SPEAKMAN LAW

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What's inside

- Essential Contract Terms
- Financial Reporting Obligations
- Trust Law Reforms
- Tax Measures Targeting Multi-Nationals
- Tightened Transfer Pricing Rules
- Interest Limitation (Thin Capitalisation) Rules

Briefly - sport

- Dan Carter enjoying his time off the field
- Super Rugby – nothing super about Blues v Highlanders game – which two teams to be axed next year?
- England share NZ rugby record of 18 top tier wins; Ireland next (all without facing ABs)
- Michael Hendry, first home grown winner of NZ Golf Open for 14 years
- Kane Williamson becomes only 3rd NZ batsman to score 2 test centuries against SA (bottle of wine to first to name the others)

Briefly – Law/Special Interest

- New Employment Contract Legislation; changes to many employment contracts required
- Changes to the Enduring Power of Attorney
- Taxpayer suffers $18m tax assessment under promoter penalties
- Financial markets conduct guide released
- New rules re retentions under construction contracts; cash to be set aside or covered by bond

Another day, another Trump gaffe it seems. Bit like Prince Philip. Good to know that our everyday home appliances can have cameras inserted into them for surveillance purposes. Reminds me of George Orwell's 1984 (great book, you gotta love it, its true… as Trump would say). See the Netherland's response to Trump's America First policy (just Google it), guaranteed to give you a laugh. An apt Led Zeppelin lyric in light of all this (bottle of wine to the first to name the song, congratulations to Andrew Dickeson last time).

"In the days of my youth I was told what it was to be a man
Now I've reached the age I've tried to do all those things the best I can
No matter how I try I find my way to do the same old jam"

Back home there is a ton of law reform going on, a rewrite of our trust laws, rewrite of contract and commercial legislation, new financial markets guidelines and of course major tax reforms particularly for close companies and new disclosure rules for foreign trusts. Read on and enjoy!

Essential Contract Terms…

Although every contract is unique there are some terms that should not be forgotten. Key terms to include in most contracts are:

- Indemnification/limitation of liability. Suppliers and customers are at different ends of the spectrum here. Suppliers wish to limit their liability, perhaps to the contract price of the goods supplied or a multiple of it. Customers wish to be indemnified for their loss. Where a supplier accedes to the customer's wishes, the parties need to address the scope of the indemnity and whether it extends only to direct losses or also to indirect and consequential losses. If these are to be included then some limitation of aggregate liability is highly recommended as these losses can be open ended, eg loss of business opportunities, though there is the difficulty of establishing damage for such losses.

- Insurance – often in supply contracts, public liability insurance is required. However, it is really up to each party to ensure that their position is adequately insured.

- Assignability – is the contract to be capable of assignment? The right to do so will become pivotally important upon a sale of the business as the purchaser will invariably want to assume the benefit of all business contracts.

- Remedies – these should be clearly spelt out. Often cancellation is not a desired outcome. In those circumstances other remedies need to be considered and included, for example liquidated damages or buy out rights.

- Costs – who is to pay for preparation of the contract or enforcement of it?

- Constitutions versus Shareholders Agreements – is it necessary to have both? What happens if the terms in one conflict with terms in the other? A conflict of terms clause is required to overcome this; usual practice is for a shareholders agreement to prevail over terms in a company's constitution. As for which of the two (a constitution or a shareholders agreement) is preferable, I will save that for a later newsletter.

- Governing law – when dealing with an overseas party, don't forget to specify NZ law as the governing law. If dealing with a party in another part of the country, specify where any dispute is to be heard (Auckland High Court, for example).

Financial Reporting Obligations…

Thresholds apply each year to determine whether companies are required to file financial statements. Most companies are only required to do so if they are "large" or have 10 or more shareholders and have not opted out of compliance.

This begs the question what is meant by "large" for these purposes.

A New Zealand owned company meets the "large" criteria if:

- As at the balance date of each of the two preceding accounting periods, its assets exceed $60m; or

- In each of the two preceding accounting periods, the total revenue of the company exceeds $30m.

Companies that are foreign owned meet the "large" criteria where their assets exceed $20m or their revenue exceeds $10m, over the 2 year measurement period.

These thresholds do not apply to "FMC reporting entities", being entities governed by the Financial Markets Conduct Act (ie financial service providers), or to public entities.

I recently struck a case of a company falling below the income threshold one year and exceeding it the next 2 years thereby triggering the filing requirement, suffering penalties for inadvertent non-compliance. As this example shows, it is necessary to remain conscious of these thresholds; no obligation to file in one year does not determine the result for the following year. Remain vigilant.

Trust Law Reforms…

The long awaited trust law reforms have now progressed to the stage of a draft bill. These reforms flow from the lengthy Law Commission reporting in 2013 and for the most part adopt the recommendations there.

The most significant aspects of the Bill, to me, are the adoption of mandatory and default duties. The mandatory duties are those that must be performed and cannot be modified or excluded by the trust deed. Trust advisers must take note that they will be required to explain these mandatory duties to their clients.

Default duties are key trustee duties recognised by the courts over the last few centuries; these can be modified by the trust deed.

A standard of care is to be adopted, ie when exercising a power of administration, a trustee must exercise such care and skill as is reasonable in the circumstances, taking into account any special knowledge or experience that the trustee has. This can be excluded by express provision in the trust deed.

Further changes of note are an obligation on trustees to make disclosure to beneficiaries of certain information and express power for a beneficiary to review actions of a trustee in the court.

The changes all make good sense to me. Users of trusts will be better placed; advisers of trusts on the other hand have plenty of up skilling to do to learn the new rules.

Tax Measures Targeting Multi-Nationals…

Focus has been strong on the tax take (or rather the lack of) from multi-nationals. Last year the Herald reported that the top 20 multi-nationals in New Zealand paid less than $2m tax on almost $10 billion revenue here (2014 figures). Had their effective tax rate in New Zealand mirrored that in their home country, the tax take would have been about $490m.

This reflects first principles in international tax planning namely to minimise the amount of tax paid in the foreign country (from the perspective of wherever their head office is located). This limits tax slippage through restrictions in availability of tax credits at home for tax paid abroad. It also reflects first principles in international tax planning of localising the IP ownership rights in a low tax country/tax haven. Google does this, for example, with the result that returns attributable to its brand attract low tax rates.

International focus to counter these results has led to far stronger information gathering and sharing amongst tax authorities around the world (including NZ). It has led to adoption of a "diverted tax" in Australia and UK which automatically taxes resident companies on the differential between their reported taxable income and what it "should" be. Taking NZ as an example, if we had in place a diverted tax in 2014, additional tax of $490m would have been collected, all other things being equal.

New Zealand is not proposing to introduce a diverted tax regime. Instead, the response here has been to tighten information gathering powers (including new and extensive reporting by foreign trusts), target withholding taxes on related party debt financing, and address cross border hybrid mismatch arrangements (which, for example, create a tax deduction in New Zealand with no corresponding tax payable on the other side – convertible notes do this).

The most recent announcements from the Government are to introduce two further stringent measures, namely to tighten our thin capitalisation rules and our transfer pricing rules. I discuss these measures in the separate sections below.

Tightened Transfer Pricing Rules…

These counter two tax minimisation strategies, namely transfer pricing and permanent establishment avoidance (TP and PE avoidance).

Transfer pricing essentially lowers the taxable income in New Zealand by lowering margins here. That is either done by head office (somewhere overseas) charging above market costs for goods supplied to New Zealand and sold here or charging above market rates of interest on loans to its NZ operations.

New Zealand's transfer pricing rules are to be strengthened so that they disregard legal form (ie what the documents say) where it does not align with the actual economic substance of the transaction. They will also be strengthened by allowing arm's length conditions to be substituted in cases where independent parties would not realistically have entered into contract terms.

These changes recognise that our existing transfer pricing legislation is 22 years old and don't reflect commercial arrangements in place now. The proposed new economic substance test (empowering the IRD to supplant economic substance for what has happened legally) will go a long way to redressing this.

Other notable changes are firstly, to shift the burden of proof for demonstrating that the actual conditions align with arm's length conditions from the Commissioner to the taxpayer. Secondly, the time bar for transfer pricing issues will be increased to 7 years (from 4 years). Both of these are significant changes.

The other major measure being introduced in these respects (to counter PE avoidance) requires some tax understanding. Overseas enterprises are generally only taxed in New Zealand on their business profits where those profits are attributable to a significant base here, referred to as a permanent establishment. PE avoidance entails overcoming any obligation to pay tax in New Zealand on business profits by ensuring the operation has no base (permanent establishment) here.

An example of this PE avoidance follows. Assume a multi-national has a subsidiary here in New Zealand. The NZ subsidiary undertakes all marketing and administrative activities to effect and record sales in NZ but it does not itself contract with consumers. Instead, once the NZ subsidiary has a consumer on the

hook it notifies its overseas parent who then enters into a contract of supply of goods directly with the consumer and invoices the consumer directly following delivery of the goods directly to the consumer.

In this example, the NZ subsidiary can be expected to receive only a fee for its marketing and administrative function. In truth, however, it has arranged the sale and ought to be rewarded as such. The proposed new measures will result in the non-resident being treated as having a permanent establishment in NZ in these circumstances. Accordingly, the entire margin on sale of the goods will be taxable here in this example.

This rule will only apply to large multi-nationals, being those that have over Euro750m global turnover.

New administrative rules are being introduced to assist Inland Revenue to investigate large multi-nationals. These include introduction of rules to default assess large multi-nationals who fail to provide requested information. Worse, where the multi-national is branded non-compliant. Where that occurs, payment of tax in dispute can be demanded up front.

These measures align with those being introduced internationally and are welcomed.

Interest Limitation (Thin Capitalisation) Rules…

In tandem with the proposals discussed earlier in this newsletter, it is proposed to tighten the rules that permit interest deductions for NZ borrowers on related party debt. Existing thin capitalisation rules deny a NZ borrower an interest deduction to the extent that the NZ borrower's debt exceeds the legislated debt/equity threshold. That threshold is 60%, having been reduced from 75% in 2011.

What these rules fail to counter is borrowing arrangements at inflated rates of interest. It is all very well limiting deductions by reference to the NZ borrower's debt/equity ratio. That achieves little unless the amount of interest is also addressed.

These new measures will do just that. They recognise that our transfer pricing rules have at times been ineffective to counter above market rates of borrowing from related parties. The rates have been manipulated by subordinating debt, the absence of security and uncommercial terms which matter little between related parties but which justify a higher interest rate, and thereby enhanced interest deductions in NZ. Transfer pricing rules have been thwarted by these sorts of manipulations.

To counter this, it is proposed to introduce an interest rate cap. This will apply to related party cross border loans only. It will be based on the ultimate parent's cost of funds (where available). There is also to be a non-debt liability adjustment. Presently, our thin capitalisation rules are based on an enterprise's debt to asset ratio with assets simply being "gross assets" taken from the enterprise's financial statements. "Debt" is limited to interest bearing debt.

It is proposed to make a significant change here; the debt/equity ratio is to be calculated with reference to an enterprise's assets net of its non-debt liabilities. Examples are trade credit and interest free loans.

Other proposals include introducing de minimis rules and a carve out from the rules for infrastructure projects financed with third party non-recourse debt.

As with the proposed tightening of the transfer pricing rules, these changes are welcomed.

Our Website…

Read our newsletters online at www.speakmanlaw.co.nz.

Come visit…

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