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In this LawBrief we cover a variety of tax issues that hopefully will be of interest to readers and their clients.

IRD Focusing on New Zealand Residents' Overseas Interests

You have probably seen in the Press that the IRD are upping the ante in contacting New Zealand residents holding foreign investments.

Clearly the IRD have the ability to identify New Zealand residents using foreign credit cards in New Zealand, as we have seen the IRD seek an explanation of such transactions via their risk review letters. Depending on what information is provided, this can result in a full audit of the taxpayer.

The latest target is New Zealand tax residents' interests in foreign superannuation and pension schemes. Many residents returning from a long stint working abroad, or new residents, will have such interests, especially those who hail from the UK and USA.

Such investments invariably give rise to potential New Zealand tax implications under the foreign investment fund (FIF) regime. There are exemptions – the Australian superfund exemptions, the 48 month transitional resident period, and the employment related and annuity exemptions from the FIF regime.

To analyse such policies from a tax perspective can be quite challenging, because if the policies are not subject to the FIF regime, the company or trust tax rules can apply, or the distributions can be taxed as an annuity or pension. Also, the rules contain some uncertainties, probably because they have not kept up with advances in the sophistication of overseas pension schemes, so we are finding that interests that might have been thought exempt may well now be caught as interests in a FIF.

Letters are being sent to taxpayers who the IRD suspect have such interests. We don't know how the IRD gather this information, but advisers need to analyse the investment from a New Zealand tax perspective to assess whether there is any default in returning income, and consider whether a voluntary disclosure is worthwhile.

Tax Treatment of Gold

From time to time we get asked to confirm the tax treatment for persons investing in gold bullion or gold coins. The answer can surprise: any gain made on sale will be taxable.

Clients will say to you that it is a long term investment and that it shouldn't be taxable.

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However, there is no return/income derived from gold except on sale. It's not like a rental property or share in a company where rental or dividend income is derived and the sale of the underlying asset can be treated as a capital and non taxable gain. As there is no income stream from gold, there must have been an intention of disposal at the time of acquisition.

Whilst gains would be assessable, correspondingly any losses should be deductible.

Deductible Interest and Renting the Family Home

Where your client has hatched a plan to buy a new house and keep the existing family home as a rental investment property, this provides an opportunity to ensure that any borrowing is related to the rental property so that the interest paid to the bank is tax deductible.

However, this has to be done the right way and in the correct order, otherwise your client can find themselves in the situation where the interest is not deductible as it relates to the new family home, or that the level of deductible interest is limited to the original amount borrowed on the former family home, which can be quite a lot less than the current value of the home.

In order to maximise interest deductions, the usual method is for the owners to sell the family home at market value to another entity which will conduct the rental activity. This entity would borrow from a bank and enable the vendors to use those funds to repay any private debt and finance the purchase of the new family home. Interest would be deductible as it is linked to earning the rental income.

If the individuals had instead kept the former family home (now rental property) in their own names, they would only be able to claim any existing mortgage interest as deductible. If they used the property as security for a new loan to finance the acquisition of the new home, the interest would be non deductible as it is interest incurred for private purposes, not for deriving assessable income.

Typically the purchasing entity would be a loss attributing qualifying company ("LAQC") so that any tax losses generated from the rental property could be directly attributed to the individual shareholders. The advantage over a trust is that a trust is not able to distribute tax losses to beneficiaries; they must stay in the trust.

LAQC's are no longer in existence from 1 April 2011. Look through companies (LTC's) are the replacement, and they have a different tax profile from LAQC's. For tax purposes they are transparent, so that the shareholder is treated as deriving the income/losses.

The issue that arises is whether the new LTC's can be used in the same way LAQC's were, resulting in deductible interest payments. Some commentators have taken the view that if the individuals were the shareholders in the LTC, a sale of a property by them to the LTC is,

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for tax purposes, a sale by the individuals to themselves of a property they already owned. Hence the funds have not been used to purchase the property which is to be rented. Instead the funds are used to finance the purchase of the new family home, and the interest is non deductible.

We disagreed with this view. The plain words of the legislation state that anything the LTC does is deemed to have been done by its owners. In our example, the LTC has borrowed funds to acquire the property to be rented and therefore the correct interpretation of the legislation is that the shareholders are deemed to have borrowed from the bank to acquire the rental property. This means interest deductions are available and the fact that the borrowed funds were ultimately used to repay private debt is irrelevant. Also, the fact that the property was purchased from the individual (who is also deemed to have acquired it) is also irrelevant. This view has been confirmed by Inland Revenue's Policy Advice Division.

LTC's can therefore be used in a similar way to an LAQC to maximize deductions for mortgage interest, although we must stress that there are many aspects to determining whether an LTC is an appropriate entity and careful consideration of all issues is required. For example:

- Are losses forecast – note there is no longer depreciation on buildings. If so, have you undertaken a loss limitation calculation?
- Have you considered the advantages and disadvantages of the LTC against the alternatives of a partnership, trust, company, sole traders, and QC (available in certain situations)?

nsaTax has been helping lawyers and accountants and their clients with these decisions to ensure all the relevant factors are taken into account – feel free to contact us.

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If you have any comments on this LawBrief or suggestions for future topics please contact Keith Turner on (09) 309 6505 or email keitht@nsatax.co.nz. Thank you

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