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Qualifying Companies & Liquidation

We have recently seen examples where IRD have assessed shareholders in qualifying companies ("QC") for tax on remission income arising from the liquidation of the company.

If a company is released from its obligation to pay creditors for which tax deductions have been taken, remission income arises under section CG 2 of the Income Tax Act 2004 in the year in which the remission occurs.

Note that under the equivalent provision section CE 4 of the 1994 Act, income arose in the year the deduction was originally claimed.

Remission income can also arise in respect of financial arrangements which are not repaid. The income arises under the base price adjustment which is performed when the company is released from making all remaining payments under the arrangement.

Remember that shareholders in a QC are personally liable for their proportionate share of any income tax payable by the company while it is a QC.

When a QC is facing liquidation, consideration needs to be given as to whether QC elections should be revoked. There may be difficulty revoking elections once a liquidator has been appointed so advisers should be considering this issue ahead of any liquidation.

Graeme Carruthers

Seminars

Our new round of seminars are scheduled to run over October and November.

They are being held in Auckland, Milford, Tauranga, Hamilton and now in Taupo.

The dates and topics will be available on our website within the next two weeks so keep an eye out for these. Alternatively, please e-mail seminars@nsatax.co.nz to be added to our seminar distribution list.

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Trusts & Beneficiaries Debts to Inland Revenue

It is accepted by Inland Revenue that where a trust owns the family home the Department cannot force the trustees of the trust to sell that home to meet any debt owing by beneficiaries.

The Department's current attitude is that in many trust structures beneficiaries do have some degree of influence over trustees of their trusts to either sell the property or to provide funds to pay debts. Where the Department feels this is the case, while they accept that they cannot force the trust to provide funds, they have made it clear they will not provide relief and will instead bankrupt the debtor.

There have been instances where a taxpayer with an interest in a trust has applied for and obtained hardship write-offs. These are however only granted in exceptional cases.

Norm Latimer**Inter-Company Loans – Does Interest Need to be Charged?**

Lender Ltd is owned Mr A (1 share) and the A Family Trust (99 shares). Beneficiaries of the A Family Trust include Mr A and Mrs A and their children.

Lender Ltd has advanced \$100k to Borrower Ltd which is owned by Mr A (1 share) and the A Family Trust (999 shares). Does Lender Ltd need to charge interest on the loan to Borrower Ltd?

The first issue to consider is whether the failure to charge interest gives rise to a fringe benefit. Under section GC 15(1) a fringe benefit will arise if there is a loan to an associated person of an employee of Lender Ltd. Although Mr A only holds 1 share in Borrower Ltd, he is deemed to hold the interests of the A Family Trust for the purposes of the associated persons rules in section OD 7. As Mr A is deemed to hold more than 25% of the voting interests in Borrower Ltd, he will be associated with that company as will Mrs A.

If either Mr A or Mrs A have been entitled to receive a source deduction payment from Lender Ltd (i.e. a PAYE or non-deduction salary or a withholding payment such as directors fees), a low interest or interest free loan will represent a benefit to an associated person of an employee of Lender Ltd. There is an exemption contained in section GC 15(2) which applies where the employer and the associated person are both companies and the

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employee is also a shareholder in the company providing the benefit. If Mr A is the only employee associated with Borrower Ltd, no FBT issues arise if interest is not charged. However, if Mrs A or another relative of Mr A is also an employee of Lender Ltd, FBT issues could arise as those employees are not shareholders in Lender Ltd.

Having dealt with FBT issues, it is necessary to consider the dividend rules. An interest free or low interest loan will give rise to a dividend under section CD 5 if the loan is to an associated person of a shareholder in Lender Ltd or to a trust under which a shareholder or spouse is a beneficiary. In this case there is a loan to an associated person of a shareholder in Lender Ltd for the reasons outlined above.

There is a dividend exclusion contained in section CD 19 for downstream transfers of value (i.e. parent/subsidiary) which is not relevant in this case. There is also a dividend exemption contained in section CW 10(2) which deems dividends paid between members of a wholly owned group to be exempt income of the recipient. Two companies will form a wholly owned group if there is a group of persons whose common voting interests in both companies are equal to 100%. Where a shareholder's voting interests in each company differ, their common voting interest is the lowest interest in either company.

In the present case, the A Family Trust holds 99% of the voting interests in Lender Ltd and 99.9% in Borrower Ltd. Mr A holds 1% in Lender Ltd and 0.10% in Borrower Ltd. As the common voting interests are only 99.1%, the companies do not form a wholly owned group. Interest must therefore be charged on the loan to avoid a taxable dividend accruing to Borrower Ltd.

If the shareholding in Borrower Ltd was the A Family Trust 990 shares and Mr A 10 shares, the companies would form a wholly owned group and the dividend would be exempt. While an exempt dividend is not gross income of Borrower Ltd, Lender Ltd is still treated as having paid a dividend which could create imputation problems under section ME 8 from a benchmark dividend perspective.

Inter-company and related party loans have the potential to create deemed dividend, RWT, FBT or Gift Duty issues or affect interest deductibility in an on lending scenario. If you are unsure whether interest should be charged in a particular situation please contact your nsaTax adviser.

Graeme Carruthers