SPEAKMAN LAW

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What's inside

It is tempting to offer observations on the Auckland centric lockdown. I refrain from doing so in preference for discussing some important events in the corporate, tax and trust areas. Most pronounced amongst these is, for me, the reputational damage to the country from the recent emergence of the 'Pandora Papers', hence my article about them in this newsletter.

Notable too is the IRD High Wealth Research Project which has attracted considerable media attention already (and appears likely to be challenged by a Chapman Tripp/Jack Hodder QC led consortium). For my part I merely comment that this project is misplaced and is a disappointing illustration of IRD's trend away from consultation with professional service firms that has for 20-30 years underpinned introduction of tax laws in New Zealand and which has worked exceedingly well (this project, and the legislative power to undertake it, has entailed precisely zero market consultation).

Another touchpoint is the extraordinary level of profits being announced by the Banks. Westpac announced a $1 billion profit (a 56% increase) while ANZ has announced a profit of just under $2 billion, up 39% on the previous year. Doesn't this signal a buoyant economy that is resisting all that pandemic enforced lockdowns continue to throw at it? No it doesn't. It reflects the impact of spending $1 billion a week in Government borrowed stimulus packages which shelter the banks from losses whilst facilitating lower cost of funds and, by extension, increased margins for them. The pain of that is yet to be felt, but surely will. All I can say is the sooner business are allowed to return to normal, if indeed they can, the better.

Want to know more about the new Trusts Act?
We can help

Bright-Line Test - Update

The bright-line period (for taxing residential investment properties) is proposed to be reduced to 5 years for new builds, while other changes are afoot including introduction of rollover relief for changes in ownership that are merely technical and which do not change the substantive ownership of the property.

These proposals are contained in the Tax Bill introduced into Parliament on 8 September 2021 (which realistically will not be passed until Parliament resumes in the new year).

Application of the 5 year new build bright-line test is to apply to residential land acquired on or after 27 March 2021 if the land:

- Has a new build on it, and was acquired no later than 12 months after the code compliance certificate (CCC) was issued for the new build.
- Was acquired with an agreement in place for the construction of a new build (an off the plan purchase) or
- Has a new build constructed on it by the owner, and
- A new build is on the land when it is sold.

Once the Bill is passed, the bright-line period can be summarised as being 5 years for land acquired in the period from 29 March 2018 to 27 March 2021 and 10 years for land acquired on or after that date, other than for new builds for which the period is 5 years. The shorter period for new builds is intended to ensure the supply of new houses is not discouraged by the 10 year bright-line test.

An obvious question is for how long a property is considered a new build i.e. is a property only treated as a new build for a defined period and for the first owner of the property?

The Bill answers this question by providing that the new build exemption is to be made available indefinitely to persons who acquire the property within 12 months of the CCC being issued for the new build.

A second proposal in the Bill deals with the absence of relief from the bright-line test for 'internal' transfers, including for example, a transfer of property to your family trust. Under current law, doing so restarts the bright-line period.

Rollover relief is to become available in those circumstances provided there is a close connection between the transfer and the trust and that is very welcome. Disappointingly, however, the proposals will not extend rollover relief to distributions of residential property from the trust to a beneficiary. These continue to give rise to a disposal that will produce income for the trustees where the property does not attract the main home exemption and the bright-line test is not satisfied.

An additional proposed change will helpfully safeguard the main home from the bright-line test.

Where the main home comprises less than half the land, current rules deny an exemption from the bright-line test for the main home. The proposed amendments cure this problem by way of an apportionment test. That test will ensure that only the non-main home portion of the land will be taxed under the bright-line test. There is also a time apportionment rule that operates when a property is not used as the main home for more than 12 consecutive months. The time apportionment rule is unchanged and ensures that tax is paid on periods of non-main home use, for example, while the property is rented out.

Settlors of Trusts

Might becoming a settlor affect the trust in some way? Yes it might. Potential impacts are summarised below.

A common occurrence by which a person might become a settlor of a trust is creation of a current account in favour of that person as a beneficiary of an amount in excess of $25,000. Unless interest is charged on the current account (it often isn't), the beneficiary will be treated as a settlor of the trust for tax purposes.

Possibly, the greatest concern arising from a person becoming a settlor is where that person is a non NZ resident and he or she in some way contributes to the trust deriving foreign source income. This has potential to make the trust a non-complying trust (which carries 'bad' tax characteristics). This will occur wherever there is no other NZ resident settlor in the income year in which the trust derives the foreign sourced income, (unless a 'saving' election is made under section HC33; please contact me for more information about these elections if these circumstances apply to you).

A second matter to watch for is the impact of an additional settlor under the land taxing rules. A settlor is associated with the trust for tax purposes, hence this creates potential for a settlor who is him or herself a property developer to taint the trust and inadvertently bring the trust's land holdings within the tax net.

A further issue is whether the additional settlor might impact the proposed rollover relief against the bright-line test on transfer of a person's land to a family trust. That test requires a close connection between the person and the trust. The requisite 'closeness' may be disturbed where there emerges an additional settlor.

Trustees Beware

Very likely, a trustee would expect legal advice that he or she might choose to obtain in response to a beneficiary's challenge to a decision made by the trustee to remain confidential. How might a trustee feel on learning that there is no confidentiality for that advice and instead a copy of the legal advice received must be given to the very beneficiary with whom the trustees are in dispute?

A beneficiary's right to receive a copy of legal advice provided to trustees was confirmed earlier this year by the Supreme Court, to the surprise and consternation of many, in a decision called Lambie Trustees Ltd v Addleman. That case has attracted considerable attention and has probably already hit your radar. Nonetheless, to recap, it involved a dispute between two sisters who were each beneficiaries of a trust of which Lambie Trustees Ltd was the trustee. One of the sisters was Prudence Addleman (who pressed the trustees for information about the trust, hence the name given to the case).

Mrs Addleman received a payment from the trust, entirely out of the blue, of $4,257,000. This was paid to her as beneficiary of the trust, about which she knew nothing and had not even known that it existed. This amount was paid to her in "full and final settlement" of her interest in the trust.

Many people, I suppose, might have reacted with glee in response to such a sizeable windfall. But it seems Mrs Addleman did not. Instead she began a campaign of seeking more information about the trust, ultimately resulting in legal proceedings against the trustee's decisions to limit disclosure to her.

Underpinning the trustee's leaning towards non-disclosure in favour of Mrs Addleman was the trustee's viewpoint that the trust was established in large part to benefit Mrs Addleman's sister, Annette Jamieson. Much of the evidence appeared to support that, notably Ms Jamieson had suffered a tragic accident at a public swimming pool in Sydney when only 19 that had left her as a quadriplegic for the remainder of her life. Ms Jamieson had received approximately $1m in compensation from the local authority and that sum had been settled on the trust.

The court however was not satisfied that the trust entailed any preferment for Ms Jamieson and essentially treated the two sisters as having equal rights to the trust, at least as regards receiving information about the trust. Consequently, Mrs Addleman was held to be entitled to receive legal advice provided to the trustee relating to withholding trust information from her.

Trustees are well advised to factor this disclosure consequence in their thinking when faced with a challenge from a beneficiary. One solution might be to limit legal advice to oral advice only. Another might be to seek legal advice in the trustee's personal capacity and pay for it personally (it is not certain that, as this is untested territory, this would overcome the obligation of disclosure, but in my view likely it would). Another alternative, if possible, might be to arrange for a protector or special trust advisor to obtain the legal advice, though again there is no certainty again that even this would overcome the need for disclosure.

At the very least, trustee's awareness of this issue is crucial.

The CBL Collapse: The Loss of $747m

CBL went from a market capitalisation of $747m to total collapse. How did that happen and what is being done about it?

Details of the cause of the collapse are scant (at least publicly) and will likely remain screened from the public until one of the many sets of legal proceedings that the collapse has spawned gets underway (which, with additional COVID attributed delays, is not likely until 2023 at the earliest).

The collapse has triggered no fewer than 7 sets of legal proceedings (and I foresee potential for more). These are:

a) A claim by the liquidators against CBL's 6 directors seeking to recover $316m;

b) A claim by one group of shareholders who together hold about 14% of the shares in the company, (known as the Livingstone Class Action);

c) A claim backed by CBL's major institutional shareholders, known as the Harbour Class Action, funded by the Litigation Property Fund (LBF Group);

d) SFO charges against the former CEO and the former CFO (and also against a third person who has name suppression);

e) FMA civil proceedings around IPO disclosure;

f) A claim by the liquidators against PWC for $278m alleging that PWC, as actuary, failed in its duties to CBL (but note that PWC has subsequently succeeded in establishing a limit of liability to a multiple of its fees, under its terms and conditions, which will reduce this claim to a relatively small sum, indeed quite possibly the claim will be discontinued if it hasn't already been discontinued);

g) A claim by the liquidators against a CBL related company in Ireland for $91m under the voidable preference provisions in the Companies Act.

The multiplicity of these proceedings begs the question which goes first and whether any of them might be combined.

My own speculation is that the FMA proceedings will lead off. Other claimants will then have the benefit of evidence produced in those proceedings to assist their claims (or, if not helpful, to factor that evidence in their decision whether or not to proceed). It might seem trite that the 2 class actions ought to be combined. That is certainly possible, but not inevitable as it would present its own issues, for example which of the two groups is prioritised for returns. Also the Harbour Class Action is extended to the directors, as well as the company, whereas the Livingstone Class Action is not so extended.

While the cause of the collapse is not yet probably known, what we do know is that CBL listed on the NZX and ASX in 2015 and even at that time, the Reserve Bank was concerned about the adequacy of CBL's financial reserves to meet claims on building warranty insurance policies, both in New Zealand and in France. We also know that, out of concern on the part of the Reserve Bank about CBL's solvency, the Bank issued a direction requiring CBLI to consult with the Bank before entering into any transaction that involved the payment of $5m or more. Notwithstanding this direction CBLI made 6 payments totalling $55m to offshore parties contrary to the Bank's direction.

The CBL legal issues are not going away anytime soon. Inevitably they will present a fascinating combination of legal issues. Inevitably also, fascinating is not likely to be the description that any defendants choose to use about the proceedings.

Pandora Papers: NZ's Connection

The Pandora Papers reportedly comprise almost 12 million leaked documents revealing steps taken by the world's rich and famous to evade tax.

New Zealand foreign trusts appear to have played a significant part. Why?

The reason is that New Zealand's framework regarding foreign trusts is, in my view, fundamentally imbalanced in favour of overseas investors to the detriment of New Zealand's reputation as a robust tax nation. That imbalance facilitates establishment of a trust in New Zealand in such a way that investors from abroad may escape tax on their investment income altogether. New Zealand's tax rules do not interfere in that result because no New Zealand tax is avoided.

This tax setting lay at the heart of the Panama Papers scandal in 2016. Those papers resulted in scorn at New Zealand for having facilitated some of the activities that the papers exposed. Indeed, the Panamanian law firm that was at the heart of the scandal, Mossack Fonseca, allegedly bragged to their clients about the ease of compliance with New Zealand's foreign trust rules and their facilitation of the desired tax outcomes. This scorn led to the John Key led Government review of our foreign trust rules, undertaken by John Shewan from PWC. As recommended by Mr Shewan, the Government considerably revamped and improved the disclosure obligations. It was Mr Shewan's expectation and belief that introduction of the revamped disclosure obligations would achieve the purpose of denying use of the New Zealand foreign trust industry for illicit tax (and other) purposes. It was also Mr Shewan's belief that New Zealand did not need to take the additional step of removing tax exemption for foreign trusts established in New Zealand and indeed it would be wrong to do so, for it would almost certainly destroy New Zealand's foreign trust industry, and the legitimate estate and wealth planning practices they fulfilled.

Clearly, a balance was sought to be found between necessary steps consistent with New Zealand's international reputation and obligations in the global scene, on the one hand, and a step too far, on the other, to extend the scope of New Zealand's tax net beyond those appropriate and expected of it.

Hence, no steps were taken at the time to impose a tax liability on New Zealand foreign trusts on their foreign sourced earnings, absent distributions of those earnings to a New Zealand resident beneficiary (I say "at the time" because subsequently New Zealand introduced hybrid mismatch rules, that in some circumstances treat trusts as 'reverse hybrids', and impose on them a New Zealand tax exposure).

Featuring in all this too is the notion of 'protecting the settlor'. New Zealand of course has a widely regarded reputation as a country free of corruption. That reputation does not apply to all countries. For a wealthy individual in such a country, the payment of tax is regarded as a risky divulgement of information to corrupt officials that may lead to kidnapping (or worse) and ransom demands of that individual or his or her family. So, a legitimate stance underpinning New Zealand's foreign trust taxation rules is the assistance they offer to overseas persons who are exposed to those sort of risks.

Nonetheless, the balancing of these factors that dissuaded the John Key led Government from removing tax exemption for foreign trusts does in my view, require urgent review in light of the Pandora Papers. These papers (seemingly) suggest that New Zealand's improved disclosure rules do not go far enough.

So what should now be done?

One option is to remove the tax exemption for foreign trusts. Media commentary appears to support this. But to my mind that would over-step what is needed. Instead, in my view, we should restrict tax exemption available to a foreign trust to circumstances where its principal connection is to New Zealand.

My thinking is that New Zealand's willingness to extend tax relief to overseas investors carries with it an expectation that those investors will invest assets here and not use New Zealand as a mere pass through to suit a foreign investor's global purposes. Offering ourselves as a pass through makes New Zealand a cog (and an essential one) in a foreign investor's use of a tax haven. This does not make New Zealand itself a tax haven, but it does make New Zealand a participatory step in the use of one.

The expectation that an overseas investor will establish investment links to New Zealand via a foreign trust here (and not just use NZ as a pass through) can be met by limiting tax exemption for foreign trusts to circumstances where the majority of the trust's assets are in New Zealand (a principal NZ connection test). The legislation fix for this is easy. In a question of balance, this would deliver an appropriate balance between New Zealand's reputational issues whilst offering an incentive for investment in a New Zealand trust through the carrot of tax exemption for income sourced outside New Zealand (so long as the principal portion of the trust's assets are in New Zealand).

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