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Recent Tax Changes – How They May Affect You

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**Recent Tax Changes – How They May Affect You**

There have been a number of significant changes in the area of international tax recently which may affect your clients. We outline some of these changes below.

***Dividends Paid to Non-Residents***

From 1 February 2010, fully imputed dividends paid to non-residents will attract NRWT at 0% where:

- The non-resident holds a direct interest in the NZ company of 10% or more; or
- The dividend would otherwise be subject to NRWT at a rate less than 15%.

Non-residents with a direct interest of 10% or more can take advantage of the 0% NRWT on dividends paid on or after 1 February 2010. This means that it will no longer be necessary to pay supplementary dividends and claim FITC credits under the foreign investor tax credit regime in respect of dividends paid to these shareholders.

From 1 May 2010, the Double Tax Agreement with Australia was amended to limit the NZ tax on dividends paid to Australian residents to 5% in the case of corporate shareholders with 10% or greater interests and 0% in the case of listed corporate shareholders with interests of 80% or more. The 0% rate is also available to other 80% shareholders who obtain IRD/ATO approval. The 0% NRWT will apply to dividends paid to qualifying shareholders on or after 1 May 2010.

NZ has also signed new tax treaties with US and Singapore which reduce the rate of NZ tax on dividends paid to certain corporate shareholders below 15% but these treaties have yet to come into force therefore the 0% NRWT rate is not yet available for these shareholders.

***Royalties***

The Australian DTA has also reduced the rate of withholding tax on royalties from 10% to 5% with effect from 1 May 2010. An amendment has been made to the royalty definition to exclude payments for the use of industrial, commercial or scientific equipment.

***Supplementary Dividend Rules***

Following the changes outlined above, from 1 February 2010 companies paying dividends to non-residents will no longer be able to claim a foreign investor tax credit in respect of dividends paid to shareholders with a 10% or greater interest or where the rate of tax applying to the dividend is less than 15%.

Companies that continue to pay supplementary dividends under the FITC rules to shareholders who are eligible for the 0% NRWT rate after 1 February 2010 will not be entitled to claim an income tax credit, so it is important to ensure that the 0% NRWT rate is correctly applied where applicable in order to avoid an unnecessary NRWT cost which cannot be recovered by way of a tax credit.

***Changes to the CFC Rules***

The Controlled Foreign Company or CFC rules were significantly amended with application to income years commencing on or after 1 July 2009. For most taxpayers the changes will apply to their 2010/2011 income year.

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Broadly speaking, the CFC rules apply to NZ residents who have interests in foreign companies which are controlled by 5 or fewer NZ residents. Instead of simply being taxed on dividends received, shareholders in a CFC are required to return their proportionate share of the CFC's income calculated as if it was a branch of a NZ company. The requirement for shareholders to return attributed foreign income under the CFC rules has traditionally been subject to an exemption for CFC's resident in a Grey List country (UK, US, Australia, Japan, Germany, Norway, Canada and Spain). However, one of the major changes to the CFC regime is the repeal of the Grey List exemption with the exception of Australia.

This change, together with the extension of the associated persons rules from 1 April 2010, is likely to bring a number of taxpayers into the CFC regime in respect of their interests in foreign companies, particularly in a family company situation where the NZ resident's interest when aggregated with those of family members exceeds the 50% control test.

At the same time an active business exemption has been introduced which prevents a person from having to return attributed foreign income from a CFC where the CFC has attributable income that is less than 5% of its total income. The active business exemption rules are complex to say the least.

If you have clients who are currently returning income from a CFC then it may pay to check to see whether the active business exemption could apply to them for the 2010/2011 and subsequent years.

If you have clients with interests in foreign companies which you have not treated as CFC's previously due to the Grey List exemption then it may pay to check whether those interests now fall under the CFC rules for the 2010/2011 and subsequent years and whether the active business exemption could apply to prevent the requirement to calculate and return attributed foreign income.

***Permanent Establishments Under the Australian Tax Treaty***

Under the double tax treaty with Australia, companies which are resident in either NZ or Australia are only liable for tax on business profits in their country of residence unless the company carries on business in the other country through a permanent establishment situated in that other country.

The new treaty with Australia contains some significant changes to the permanent establishment definition. These changes apply from 1 April 2010. Some of the changes include:

- A wider test now applies where an entity has a dependent agent in the other country who habitually exercises an authority to substantially negotiate or conclude contracts on behalf of an enterprise. The previous wording only referred to an authority to conclude contracts. Where previously a permanent establishment could be avoided by ensuring negotiated contracts were referred back to the principal in the country of residence for signing, the extension of the test to include an authority to substantially negotiate contracts could bring activities involving sales representatives within the permanent establishment definition.
- A deemed permanent establishment will now arise where an enterprise performs services in the other country through individuals who are present in that country for more than 183 days in any 12 month period and more than 50% of the enterprise's income is derived from services performed in that country or the services are performed in relation to the same or connected projects.

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- On a positive note, a permanent establishment will only arise in relation to substantial equipment where a person operates substantial equipment in the other country for more than 183 days in any 12 month period. Previously a permanent establishment arose where substantial equipment was used by, for, or under contract with an enterprise which included equipment leases. The introduction of a 183 day test is also welcome as it will exclude certain short term activities from the permanent establishment definition.

If you have clients with Trans-Tasman business operations then we strongly recommend that you review these changes to the permanent establishment definition to determine their impact.

**Graeme Carruthers****Operating in the Dark After Tax Case**

The Court of Appeal recently delivered the much anticipated decision of *CIR v Penny and Hooper* which is the latest in the line of tax avoidance cases dealing with the question of “market salaries”. The court found by a 2-1 majority the arrangement constituted tax avoidance. Much has been written in the media about this case and we have received numerous enquiries from clients concerned about the impact of the decision.

In reaching its decision the Court took an holistic approach to the question of tax avoidance, “looking through” the trading structure to the economic reality of the situation. The Court found that a number of factors which showed the “hallmarks” of tax avoidance were present, those being artificiality, pretence and a lack of commercial reality. A positive aspect of the case is the finding that there was nothing improper about the use of a company/trust structure and that failure to pay a market salary did not of itself constitute tax avoidance. The Court stated there would be a number of situations where a prudent business owner would not pay a market salary and gave examples such as times of financial hardship or if the business was in a development phase. As a shot across IRD’s bow the court also said that it would not expect IRD to intervene in marginal cases and that each case must be judged according to its own facts. Therefore the case is not expected to open the “floodgates”, and IRD have publically stated the decision will not result in any major crackdown in this area.

Our view is that the outcome of this case will be of limited significance for businesses which are not based around providing “personal services” although entities set up purely to provide “management services” to a related trading entity may come under closer scrutiny.

As a practical response, we recommend that trading structures are reviewed to ensure that objective commercial reasons underlie any structures where personal services income is diverted through companies or trusts. Documentation such as employment contracts and management agreements should also be in place to reflect arms-length arrangements.

There is no word yet on whether this case will be appealed but if you think your clients trading structure might have crossed the line between legitimate tax planning and tax avoidance give us a call to discuss what options are available.

**David Weaver**