land. Fortunately, Inland Revenue's proposals do not go that far.

This all begs the question when property has been acquired for private or domestic use. If an apartment remains vacant, or the land is bare land, is it used privately?

Inland Revenue's view on that score is that where land is wholly vacant or unused, the use could be considered income earning if:

It is held for a business of dealing in, developing or building on land;

It is held for another income earning purpose (for example, land purchased to expand a current business onto, or to erect a rental property); or

The taxpayer otherwise informs Inland Revenue at the time of purchase that the land was acquired solely with an intention of resale for profit.

In all other situations where land is wholly vacant or unused the use would be considered private.

Global Minimum Tax Proposal

If ever there has been a bold and ambitious tax proposal, this is it. The OECD, in its continued targeting of tax planning by multinationals, proposes common global minimum tax rules. These will operate by way of top up taxes where the effective tax rate of a multinational group's overall income falls below acceptable levels.

These proposals remind me of the strategic finance cases involving the Australian owned banks a few years ago. Those cases ultimately saw the banks having to pay well over $1 billion to Inland Revenue following tax avoidance findings against them from the tax arbitrage arrangements they employed. By way of example, the arrangements implemented by Westpac reduced its effective tax rate in New Zealand to 18% (at the time the corporation tax rate was 33%). I recall a well known and regarded tax practitioner and adviser to Westpac being cross examined on why it was that Westpac (and its advisers) considered an 18% effective tax rate to be appropriate; that was a difficult question for him to answer.

The arrangement employed by the banks in those cases have since met with a legislative response (in the form of the hybrid and branch mismatch rules and extensions to non-deductible equity rules). Similarly, OECD led initiatives since then have brought a tightening of the thin capitalisation rules, a new restricted transfer pricing rule (capping the permitted interest rate on related party debt) and extensions to the source taxation rules via widening of the permanent establishment definition. Nevertheless, the OECD has continued to be alarmed at income shifting practices implemented by multinationals, including most pronouncedly in relation to income arising from a digital platform.

The central plank in the new global minimum tax proposal is an "income inclusion rule". This will essentially top up a multinational's tax paid in a country where income is sourced. It will top up the tax to ensure a minimum rate of tax is imposed (no such rate has as yet been announced). This can

broadly be expected to ensure that a multinational's effective tax rate on its New Zealand earnings is, for example, aligned to the effective tax rate in its home jurisdiction.

There are enormous complexities with rules of this type. A starting point is the need for commonality in the calculation of income and characterisation of that income. Will all countries in which a multinational operates be required to apply the same accounting standards in calculating income? Is income of a capital nature to be treated for this purpose as the same as other income, and the global minimum tax rate imposed accordingly? Is an allowance to be made for capital gains arising in New Zealand, given that New Zealand does not have a broad based capital gains tax system? What other exemptions or carve outs are permitted? For example, if New Zealand were to introduce specific tax relief as an incentive measure (NZ has commonly done this in the past), will a corresponding adjustment be permitted to the New Zealand top up tax required?

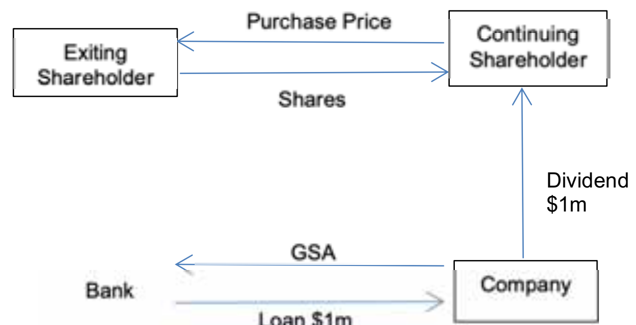
The OECD is presently consulting on the proposal. Likely, any implementation remains years away but if such a proposal is implemented, rest assured it will be wide sweeping and compliance costs relating to it will be high.

Selling your Shares in a Private Company

A shareholder in a private company is often unable to exit the company, for want of liquidity in his or her shares. Invariably the only buyers for the shares are the continuing shareholders; particularly where the sale parcel is a minority stake, third party buyers are simply not attracted.

Funding the purchase price for the shares being offered for sale is the primary hurdle for the continuing shareholders. A shareholder's intended exit is therefore hamstrung by the inability for the continuing shareholders to finance the purchase of the shares and the lack of interest on the part of third party buyers.

What can be done about this? The answer is to use the company resources to fund the continuing shareholders into purchasing the shares. See the diagram below.



Does company law permit this? Yes, though specific procedures in the Companies Act must be followed. These procedures demand that the company remains solvent post the giving of the financial assistance. The flexibility to effect a transaction such as that above is one of the key advantages of the relaxed maintenance of capital rules introduced by the 1993 Companies Act (under the predecessor legislation, this sort of transaction was strictly prohibited).

Some key considerations remain and these are:

a. In the example above, the dividend is paid to the continuing shareholders only, thus the dividend is what is called a discriminatory dividend. Such a dividend is not always possible; where it is not possible, the dividend can be replaced with a loan to the continuing shareholders (the loan will not count towards the company's solvency).

b. The directors need to be satisfied that the giving of the financial assistance is merited – often the key consideration here is whether facilitating the shareholder's exit achieves a stable shareholding platform going forward. The price for the shares will be an important ingredient here.

c. Tax considerations, such as whether dividend stripping rules apply to tax the sale proceeds in the exiting shareholder's hands as a receipt in lieu of dividends (on a genuine sale, those rules do not apply), and imputation streaming rules if the assistance is by way of a discriminating dividend, particularly if the exiting shareholder is a non- resident and unable to make use of imputation credits.

While these issues are important, my experience is that in most cases the transaction shown in the diagram above is achievable and is a neat solution to an otherwise insoluble problem.

Branch Mismatch Rules and Head Office Charges

Charges by a head office to a branch in another country are made to ensure that the branch country taxes only that much of the multinational entity's income that properly reflects the activities undertaken in the branch country. For example, where head office borrows funds overseas and these are in part applied in funding the branch (say as to 50%), it is standard practice to attribute interest costs (50% in this example) to the branch, thereby reducing the taxable income for the branch in its home country. How do the branch mismatch rules apply to these charges/deemed payments?

The branch mismatch rules do have potential to apply here. They apply to the extent that the head office charge does not reflect a simple allocation of actual third party costs; they will apply to a profit margin charged by head office to a branch, or a charge for some internally performed function.

Inland Revenue offer this example.

Root Co, a foreign company resident in Ashes Country (a foreign jurisdiction) operates through a branch in New Zealand. Root Co manufactures cricket bats in Ashes Country at a cost of $150 per bat and charges the branch $250 per bat. The $100 mark up recognises the profit generating activities of the manufacturing process in Ashes Country. It is in line with the mark up on sale of bats in Ashes Country.

The branch mismatch rules will attach to the $100 mark up. The branch will be denied a deduction for it unless Ashes Country taxes the $100 mark up (inevitably it won't), until there is surplus assessable income against which it may be set off. This highlights the need for a branch to ascertain the tax treatment in the country of its head office in order for it to claim a deduction for head office charges.

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