nsaTax
| Taxation and Trust Specialists |

TaxBrief

December 2017

Bright-line Test Gone Wrong

We have come across a recent example where the two year bright-line test relating to land sales has created an unexpected result, and reinforces why providing tax advice “on the hoof” is a dangerous sport to participate in.

The client was a partnership of two non-associated persons (A & B) that had acquired a residential rental property for $650,000 in 2013, well before the introduction of the two year bright-line test on 1 October 2015. Given the land had been held prior to 1 October 2015, the bright-line rule was never going to be an issue in relation to the eventual sale of the property by the partnership.

The partnership dissolved in December 2016 when Partner A sold their interest to Partner B. The agreed price was $450,000 reflecting the market value of Partner A’s 50% interest in the property at that time. As noted above, because the property had been owned since prior to 1 October 2015, there were no bright-line issues to consider for Partner A.

In February 2017, the tenant gave notice and Partner B decided residential rentals were not for him, so he decided to sell the property. In March 2017, Partner B negotiated a sale at $1,200,000 (after fees).

The question posed by the client was whether Partner B had a tax liability on the 50% interest purchased from Partner A and sold within four months. The “profit” on sale was $150,000 (sale price of 50% share $600,000 less cost of 50% share of $450,000). Unsurprisingly, the conclusion was that Partner B did in fact have a tax liability on the interest acquired from Partner A with a resulting tax liability of $49,500. Partner B wasn’t unhappy about this as he was expecting a tax liability having been forewarned by his accountant this was likely to be the outcome.

However, what came as a complete shock to Partner B was that they also had a tax liability on the other 50% interest in the property under the bright-line rule, despite the fact they had held that interest since 2013.

Under the partnership rules in Subpart HG of the Income Tax Act 2007, when a partnership is finally dissolved, there is a deemed sale of all partnership assets to a single notional third party at market value, and a corresponding deemed acquisition at market value. Accordingly, Partner B is deemed to have disposed of and then reacquired the property for $900,000 in December 2016 from an unrelated third party.

Consequently, when Partner B sold the property in March 2017 for $1,200,000, the bright-line rules applied to tax the entire profit because the property was sold within two years of the deemed acquisition date of December 2016. Therefore, Partner B had derived taxable income of $300,000 with a corresponding tax liability of $99,000.

We agreed with the client that this was both an illogical and inequitable outcome, but sadly there is not always logic or equity in tax…

Bob the Builder

In February 2015, the Government sought feedback on proposals to remedy long standing issues relating to debt remission as a result of the issue by IRD of a Questions We've Been Asked in October 2014 relating to tax avoidance and debt capitalisation. The media release was titled "Debt-remission consultation taxpayer friendly" and the Bob the Builder-esk essence of the release was "can we fix it? yes we can!"

The statement observed that "… this proposal will address a situation where over-taxation is taking place," and further "the Government is very keen to ensure fairness in the tax system".

Fast forward two and a half years, and a couple of attempts at getting the draft legislation right, and it turns out Bob the Builder may have fixed one leak, but this has caused other leaks to spring up as the following example demonstrates.

Company 1 ("Coy1") is owned 100% by an individual and is a successful trading business. Company 2 ("Coy2") is owned 100% by the individual's Family Trust but has traded unsuccessfully. Both are ordinary companies. Coy1 has lent $4m to Coy2 over a period of 5 years (2010 to 2014 inclusive), but Coy2 would only be able to repay $2.5m of this debt if its company was liquidated. The outlook for Coy2 was that its financial position was unlikely to improve over time i.e. it will never be in a position to repay the debt in full.

Because Coy1 and Coy2 are not 100% commonly owned, there is a requirement to charge interest on the loan to avoid a deemed dividend arising. Interest was duly charged on an annual basis with Coy2 taking a tax deduction for interest charged. Coy1 returned the interest as income but each year claimed a bad debt deduction for the interest in recognition that Coy2 is unable to pay it. For the purposes of this article, let's assume that interest amounted to $750k.

In late 2014, advice was sought with a view to restructuring ownership of the companies to avoid the need to charge interest on the intercompany loan. Based on that advice, Coy1 acquired all of the shares in Coy2 so that they formed part of a wholly owned group. From that point on, no interest needed to be charged on the intercompany loan.

The 2014 advice took into account the potential liquidation of Coy2 at some point in the future. On liquidation, the plan of attack would have been to simply let Coy2 fold once it has repaid as much of the debt as it could. Coy2 would have been left with $1.5m of debt it could not repay together with $750k of accrued but unpaid interest. Under tax law at the time, the unpaid interest and principal would result in financial arrangement income of $2.25m. Coy2 would likely have had tax losses to shelter this income but even if it didn't, on liquidation the company disappears and there is no one left standing to pay the tax.

Coy1 on the other hand suffers a non-deductible capital loss in terms of the unpaid principal and the unpaid interest had already been "reversed" through bad debt deductions so it would be in a net nil position.

That's pretty good advice, right? Well it was until our friends in IRD Policy came along with their "can we fix it, yes we can" attitude. IRD policy say they want to "ensure fairness in the tax system" so they "tweaked" the legislation to fix a problem with look-through companies and partnerships by introducing a new section EW 46C.

The effect of the law change is that when Coy2 is eventually liquidated, section EW 46C kicks in and deems the total outstanding balance of the debt to have been repaid, including the accrued but unpaid interest.

For Coy2, this means there is no longer any financial arrangement income arising because it is deemed to have repaid its debts in full. Instead, it is sitting with a bunch of unutilised tax losses.

Coy1 is deemed to have received the full principal as well as the accrued but unpaid interest. Coy1 therefore derives interest income of $750k which is effectively a claw back of the bad debt deductions it previously claimed. Consequently, Coy1 has a $210k tax liability on an income amount it will never receive.

Ouch! Good one Bob!

The Government was commended for taking steps to resolve the long standing issue with debt remission and transparent entities (LTC's and partnerships), however, in doing so, it has created a liability where one previously did not exist which is far from ideal. Whilst the above scenario is somewhat unique in terms of its factual background (and we have spared you all of the gory details like why Coy1 & Coy2 can't undertake loss offsets/subventions), it will not be the only situation where these rules result in an undesirable and unexpected outcome.

The recent changes are not the panacea we were hoping for, and as demonstrated above, can upset previous prudent tax planning.

On the plus side, but of no assistance in the above example, the rules do provide scope to mitigate tax liabilities and in another recent example, financial arrangement income under the new proportional debt remission rules of some $1.3m was able to be reduced to $300k with a bit of magic wand waving by nsaTax, but that's a story for another day.

2017 in Review

It's been a big year here at nsaTax. We have seen a number of staff changes in the last 12 or so months with a few of our long serving staff moving on to greener pastures (Keith Turner, Lisa Murphy and Tim Chemaly), but we have managed to replace them with some equally capable staff in Maggie Jaques and MaryAnne Anderson, with another tax specialist starting with us in the New Year (but exactly who that is, is top secret right now).

We are well settled into our new and modern premises on the corner of Crummer Rd and Vinegar Lane in Ponsonby, and the locality to amenities, shops and the odd pub/restaurant is proving to be a hit with everyone. It's just a shame the parking around here is so diabolical but that said, we now have access to two offsite client carparks.

We've had a great year when it comes to dealing with IRD disputes with some massive wins such as:

1. A long running (7.5 year) dispute on the availability of $3.5m of imputation credits dating back to a supposed forfeiture on the death of a shareholder in 1997 (yes you read right),

2. A binding ruling application (and ensuing "dispute") regarding the tax status of transferrable development rights sold in bulk (tax at stake was around $2.25m),

3. Arguing the recharacterisation of a "management fee" to reflect the legal form being in part interest and in part a share of partnership profits, saving close to $5m in GST for the client,

4. Successfully arguing that a new resident who had applied for working for family tax credits was not precluded from being treated as a transitional resident, despite the clear wording in the Act. Foreign sourced income in the vicinity of $1m per annum would otherwise have been taxable in NZ rather than exempt from tax, saving the client around $1.3m in tax.

We have also had wins for clients that were massive for them despite the tax at stake being a little more modest, including:

1. Convincing IRD to cease pursuing a $200k GST liability. Our client had claimed GST charged to it when the supply should potentially have been zero rated. IRD sought repayment of the GST leaving our client to pursue the supplier for the overpayment. However, the client was unable to recover the GST from the supplier as the supplier had been liquidated potentially resulting in a windfall gain to IRD at our client's expense.

2. A big win on oft forgotten time bar issues. The client was subject to an IRD audit which had been ongoing for some time before nsaTax got involved. The dispute had come to a head because the client had conceded to IRD that they had claimed deductions over a period of years for expenditure they weren't entitled to. The client had already signed one time bar waiver and had another two dropped on them along with an instruction effectively to "sign or else…".

   As it turned out, the time bar waiver the client signed was for a period that was already time barred so was effectively invalid, and the other two were for periods which IRD were too late to start the dispute process i.e. the time bar period hadn't passed but the IRD didn't have enough time to get through the formal dispute process and issue an assessment before the time bar period passed.

   After a bit of argy-bargy, IRD conceded and the client was very happy to call the bank and advise them he no longer needed the $200k loan he had recently applied for!

Christmas/New Year Hours

This year, our offices will close on Thursday 21 December at 2pm and will reopen on Monday 15 January 2018. Not everyone is back then, but we should be close to having our full complement of staff back the following week.

We trust your year has been as good as ours - we are all looking forward to a well-earned rest over the Christmas/New Year break. Thank you for your continued support and we look forward to doing it all again next year.

From the Team at nsaTax, Merry Christmas and Happy New Year! Enjoy your break, and safe travels.