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NEWSLETTER

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What is the cost of your fixed term debt?

The Reserve Bank of New Zealand uses the Official Cash Rate (OCR) to maintain price stability, i.e. to keep inflation between 1% and 3% over the medium term. Given the recent drop in the OCR (from 3.5% to 3.25%) and the potential for future reductions, it is timely to consider the benefits of changing the terms of your fixed term debt. For example, Bob fixed the mortgage on his rental property at 6.25% for three years. One year later, Bob's bank is offering a 4.95% two year fixed interest rate. Bob is eager to change his mortgage to the lower rate, so he sets up a meeting with his bank manager. At the meeting Bob is told that he can change interest rates but will be charged a $10,000 Break Fee. Why is Bob charged this fee?

A break fee is generally charged as compensation for the loss the bank will suffer if the interest derived from an existing loan reduces as a result of a switch to a lower rate. It is generally calculated on the difference in the bank's margin on the interest rates the borrower is moving between. For example, Bob borrowed $550,000 on a five year fixed term at 6.75% p.a. After three years Bob has $500,000 remaining on his home loan balance and wants to change interest rates to the better 4.95% on offer. Changing over to this interest rate would result in Bob's bank losing about $18,000 of interest income. As a consequence, the bank may look to negotiate a fee of say $10,000 with Bob if he remains with the bank as an ongoing customer.

As break fees can be significant, it is also important for Bob to know whether it can be deducted for tax purposes.

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Tax deductibility of break fees

In 2012 Inland Revenue issued three public binding rulings relating to the deductibility of break fees incurred by landlords:

- BR Pub 12/01 - break fee paid by a landlord to exit early from a fixed interest rate loan.
- BR Pub 12/02 - break fee paid by a landlord to vary the interest rate of an existing fixed interest rate loan (Bob's situation).
- BR Pub 12/03 - break fee paid by a landlord to exit early from a fixed interest rate loan on sale of rental property.

Inland Revenue broadly concludes that break fees on borrowings are deductible where a landlord has borrowed to buy a property from which rental income is derived (or to refinance another loan for that purpose). However the timing of the tax deduction will depend on the situation in which the break fees are incurred.

If the break fee is incurred to repay the loan early, then the break fee will be deductible when it is incurred. In Bob's situation, where the break fee is paid to vary the interest rate under the loan, it will depend on whether he is a cash basis person or not. Whether someone is a cash basis person is determined by the levels of debt and deposit arrangements to which they are a party. Cash basis Bob is able to deduct the amount of the break fee when it is incurred, unless he has chosen to adopt a spreading method, in which case it will be required to be spread over the term of the loan. Non-cash basis Bob will have to spread the fee over the term of the loan.

Whether or not to switch should be decided based on the cash flow cost to do so, the final negotiated fee with the Bank, whether interest rates are expected to increase or decrease and when the benefit of the tax deduction will be claimed.

The impact of 'dairy'

Fonterra's latest estimate of the dairy payout for the 2015/16 season is $3.85/kg milk solids. This comes off a record $8.40/kg for the 2013/2014 season. It is estimated the average dairy farmer needs $5.60/kg of milk solids to breakeven, so it goes without saying that financial upheaval is coming, but how significant and wide reaching will it be?

Despite the milk price dropping, it was a positive sign to see 126,063 people attend the 2015 National Agricultural Fieldays. That is over 6,000 more than last year. However, the true test will be what the revenue numbers will be for spending at the event. Last year, equipment sales of $369m occurred.

The extent of the impact is likely to go beyond discretionary commercial spending, on items such as infrastructure and new equipment, and extend to personal spending on items such as entertainment, transport and clothing. Rural communities across the country will feel the economic pressure. Banks will focus on highly indebted farmers, and some are likely to be forced to sell their farms. As the risk factor across the agricultural sector worsens, banks will adjust their margins across their wider lending portfolio (a means banks use to spread their risk) which could drive an increase in the cost of debt for all borrowers. The New Zealand exchange rate with the United States dollar has been consistently dropping over the past 18 months, in part being exacerbated by the drop in the diary pay-out, and this will cause the price of all imports to rise – private and commercial.

On the bright side, 'dairy' comprises 20 per cent of New Zealand's exports, so although it is material, it is not the only egg in New Zealand's basket. The remaining 80 per cent of exporters will enjoy the benefit of the lower New Zealand dollar. The tourism sector is also expected to grow as a result of the change in the exchange rate.

To survive, it is essential that all businesses that are reliant on the dairy industry ensure they are resilient and well prepared. Being proactive and talking to your banker and accountant early is key. Forecast cash flow and budgets should be reviewed and revised to ensure they are realistic. Further, methods for creating cost efficiencies should be implemented to ensure your business remains competitive…and survives.

Land – themes of change

There is currently significant public interest in the New Zealand housing market, whether it be issues relating to the Auckland 'bubble', property speculation, non-resident buyers, banking restrictions or a combination of these. In response, the Government is introducing a number of changes designed to either directly influence the market, or assist with decision making when

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deciding whether further changes are required. The key changes are summarised below.

Bright-line test

In the 2015 Budget the Government announced a new bright-line test that will apply to residential property acquired from 1 October 2015. The test will require income tax to be paid on any gains from the sale of residential property bought and sold within two years, with the exception of the 'family home', inherited property and property transferred in a relationship property settlement.

Inland Revenue has now released an issues paper setting out how the test might work and to ask for feedback on the finer details.

It is proposed that the two-year period will run from the date a purchase is registered on Landonline (Land Information New Zealand's online centre), and end on the date the person enters into a sale and purchase agreement.

Because of the risk (from the Government's perspective) that the new rules could apply at the height of Auckland's property bubble, the issues paper recommends that losses incurred on the sale of land should be ring-fenced and only able to be offset against profits from other land sales.

IRD numbers for purchase and sale of property

Buyers and sellers of residential property will be required to provide their IRD numbers at the time a property is transferred. Their IRD numbers will be included with the information submitted to Land Information New Zealand as part of the transaction process. There is an exclusion for New Zealand individuals purchasing or selling their main home (only one main home is allowed). But the exclusion doesn't apply to:

- someone selling their third main home in two years,
- trusts, or
- non-residents.

Where a person is currently a tax resident of another jurisdiction, they will also be required to provide their country of residence and their overseas equivalent of an IRD number.

This initiative is designed to provide the Government with better information regarding the volume of overseas buyers purchasing in New Zealand and improve Inland Revenue's ability to enforce income tax obligations and prevent tax evasion. Whilst the need for the change has merit, it will mean a large number of private Trusts that don't derive income will have to register with Inland Revenue and face annual compliance costs going forward.

Reserve Bank of NZ (RBNZ) Deposit changes

The RBNZ's deposit rules will change from 1 October 2015. Banks will be required to limit lending for residential property investment in Auckland at LVRs greater than 70% (i.e. a 30% deposit) to 2% of new lending. This initiative aims to promote financial stability by slowing down investor activity in the Auckland region.

For those outside Auckland, the minimum deposit requirement will remain at 20%, but instead of lending below this threshold being capped at 10%, it will be relaxed to allow 15% of new lending to have a deposit below 20%.

Trusts and shareholder continuity

New Zealand has one of the highest number of Trusts per capita in the world. One of their common uses is to act as shareholder of family operated companies. Despite this wide use of Trusts in corporate structures, it is surprising how often the tax consequences of changes to the Trust are not properly considered, such as a result of a divorce.

In order for a company to carry forward tax losses and imputation credits, certain levels of shareholder continuity must be maintained. The risk for a company with a Trust as its shareholder is that changes to the terms of a Trust Deed can result in a 'resettlement' of the Trust (akin to the termination of the old Trust and formation of a new Trust). The change could give rise to the transfer of shares to a new shareholder leading to the forfeiture of a company's losses and/or imputation credits.

There are no formal guidelines in New Zealand and a lack of commentary for determining whether a variation to a Trust Deed will lead to a resettlement, however guidance can be derived from Australian law.

The Australian Taxation Office (ATO) has released a Decision Impact Statement, which considers the Full Federal Court decision of *Commission of*

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Taxation v Clark & Anor (Clark), and sets out the ATO's view on when changes to the terms of a Trust Deed will result in a resettlement.

A previous Australian High Court decision had established the three main criteria for determining the continuity of a Trust were: the constitution of the Trust under which it operates, the Trust property, and the membership of the Trust. In Clark the following changes had been made:

- A change of trustee,
- A material change in who would benefit under the Trust,
- A change in Trust property,
- A number of changes associated with rights of indemnification between the old trustee and beneficiaries, and the new trustee,
- A discharge of liabilities, and
- A transition from a dormant Trust to an active Trust.

The Full Federal Court rejected the ATO's contention that the changes to the Trust resulted in 'substantial discontinuity' with respect to each of the criteria. The Court held that provided the Trust was amended under a power of amendment as set out in the Trust Deed, and the continuity of property of the Trust is established, then regardless of the changes there is no resettlement of the Trust.

Although the outcomes in Clark and the ATO's Decision Impact Statement are favourable, it is unclear how much weight Inland Revenue would place on them. Irrespective, it is important to consider the impact of any changes to a Trust's Deed, whether they will give rise to a resettlement of a Trust and the implications of a resettlement.

Deduction disallowed for management fee

The days of trading in your personal name are long gone. Whether trading occurs through a company or multiple companies, held by a Trust with a corporate trustee or multiple Trusts with multiple corporate trustees, either way, the utilisation of special purpose entities is common. Because of the common control that exists in these situations, it is all too easy for transactions between entities to be poorly documented. A recent Taxation Review Authority (TRA) decision reminds us all of the need to do better.

The TRA decision related to whether a taxpayer was entitled to a tax deduction for a management fee that had been charged by a related entity. The problem was that there was no evidence that management services had actually been provided and the deduction was disallowed.

The case, TRA 013/10, involved a dispute between Inland Revenue and Q Land Trustees Ltd (Trustee), the corporate trustee of the Q Land Trust (the Trust). During the 2005 income year, the Trust claimed a $1,116,000 deduction for management fees paid to Q Land Ltd (a company it indirectly owned). The management fee reduced the Trust's income to zero and was absorbed by the company's tax losses. Inland Revenue disallowed the deduction on the basis that it was not incurred in the derivation of gross income or, it was part of a tax avoidance arrangement.

The Trustee relied on the decision in *Lockwood Buildings Ltd V C of IR (1996) 17 NZTC 12,483* (Lockwood), which made it clear that an arbitrary allocation of management expenses is acceptable. In Lockwood a holding company took over the management services for its multiple subsidiary companies and received a combined management fee of $1,901,821. The High Court upheld the deduction for management services.

However, the TRA found the facts in Lockwood were distinguishable from the present case as the costs were clear and properly documented. This was in contrast to the Trustee's case where the fee was not fixed by reference to its costs but simply by reference to the Trust's total income and the charge could not be supported by any written management agreement, invoices or company resolutions.

The TRA ruled in favour of Inland Revenue, denying a deduction on the grounds that there was no sufficient connection between the fees and the carrying on of Q Land Ltd's business and there was no record that any management services were in fact supplied. This was despite the TRA acknowledging that the Trust required management services.

Not only was the $1,116,000 deduction denied, but the Court also ruled that it was a tax avoidance arrangement, lacking commercial reality. This decision was reached once the TRA had concluded it was not Parliament's intention for a company's loss to be transferred to a Trust, which was the effect of the management fee. The TRA stated that the management fee served no commercial purpose. A shortfall penalty of $184,000 was imposed for taking an abusive tax position (reduced by 50% for previous behaviour).

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This case brings about a strong reminder – transactions between commonly controlled entities should be approached no differently than if it was a transaction between third parties.

Snippets

Trustpower case

Inland Revenue has won an appeal against Trustpower involving the deductibility of feasibility expenditure. The Court of Appeal has ruled that $17.7m of costs incurred to investigate and apply for resource consents are non-deductible, even though the costs were incurred before any decision was made to proceed with the project for which they were being acquired.

The Court of Appeal concluded expenditure incurred on possible projects was for the purpose of extending, expanding, or altering Trustpower's business, and is not part of carrying on its ordinary business activities. On this basis, the expenditure is on capital account and not deductible.

The decision is of concern because it appears to result in all feasibility expenditure incurred to investigate potential capital projects being on capital account (and thus potentially 'black hole expenditure' if the project does not proceed). It is contrary to existing case law and Inland Revenue's own interpretation statement on the matter, which leaves the law in a state of confusion.

Trustpower is to appeal the decision to the Supreme Court, though it is unlikely the outcome will be known until the latter half of 2016. Given the current uncertainty it is hoped that Inland Revenue will issue its view and advice on the decision.

Tax inspectors without borders

A new initiative, dubbed "tax inspectors without borders" has been launched to help poor countries crack down on tax avoidance and fund their own development.

According to policy research group, Global Financial Integrity, nearly US$1 trillion is estimated to leave poor countries each year in illicit finance, stemming from tax evasion, crime and corruption.

To help developing countries stop these outflows, the "tax inspectors without borders" initiative will see experts from well-functioning states lend a hand to officials in poorer countries with carrying out audits to detect tax dodging; mainly by multinationals (a number of multinationals are using aggressive tax planning to reduce their tax bills, or avoid paying taxes altogether).

It is hard to imagine how such an initiative will play out given the dangers that exist in some developing countries around the globe – do we picture paramilitary types carrying calculators.

If you have any questions about the newsletter items, please contact me, I am here to help.

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