NEWSLETTER

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Tax consequences of Death & Distributions

The tax consequences of the death of an individual have been an area fraught with difficulties. The current law is unclear and there have been repeated calls for reform. The preferred treatment currently adopted by practitioners does not necessarily coincide with IRD's interpretation of the law – and this has sometimes resulted in estates having to deal with unexpected tax bills. This has not been satisfactory, and there is finally some resolution to the problem.

An announcement was made on 1 July 2004 by Dr Cullen, to clarify the income tax rules on transfers of assets at death. The rules are intended to add greater certainty and consistency, and to provide a uniform income tax treatment for the asset transfers. These rules are also intended to apply to "in kind" distributions from trusts and companies. The three main proposals are:

- A disposal and acquisition of a taxpayer's assets and liabilities will be deemed to occur at market value, on the date of his or her death.
- "In kind" distributions of assets by companies and trusts (including estates) will be treated as dispositions and acquisitions at market value.
- Gifts will be treated in the same way as "in kind" distributions.

These rules will take effect from the date they become law. While the effect of some of these rules may not be advantageous to the taxpayer, at least there will be certainty in terms of the tax treatment.

Australian Unit Trusts Loophole to be closed

Legislation will be introduced to close a loophole that currently allows New Zealand investors who invest in Australian unit trusts to pay minimal tax. Where the Australian unit trusts make distributions to New Zealand investors these distributions will usually be taxable as foreign dividends. If the unit trust does not make a distribution but issues bonus units instead, these are not usually taxable to the New Zealand investor. At present, New Zealand beneficiaries of offshore unit trusts (commonly Australian unit trusts) can avoid paying tax on dividends by agreeing, in advance, to have amounts payable to them reinvested in new units. These new units can then be distributed as a tax-free bonus issue of new units. This is considered unfair, as identical investments in New Zealand are usually subject to income tax.

The proposed legislation will change the definition of what constitutes a "taxable" bonus issue in relation to unit trusts. An investor who receives a bonus issue of units will be taxable on that receipt.

Effectively, this also creates a capital gains type tax and will affect both domestic and foreign unit trust investments. The differences in the unit trust investments will be ignored. For example, if the unit trust makes a capital gain, that gain is not taxable to the trust. But if units are issued to investors out of this gain, that issue will be taxable to investors without any imputation credits being attached. Although the changes were implemented mainly for New Zealand investments in Australian unit trusts, they will also apply to New Zealand investments in other jurisdictions.

Under the current rules, tax treatment of different investments can change according to a number of factors, which makes it difficult to assess various savings options for investors. Because of the disparities involved in these options the government has indicated that it will be reviewing the whole area of offshore and domestic savings.

The amendment will be considered as part of the Venture Capital Tax Bill that will be reviewed by Parliament later in the year, and will apply from the date of enactment.

Split & Flexi Loan Facilities

A recent High Court case in Australia decided that a split loan facility used for a rental property investment and for a home loan was primarily entered into for the purpose of obtaining a tax benefit. Although, the case was decided in Australia it highlights the importance of exercising caution if using a split loan facility.

The split loan facility obtained by the taxpayers enabled them to borrow one amount and split it into two accounts. The two accounts were their home loan account and an investment loan account for their rental property. They could then make repayments exclusively to their home loan account. This allowed them to deduct all interest continuing to accrue on their investment loan account while allowing their home loan to be paid off earlier.

The Court concluded that the structure of the loan was to optimise wealth, and was dependent entirely on the tax benefits that were derived. It indicated that this was not because of the general deductibility of the interest, but was because of the deductibility of the additional interest on the investment loan as a result of the repayments being made exclusively to the home loan. A similar rationale is likely to apply in New Zealand.

This decision highlights that if a split loan facility is used for a business or investment purpose as well as for personal reasons, care will need to be taken to ensure that the actions involved in running the facility do not amount to a ‘scheme’ or a tax avoidance arrangement. In addition, it should be able to be shown that there is a clear commercial purpose for the way the loan account is set up and managed.

In New Zealand, banks have been encouraging their clients to have “revolving credit” or “flexi-mortgages”, as a means to reduce interest costs.

While there may be an ultimate saving on interest, difficulties arise if the mortgage funds are used for both business and private purposes.

There would need to be an apportionment of the interest cost between the deductible business portion and the non-deductible private portion – and this may not be an easy exercise! Also, if a loan is initially used for business purposes and repaid, then used for private purposes, the interest ceases to be deductible.

Therefore, unless the interest savings are significant, it may not be worth the cost of having to separate the business v private portions of the mortgage.

Withdrawing from your Business

According to a recent Ministry of Economic Development report, 86% of NZ businesses comprise five or fewer full time employees. We suspect a significant proportion of these are ‘family owned’ businesses where another generation of the family is, or will be in the future, a key player in the business.

With any change in ownership there are a number of issues to consider. The involvement of family, if not managed well, can complicate matters. Assuming the issues relating to succession and hand over of business management can be worked through, it is common for the retiring person to want to retain an interest in the business, and seek a continued entitlement to claim certain tax deductions, as they have always done.

Typical problem areas include, but are not limited to, expenses (which we will refer to as “standardised deductions”) for the following:

Telephone expenses – 50% for domestic line rental, 100% for a separate business line.

Vehicle running – up to 25% allowed with no logbook.
Subscriptions – depending on type usually 100% allowed.
Home office use allowance – based on exclusive area set aside.

How each is treated will depend on the level and type of ownership retained and the extent of the retiree’s involvement.

Where the retiring person provides vendor finance, charges interest thereon and does not retain an ownership interest, it will not be possible to justify any claims relating to the above expenses. Vendor finance is usually regarded as a passive investment (unless the person is in the business of lending), similar to having funds on term deposit.

To qualify for a tax deduction, the expenses need to be directly related to the earning of the income (interest). Generally, it will not be possible to show a direct link between the expenses referred to above and the interest income.

Where an ownership interest is retained, the extent to which the “standardised deductions" can be claimed will depend on the circumstances. The "standardised deductions" are usually claimable by people who are in business full time. If the retiree's involvement is less than full time then this may need to be reflected in the claims made. For instance, the home office may no longer be for this exclusive purpose. It may also be used as a spare room. If depreciation has been claimed as part of the home office allowance this may need to be recovered or the claim adjusted depending on the circumstances.

The above is an illustration and each situation will depend on its own circumstances. If you are considering withdrawing, or changing your level of involvement, in the business, be aware that your entitlement to certain deductions may also change.

Little Snippets

Venture Capital Tax Bill

The Venture Capital Tax Bill was introduced into Parliament on 29 March 2004. The Bill contains measures aimed at removing barriers that currently discourage investors from investing in New Zealand, in particular by:

- Providing assistance to companies seeking venture capital investment by removing tax barriers to enable access to foreign venture capital. This amendment proposes to assist non-resident investors by excluding gains from income tax on the value of the shares in unlisted resident companies.

- Proposed amendments to allow partners in a special partnership to offset losses from the special partnership against other income. In addition, to remove the requirement to re-register a special partnership every 7 years. While this is aimed at foreign venture capitalists, this could be a worthwhile and cost-effective avenue to explore for potential ventures expecting start up losses.

The Bill will be reviewed by Parliament later in the year.

If you have any questions about the newsletter items please contact us, we're here to help.

Property Developers Rental Adjustments for GST Purposes

A High Court decision on 14 May 2004 has confirmed that property developers who rent out residential properties pending their sale have to make adjustments only on certain costs related to the rental activity. No adjustments need to be made on the costs incurred while the property was vacant.

Properties let for the principal purpose of residential accommodation are exempt supplies for GST purposes. However, if the purchase of the property was for the principal purpose of property development and was subsequently rented out for domestic purposes prior to sale, a GST adjustment would need to be made. The GST adjustment to be paid back is the lower of the GST component of the cost or open market value of the provision of the rental accommodation.

The Court agreed with the taxpayer and held that the principal purpose and subsequent purpose co-exist with each other and that depreciation was the only unique cost relating to the provision of the rental accommodation. The Court also agreed with the taxpayers that they were entitled to offset the GST adjustments paid back for the residential rental, when the property was sold, even though the adjustments were "period by period" and not "one off".