Joint Ventures – taxation risks and advantages

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Abstract

Both here and in Australia, the unique commercial and tax features of joint venture are finding favour in forestry, fishing, technology and infrastructure projects. For New Zealand mining companies, joint ventures provide a means of access to foreign know how and investment funds, while retaining their corporate independence and their hard-earned tax losses.

This paper discusses some of the practical income tax and GST considerations where a joint venture structure is contemplated. The first part of the paper considers income tax, and in particular how joint ventures enable companies to access and carry forward tax losses. It explains why a joint venture may be advantageous relative to a jointly owned company.

The second part of the paper concerns GST and the focus is on two aspects:

- Joint ventures may be registered for GST. In some instances they have no choice and are required to do so. Where a joint venture is registered in respect of a taxable activity, the members are not permitted to register in respect of the same activity. This may be problem where the member has incurred its own expenses and the member wishes to register in its own right to claim back the GST on those expenses. This paper explores the issue and possible solutions.
- It is not uncommon to see joint ventures claiming GST on the costs of production, and the production being sold (and GST is being charged) by the members. In this paper we consider whether these arrangements have a tax risk, and what can be done to make them technically sound.

Introduction

In the New Zealand petroleum mining sector, virtually every permit is owned by a joint venture consortium. In the New Zealand mineral mining sector, joint ventures are not so common, but they have been used on two of the more significant North Island gold projects: the Golden Cross project, near Waihi, and the Martha Hill project, in Waihi.

JV fundamentals

What are the reasons for entering into a joint venture?

There are probably four major influences: know-how, cost, risk, and tax. The know-how, cost and risk components do not need much explanation. A joint venture structure allows the companies concerned to pool their financial resources and experience, while at the same time limiting their liability to each other and the world at large.

As most readers will be aware, a joint venture (unlike a company) does not have a separate legal personality. Some joint ventures will use a nominee company as a vehicle for common ownership, but the nominee company has no beneficial interest in the joint venture assets.

A joint venture should also be distinguished from a partnership. Under the Partnership Act 1908, the members of a partnership have joint and several liability for the partnership debts. Consequently, partners only share in the profits of a partnership after deducting their joint costs.

Joint venture partners, on the other hand, each take a share of the joint venture product, or the proceeds from the sale of the joint venture product. They are individually responsible for their share of expenses and do not share joint and several liability to the world at large.

Tax losses

As mentioned, one of the significant reasons for a joint venture is in relation to taxation, and in particular tax losses. There are a number of issues in relation to accessing tax losses that affect the choice whether to use a joint venture structure.

Access to tax losses

Mineral mining companies will usually accumulate tax losses in the prospecting, exploration and development phases of a project. The tax characteristics of joint ventures and partnerships allow the members of these unincorporated bodies immediate access to these losses. Joint ventures and partnerships do not pay income tax or carry forward tax losses. The tax losses are enjoyed and tax liabilities are met by the members/partners.

There is one distinction between partnerships and joint ventures for income tax purposes. A joint venture does not file a tax return. Rather, the members of the joint venture will include in their individual tax returns their share of the joint venture's revenue and costs. A partnership, on the other hand, must file a tax return. Thus, each of the partners will include their share of the annual net income or loss disclosed in the partnership's tax return in their individual income tax returns.

Specified minerals – specific considerations

New Zealand tax legislation distinguishes between miners for specified minerals (which includes gold and silver) and miners for other minerals (including coal).

Our comments below mostly concern tax issues that affect all mining companies. However, we do address some issues that are specific to specified mineral miners and, where they are so addressed, this is noted accordingly.

Group loss offsets

In New Zealand, companies that are members of a group of companies are permitted to elect to offset the losses of one group member against the profits of another group member. The members of the group must have 66% common ownership. Consequently, where the mining project is carried out by a jointly owned mining company, these losses are usually unable to be accessed, unless one of the shareholders holds more than 66% of the shares in the mining company.

On the other hand, a joint venture structure allows the joint venture partner to offset its share of mining losses against other group companies.

Miners for specified minerals are permitted tax deductions for most expenses in the year the expense is incurred. Their allowable deductions include development costs and the costs of all plant and equipment associated with developing a mining site. These costs, and in particular

the costs of plant and equipment, would generally have to be capitalised for projects involving non specified minerals. Naturally, these rules can create significant up front tax losses for specified mineral miners. Yet there are restrictions on how the losses can be used. The most important restriction is that specified mineral miners are not permitted to use the loss grouping rules.

Yet, even with that restriction, and possibly because of that restriction, a joint venture structure may be advantageous, as it allows each member to manage these quarantined tax losses to suit their particular circumstances.

Loss carry forward

In New Zealand, the carry forward of tax losses is subject to maintaining 49% shareholder continuity. This continuity must be measured from the beginning of the year the tax loss is incurred through to the end of the year that the tax loss is utilised. Thus, companies in New Zealand carrying tax losses must be continually aware of potentially significant changes on their share registers.[1] Where there is any significant change in shareholder composition, the tax losses are potentially at risk of forfeiture.

The loss rules also have a "look through" test to the share registers of the shareholders[2], and so a significant shareholding change in the shareholding of one or more shareholders may affect the carry forward of losses in the tax loss company.

In the writer's experience, many mining companies in New Zealand are single project entities. Therefore, rather than offset their tax losses against income derived from other projects, the losses often need to be carried forward until they can be offset against project revenues.

Thus, if a consortium of investors used a jointly owned company for a project, the rules requiring shareholder continuity would restrict:

The ability to join or change shareholders in the jointly owned mining company; and

The ability to join or change shareholders in the companies investing in the jointly owned mining company.

In a joint venture, the loss is held by each of the members, and consequently new members can be brought into the joint venture without jeopardising the tax losses of the other partners.

It also means that each of the members is free to bring in new shareholders, issue more capital or restructure its balance sheet without having to be concerned about the possible affect on the tax losses of the other members.

Permit area loss carryforward

Unlike other taxpayers, specified mineral miners have the unique ability to continue to carry forward tax losses, even where they have breached their shareholder continuity threshold of 49%. This special loss concession comes with some conditions, which essentially quarantine the tax loss to the permit area where it was incurred and require that the loss may only be used against income from that permit area[3].

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[1] There are concessionary rules which allow a company to ignore transfers of shares between minor shareholders (holding less than 10%) in the normal course of trade. These rules sometimes don't apply where it would be obvious to the directors, without having to make specific enquiry, that continuity has been lost.

[2] Normally no look though is required where the shareholder is a listed company holding less than 50%, but note exception in section OD 5(8) of the Income Tax Act 2004.

[3] or areas that are geographically contiguous.

A joint venture structure allows the partners to use this concession, knowing that it will not affect the other members' access to their tax losses. For example, the member may wish to raise capital by issuing shares to a new shareholder. The share issue may breach its loss continuity threshold, which will quarantine that member's tax losses to the relevant permit area. However, as noted, the tax losses held by the other members are not affected and are not similarly quarantined.

3 for 2 loss burning

Where specified mineral miners earn non mining income[4], their mining losses (to the extent they are not used against mining income) must be offset against that non-mining income on a 3:2 basis[5]. This rule means that mining companies have to be very careful about the timing and amount of non-mining income they derive, as they could effectively be burning (i.e. wasting) 50% of their mining losses.

Sometimes the derivation of non-mining income may be unavoidable. For example, where a consortium of investors uses a cashed-up jointly owned company, that mining company will earn interest and the interest will have to be offset on a 3 for 2 basis against any available mining losses.

With proper planning, this wastage may be minimised or avoided and a joint venture structure is one of the more effective structures to do this. In a joint venture scenario, each of the members can minimise its interest earning, usually by keeping surplus cash in a holding company.

Goods & Services Tax (GST)

Background

In New Zealand, a joint venture can be registered for GST. Consequently, while a joint venture is not a person for income tax purposes, it can be treated as a person for GST purposes.

New Zealand has had GST since 1986. One would think that, after nearly 20 years, the rules in respect of joint ventures would be settled and consistently applied. However, on some matters, that is not the case at all.

The GST Act requires every person who carries on a taxable activity to register for GST where that person makes supplies that exceed $40,000 in a 12 month period. The GST Act also allows persons to register if their supplies are below this threshold, but their registration is at the discretion of the Commissioner. Where a mining company has no production (i.e. it is purely an explorer), it will usually have to rely on that discretion.

The writer is aware of a variety of GST treatments around joint ventures, some of which raise potential difficulties. In this paper, we discuss two of the more common issues where there are differing treatments:

- The ability of a joint venture partner to be registered for and recover GST where the joint venture is itself registered for GST; and
- The appropriate GST treatment when joint venture product is sold by the members.

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[4] common examples being interest or property rental income

[5] i.e. $300 of mining losses must be used against every $200 of non-mining income. The rule is an arcane historical by-product, which is understood to have its genesis in the era in the 1970's when the company income tax rate was 48% and the rate for specified mineral miners was 33%.

The right to be GST registered

It is not uncommon for both the joint venture and the members of a joint venture to be registered for GST. Usually, the members register for the practical reason that they want to recover GST charged on their own expenses (those expenses that cannot be shared with the other joint venture members). Yet, the GST Act states that, where an unincorporated entity (i.e. a joint venture) is registered for GST, the members of that body shall not themselves be registered for that activity. Therefore, where a joint venture is GST registered, the issue is whether the member is similarly entitled to also be GST registered.

The only technically robust response to this question is to be able to point to a supply that the member makes, or may make, in its own right.

In the case of petroleum joint ventures, those separate supplies include their interests in joint ventures, which are frequently traded and farmed-out. This trading of joint venture interests is both a risk diversification technique and a way of financing new projects. In general, these transfers of joint venture interests are treated as taxable supplies. However, that treatment has not been consistently applied. There have been numerous transfers that have been zero-rated on the basis that the interests supplied were a taxable activity that was being carried on as a going concern. Over the years there have been several GST cases that have considered whether a supply of a going concern has occurred. This has altered the perception of tax advisors generally and the view of most, when advising a vendor, would be that GST should be charged to remove any GST risk to the vendor.

The associated effect has been to transfer GST risk to the purchaser, who now has to be able to convince the IRD that it should be registered for GST and that it can recover the GST charged. This may potentially be difficult where the purchaser has no substantial presence in New Zealand and no apparent taxable activity of its own.

Supplies made by the JV

One solution to the problem of registering the joint venture members is to have a joint venture operating agreement (JVOA) that requires all production to be sold to the joint venture partners. The prospect of production being on-sold by the members will usually be sufficient for the members to gain registration in their own right.

Where the joint venture is supplying the members, the writer would consider the correct GST process to be as follows:

- The joint venture would claim back GST input credits on its costs.
- The joint venture would charge the members for the supply of product.
- The members would claim back GST on the product purchased from the joint venture, together with GST on any other costs incurred.
- The member would charge GST on its supplies of product (zero-rated if exported).

However, in some instances, the writer is aware of petroleum joint ventures where only the first and fourth steps have been occurring i.e. the joint venture claims all the GST inputs on the costs of production and the members charge GST on the sale of that production. The potential issue with this scenario is that the joint venture does not appear to be making any taxable supplies, which raises the question of its entitlement to claim input tax on the production costs.

In the writer's view, there is a possible technical argument that the joint venture is making taxable supplies to its members, for nil consideration. Joint ventures that supply product to their members without charge are not caught by the rules for supplies to associated persons[6]. The GST Act normally requires supplies between associated persons to occur at open market value; however the definition of associated persons does not connect a member of a joint venture with a joint venture.

It is possible that some joint ventures making supplies in this way are not even aware of the potential issue and therefore they are not consciously using the nil consideration argument. If the joint venture is relying on this argument, it would be prudent to be issuing nil invoices for the supplies if only to concurrently evidence the respective positions of the joint venture and its members.

IRD action

The discussion above outlines some areas of uncertainty is relation to the application of the GST Act to joint ventures and their members. The writer has presented his own submissions to the IRD Policy group and the IRD has agreed that legislative correction may be required. At the time of preparing this paper, the IRD has advised the writer that the IRD has agreed to consider the issue and consequently it is preparing a work programme for the task. The writer understands that the programme is likely to involve some consultation (possibly through the issue of a discussion document).

In the writer's experience, the potential difficulties associated with these issues have been avoided by a sensible and pragmatic approach taken to date by IRD Operations. As some readers may be aware, the IRD also has a team within the Corporates group who are responsible for handling companies in the mining and petroleum industry sector. While they are aware of the GST issues described above, they have shown a fair degree of tolerance for the range of positions that have been adopted by various companies. While this is commendable, it is not a satisfactory position to be so reliant on the IRD's favourable discretion given the often sizeable transactions that occur in this sector, and so the policy initiative is imperative and important.

Overall conclusion

As noted at the beginning of this paper, a joint venture structure offers unique advantages for any venture where a company needs access to finance and know-how. A joint venture allows companies to access the financial resources and experience of other companies, while maintaining relative independence.

The writer trusts that this paper has helped outline the potential tax benefits as well as some of the issues associated with their use. The views expressed in this paper are those of the writer and are not necessarily those of Ernst & Young.

Author

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[6] The writer is not aware of any proposed change to this position, but it should be monitored.