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FOREIGN TRUST DISCLOSURE RULES

A report was released late June following the Government's inquiry into New Zealand's foreign trust disclosure rules. The inquiry was a direct response to a perception that, as a result of the Panama Papers leakage, New Zealand is a tax haven and has "weak" laws around due diligence and reporting of foreign trusts.

The inquiry examined New Zealand foreign trust disclosure rules and reported on whether the rules and the enforcement of the rules are sufficient to ensure that New Zealand's reputation is maintained internationally.

The inquiry concluded that the current disclosure rules are "inadequate" and "not fit for purpose". It considered that strengthened disclosure requirements should act as a deterrent to offshore parties looking to use New Zealand foreign trusts for illicit purposes.

The recommendations included in the report are designed to achieve a balance between allowing foreign trusts to continue in New Zealand, while materially reducing the scope of foreign trust structures being used for hiding illegal funds or evading tax.

The recommendations include:

- Expanding required disclosure to Inland Revenue. The current rules require only the name of the New Zealand-based trustee and whether the settlor was resident in Australia. The proposed revised disclosures will require the name, email address, foreign residential address, country of tax residence, tax identification number of the settlors, trustees, protector, beneficiaries and any person effectively exercising control;
- Annual returns and financial statements to be provided to New Zealand Inland Revenue;
- A requirement to file the trust deed when registering a foreign trust;
- Imposition of a fee (proposed to be $270 per annum) to cover administration costs of the new regime;
- Maintaining a register of foreign trusts, searchable by regulatory agencies;
- Early application of New Zealand's Anti-Money Laundering ("AML") laws to lawyers and accountants. AML due diligence and reporting requirements to apply when they establish/administer New Zealand foreign trusts;
- Revising the legislation/regulations around reporting of suspicious financial transactions that do not go through a New Zealand bank.

The Government has announced that it will action all of the recommendations. There are modifications to some of the recommendations, such as the early application of AML to lawyers and accountants to be "as soon as practicably possible" (citing issues regarding legal privilege and regimes supervision that can only be dealt with by an Act, not regulation).

We expect a tax bill in August 2016 including incorporating the proposed changes to legislation.

IRD TO REVIEW "OBSOLETE" GST REGISTRATIONS

Inland Revenue have indicated they will review inactive GST registrations.

There is a concern that there are a number of persons who have registered for GST previously whose GST activity has ceased. Anecdotally we understand that there are potentially around 15,000 GST registrations that are inactive.

A consequence of GST de-registration is a requirement to pay GST on the market value of all assets held within the GST registration.

It is our view that Inland Revenue will likely focus their attention to GST registered owners of life-style blocks. We are aware that often a person acquiring a life-style block will seek to voluntarily register for GST to reduce the cost of entry. The issue arises where the GST activity ceases at a later point in time, resulting in a GST cost (as above), but the cost of the property has increased significantly and the person cannot afford to pay the GST on de-registration without disposing the property (or other valuable assets).

We expect to see formal communication in this regard in due course.

RESIDENTIAL LAND WITHOLDING TAX UPDATE

We have previously reported that a residential land withholding tax ("RLWT") is to be introduced to supplement the new "bright-line" land taxing provision. The RLWT provisions have been enacted and apply to sales on or after 1 July 2016.

Broadly, the bright-line provision requires income tax to be paid on any gains from the sale of residential property acquired after 1 October 2015 and sold within two years, subject to certain exclusions (such as the vendor's main home).

RLWT is required to be withheld where:

- The property being sold is residential land (as defined in the context of the bright-line provision) located in New Zealand;
- The vendor acquired the property on or after 1 October 2015 and has owned the property for less than two years before disposing of it;
- The sale amount is paid on or after 1 July 2016;
- The vendor is an offshore RLWT person (we note this is different to the definition of "offshore person" in the context of IRD number applications).

The definition of an offshore RLWT person is different for individuals, companies, partnerships and incorporated clubs and societies.

RLWT will not be required to be deducted when the vendor holds a certificate of exemption. A certificate of exemption can be obtained where the seller is an individual or trust and the property would be subject to the main home exclusion under the bright-line test. In addition, a certificate of exemption may be available where the seller carries on a business relating to land and has either provided acceptable security to Inland Revenue or has a good compliance history.

There is a prescribed form that needs to be completed as part of the sales process, "Residential land withholding tax declaration" (Form IR 1101), if the land was acquired on or after 1 October 2015.

The obligation to deduct RLWT primarily lies with the vendor's conveyancer or solicitor. If the vendor does not have one, this obligation will pass to the purchaser's conveyancer or solicitor. In the absence of either the obligation will fall on the purchaser. The RLWT must be paid by the 20th day of the following month.

In respect of the quantum of the withholding tax, the lowest of three calculations is applied:

- Sale price x 10%;
- Sale price minus purchase price the vendor originally paid for the property multiplied by the RLWT rate (being 28% for companies and incorporated societies and 33% for all other taxpayer's) or zero;
- Sale price minus any amounts required to cover any mortgage or other security with a New Zealand registered bank or licensed non-bank deposit taker against the property, and minus any outstanding local authority rates. N.B. the security amounts can only be deducted if the person responsible for paying the withholding tax is the vendor or vendor's solicitor.

A person who has sold land and had RLWT deducted can still file a New Zealand tax return and this would facilitate a refund of any excess tax withheld.

CASE LAW CORNER

Honk Land Trustees Ltd v CIR (deductibility of management fees)

Back in 2005, Honk Land Ltd ("HLL") who had tax losses "charged" a related trust (Honk Land Trust, "HLT") over $1m in "management fees". The High Court has recently upheld the TRA's decision that the management services were not in fact provided. Accordingly, the payment of the fee was not deductible because it was not linked to the earning of assessable income by HLT, or, if that was wrong, the charging of the fees amounted to tax avoidance.

The High Court found that there was no documentary or independent evidence to support that management services were in fact carried out by HLL for Honk Land Trust ("HLT"). A number of concerns were canvassed, including the significance of the management fee as compared to fees the company charged the trust.

The key points to take from this case are:

- Only charge for management services where another person has actually performed those services, they must be bona fide;
- Agree between the parties, before the event, that services will be charged for and what services will be provided (and to whom);
- Have written evidence, documented at the time of performance, that support the management services have been provided;
- Charge for the management services on a regular basis;
- Calculate the fee on a reasonable basis.

As an aside, please do not forget GST. We often see the payment of GST being inadvertently missed on supplies of management services between associated (or closely connected) persons.

Anzco Foods Ltd v CIR (depreciation on intangible property)

In this case the High Court considered the core elements of depreciable intangible property while coming to its decision. The High Court reminded taxpayers and their advisors of the need to carefully construe the terms of a transaction before assuming the tax outcomes.

The case concerned land which had been sold by a freezing works company, AFFCO, in 1999 subject to an encumbrance that restricted the purchaser from using the land for slaughter of livestock, meat processing or freezing for a period of 20 years from possession date. Further this encumbrance was to remain on the land regardless of whether the property was then on sold to another party.

In 2004 the purchaser sold the land to ANZCO, subject to the encumbrance. However ANZCO did not accept that they were bound by the terms of the encumbrance.

Upon acquisition ANZCO leased the land to Itoham to manufacture a variety of meat products. As a result, AFFCO sought to enforce the encumbrance. This resulted in the case being settled that ANZCO paid $5.6M to AFFCO so that the encumbrance can be removed for the purpose of meat processing and freezing.

ANZCO treated the removal of the encumbrance on the land as depreciable intangible property and therefore claimed deductions for the depreciation amounts in its tax return.

The Commissioner disagreed with this and disallowed the deduction for the following reasons:

- AFFCO had no actual right to use the land to convey to ANZCO;
- ANZCO did not acquire a right to use the land, rather the $5.6M was paid for the removal of a restriction on the right to use land, which was not legally the same thing;

- The "right to use land" does not extend to rights which form part of the fee simple estate (which was owned by ANZCO);
- For an intangible asset to be depreciable it must have a finite useful life that declines in value. The Court held there was no diminishment of the value of the right in the hands of ANZCO;
- The rights acquired did not have a finite lifespan but were inherent rights of ownership which continue to run with ANZCO's ownership of the land;
- The rights were inherent in the fee simple estate owned by ANZCO, so would not be expected to decline over time.

The key points to take from this case are:

- Do not accept at face value the terms or description used by parties;
- Land is not depreciable property and the release of a prohibition as to its use does not give rise to a separate entitlement to depreciate.

Queenstown Airport Corporation Ltd v CIR (depreciation)

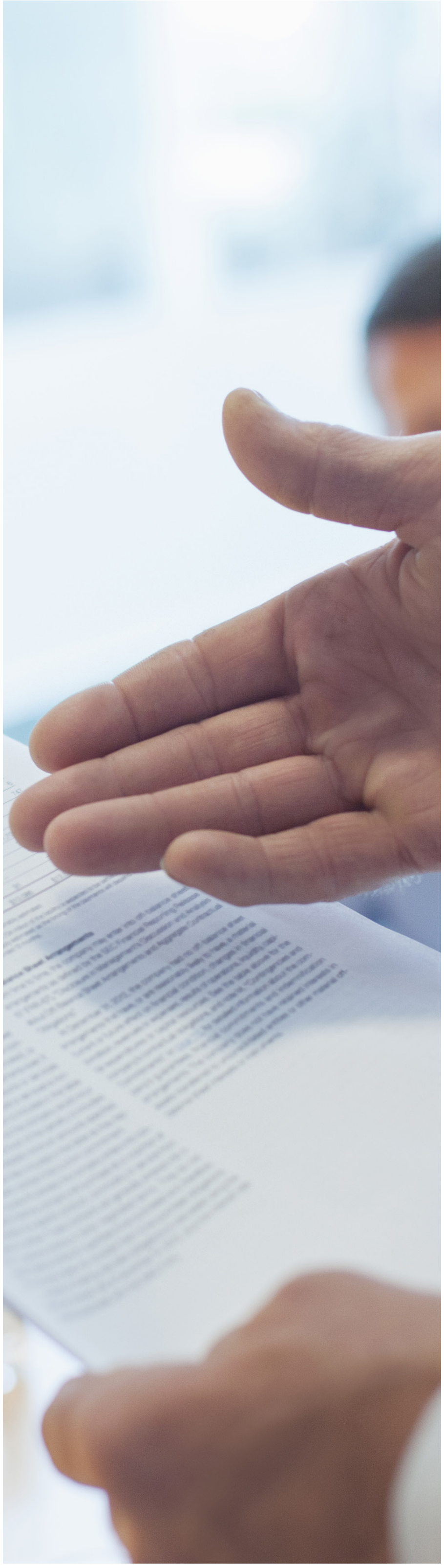
In this case the High Court confirmed the Commissioner's assessments in declining depreciation deductions for the cost of constructing an embankment and a runway end safety area ("RESA").

The case concerned an engineered fill embankment out from the existing cliff to provide a safety zone in the event of an incident during landing or take-off which results in an aircraft undershooting or overrunning the runway surface.

The Queenstown Airport Corporation Ltd ("QAC") claimed a depreciation deduction for the cost of construction of the embankment and RESA on the basis this was a depreciable land improvement. However the High Court confirmed that a depreciation deduction was not allowed on the basis that the embankment and RESA was land which is not a depreciable land improvement (as to be a depreciable land improvement it must be explicitly listed as such in legislation). Further the High Court accepted evidence that it was QAC's intention that the embankment would "stay in place forever". Hence having no fixed life, which is required for property to be depreciated.

The key points to take from this case are:

- A depreciable land improvement must be explicitly listed in legislation;
- For property to be classified as a depreciable asset it must have a finite useful life that declines in value and is subject to wear and tear.



"TAINTED CAPITAL GAINS" - WELCOME RELIEF

Under the current tax rules, a distribution of a capital gain by a company to its shareholders is taxable unless the distribution is made in the course of the liquidation of the company. However this exemption does not apply to capital gains arising in transactions with associated persons, except in limited circumstances where the associated person capital gain arises in the course of the liquidation of a close company (and the associated person is not a company). These gains are commonly referred to as "tainted capital gains".

Take the following example. Mum and dad operate a successful business through a company owned by them. Mum and dad decide to retire and the company sells the business to a company owned by their daughter and son in law, resulting in a $500,000 capital gain. This gain is not taxable to the company. However when the gain is distributed by the company, even on liquidation, mum and dad will be taxable on the $500,000.

Further, even if the capital gain arose in the course of the liquidation of the company the amount would remain taxable because the transaction resulting in the capital gain is with an associated company.

As a result commercially driven transactions and even normal family succession planning were seriously compromised, with transactions having to be carefully structured to ensure a tainted gain did not arise.

From a policy perspective it is difficult to justify the legislation as it stands. The original policy intent was to prevent companies creating artificial capital gains with related parties which could be distributed tax free without liquidating the company under the tax legislation as it stood prior to 1985 (instead of distributing revenue reserves).

Since then the legislation has been changed to tax the distribution of capital gains unless this was done on liquidation and, in our view, effectively making the tainted capital gains tax rules unnecessary.

Further the situation was aggravated when the somewhat narrow definition of "related person" was replaced with the extensive definition of "associated person" meaning far more transactions were caught by the rules.

Finally, the over reach of the tax rules relating to capital gains has been recognised, with the "tainting" being removed from almost all transactions. A Bill proposes a wide range of changes to the tainted capital gain rules. Inland Revenue is to be commended for driving this change.

The capital gains that remain affected are those between associated companies where:

- At the time of disposal, a group of persons holds in both the vendor and purchaser company a common voting or market value interest of 85%; and
- At the time of liquidating the vendor company there is effectively an 85% common voting or market value interest in both the vendor company and the company now owning the property.

Unlike the associated persons rules there is no proposed aggregation of shareholdings held by associated persons etc. So looking at the example above, as there is not an 85% common voting interest in each of the companies the first part of the requirement above has not been met. This means that the distribution of the $500,000 capital gain will not be taxable to mum and dad.

The proposed changes are to take effect from the date of enactment and apply to distributions made on or after that date. As a result the rules effectively apply retrospectively, i.e. if a company is currently sitting on a tainted capital gain, it may be distributed tax free on liquidation after that date (unless the transaction was with an 85% or more commonly owned company and the two companies are still 85% or more commonly owned).

BREXIT - A FOREIGN EXCHANGE CONUNDRUM

It is often a surprise to taxpayers that our legislation taxes unrealised foreign exchange gains (unless exemptions apply).

For example, let's assume James borrows GBP 300,000 to acquire a property in the South of England (Basildon, Essex). At the time of the borrowing assume the exchange rate was NZD 1 = GBP 0.50.

Based on this exchange rate, the NZD equivalent of the GBP 300,000 is NZD 600,000.

As we are aware the Brexit decision has caused shock waves around global financial markets and exchange rates alike. A consequence is that the GBP has weakened against the NZD and now, for the purposes of the example, assume 1 NZD buys GBP 0.55.

Restating the GBP 300,000 borrowing, the NZD equivalent is NZD 545,455. Under the current exchange rate, James now only needs to repay an equivalent of NZD 545,455 for the borrowings. He has made a gain of NZD 54,545. Albeit this gain is unrealised, it is taxable income (unless he qualifies for concessionary treatment) and should be considered in your tax planning programme.

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