the right read

PocockHudson

JULY 2007

Winter has definitely arrived with a vengeance! A lot of new developments have taken place since our last newsletter.

There have been some changes within our firm. We have had several new faces join our team over the last few months. You are sure to become acquainted with them in due course.

The May Budget delivered a few changes that will affect many of you, in particular the reduction of the Company tax rate to 30%, and some alterations to the KiwiSaver regime.

If you have any questions regarding KiwiSaver, talk to your usual advisor within our firm.

Best regards
Anna, Bryan, Richard & the team at Pocock Hudson.

SELLING A BUSINESS

When a business is sold, there are a number of tax issues that must be considered depending on the type of business structure that the vendor has. Typically, businesses are operated by sole traders, partners in a partnership, or through a company. Before embarking on a sale, it is generally advisable for a vendor to seek professional advice on possible strategies for exiting the business, and the commercial and tax issues that may arise.

The tax issues that need consideration when a business is sold include:

Depreciation recovery – the vendor will have depreciation recovery income if the sale price of the business' fixed assets is greater than book value. Where the sale price is greater than the cost - which is often the case when a building is sold - the excess over the cost will be a non-taxable capital profit. If the sale is to a related party, the capital profit arising will not be immediately taxable, but will be taxable when that profit is distributed to shareholders when the company is wound up in the future.

Trading stock – the sale of trading stock will always give rise to taxable income to the vendor.

Goodwill – In the sale of a business where goodwill is part of the selling price the vendor will want that component of the sale price to be a tax free capital receipt. Goodwill can be a tax free receipt if it is personal (or business) goodwill that is included in the sale price. If the goodwill relates to the premises from which the business operates (generally known as site goodwill), the goodwill will be taxable to the vendor. This situation can arise either from the vendor granting a lease to the purchaser (if the vendor owns the premises) or sub-leasing the premises (if the vendor is the lessee of the premises). This goodwill income can be spread over the year of receipt and up to five succeeding years. Where the vendor is the lessee of the premises and sells the lease (rather than sub-leasing) to the purchaser, that sale will be a tax free capital receipt to the vendor.

Employee Leave Provisions – when a business is sold, the employees of the business are frequently taken over by the purchaser. The vendor will have accrued leave provisions in relation to employees'

THIS EDITION

Selling a Business	**1**
Depreciation of Your Rental	**2**
KiwiSaver	**2**
Tax Thy Neighbour	**3**
Snippets	**4**

All information in this newsletter is to the best of the authors' knowledge true and accurate. No liability is assumed by the authors, or publishers, for any losses suffered by any person relying directly or indirectly upon this newsletter. It is recommended that clients should consult one of our directors or managers before acting upon this information.

holiday pay, sick pay and so on. The legislation relating to leave provisions when a business is sold provide that where a business is sold, the vendor is allowed a tax deduction for the employee leave provisions that have been accrued. However, if the sale is to an associated person, it is the purchaser that gets the deduction when the employees are paid their leave entitlement by the purchaser.

GST – the vendor must account for GST on the sale unless the vendor is not registered for GST, or if the sale of the business is as a going concern (for GST purposes). If there is any doubt whether or not GST is applicable to the sale, it is advisable to have the purchase price as being "plus GST if any". This is to ensure that where there is GST payable on the sale, it is the purchaser that bears the cost of the GST.

Sale of Shares – if the vendor is a company, it can consider selling the shares in the company instead of selling the assets in a business. A sale of shares will generally result in a capital non-taxable receipt to the vendor – unless the shares were acquired by the vendor for the purpose of on-selling them. Selling a business by share transfer allows the issues that have been outlined above to be eliminated as the company is retaining the business. This option tends to be the more attractive one for the vendor mainly because of its tax free nature, and also the simplicity of the transaction.

There are obviously a number of issues to be considered when selling a business. Therefore, it would definitely be advisable to seek professional advice before embarking on a sale.

DEPRECIATION OF YOUR RENTAL

In recent times the IRD has expressed the view that separating a residential rental property into its component parts for depreciation purposes was unacceptable. This view had been publicised in a media statement.

The IRD has now taken the next step in supporting this view. A draft interpretation statement has been released that explains the IRD's position. The document itself is 69 pages long and goes into considerable detail.

Where a depreciation deduction is claimable on an asset, the next step is to define that asset. For applying this rule the IRD has carried out a historical analysis of case law developed from the Income Tax Act 1976. Under this Act a deduction for depreciation or repairs was allowed in respect of an "asset". Disputes often arose when taxpayers claimed what they considered were "repairs and maintenance", but which the IRD considered to be capital improvements. This resulted in a considerable amount of case law which sought to identify the "asset" that has been repaired or improved.

The Court's approach has been to determine if an item for which expenditure has been incurred would be part of an asset (i.e. part of the building or separate from it). The IRD has followed this approach. Two distinct tests have been identified in the interpretation statement; they are referred to as the physical separation test and the functional separation test.

Physical separation considers whether or not the item is "fixed" to the building. For example, can the item be removed and relocated without difficulty? Functional separation looks at whether or not the item carries out a function separate to the function of the building. For example, would the building be regarded as complete without the item? The view is taken that if an item is part of the greater asset (i.e. part of the building) it cannot be separately depreciated; it must be depreciated with the rest of the building.

The document analyses a number of common examples, and the following items are considered to be part of the building and not separately depreciable:

- Plumbing and piping
- Electrical wiring
- Internal walls
- Internal and external doors
- Garage doors (internal access)
- Wardrobes and cupboards (built into the wall)
- Kitchen and bathroom cupboards
- Linoleum and
- Tiles (floor and wall)

The following items can be regarded as separate assets and can be depreciated at different rates:

- Wardrobes and cupboards (not built into the wall)
- Carpets
- Curtains
- Blinds
- Water heaters
- Hot water cylinders

Because the tax legislation does not prohibit depreciating an asset based on its component parts the correct position is currently unclear. However, the IRD has gone to great lengths to support its view that it does not favour separation of assets. The IRD has indicated that if a dispute were to arise it would take the matter to Court to prove its point.

KIWISAVER

On 1 July this year the long awaited Government organised superannuation savings scheme came into effect. KiwiSaver is a voluntary savings scheme aimed at helping New Zealanders save for their retirement.

What does KiwiSaver involve?

Employers are required to provide new employees with information on joining KiwiSaver, and they are responsible for making deductions from their employees' pay. All new employees are automatically included in the scheme unless they sign a form to opt out. An employee who has opted out and who wants to stay out must continue to opt

out every time they change employers. If they do not opt out every time they change employers, they will automatically be included in the scheme. Current employees are exempt from the scheme but they can voluntarily join if they wish.

Employees who participate will have either 4% or 8% of their gross salary or wages deducted and allocated to a superannuation provider, who will either be an IRD default provider, an employer's preferred provider or one of the employee's choice. Once employees reach the New Zealand superannuation qualification age – which is currently 65 - they will be able to access their money and will hopefully have a nice tidy nest egg to see out their retirement.

What are the benefits?

The Government sees KiwiSaver as an opportunity for people to make a commitment to saving for their retirement. Once savings are put into KiwiSaver, there is no ability to withdraw the funds in the scheme until retirement – which could seem a long way away if you are only 20 years of age. The inability to withdraw funds from the scheme is seen as a mechanism to curb the temptation for people to access their savings for frivolous purposes. The only exceptions to this rule are where the person:

- makes withdrawals to assist with the purchase of a first home (but only after at least three years membership);
- has significant financial hardship;
- has serious illness; or
- permanently emigrates

Every person who joins KiwiSaver will have a 'kick start' payment of $1,000 placed in their KiwiSaver account by the Government. The Government will also provide a 'tax credit' by matching member's contributions by up to $20 per week (or $1,040 per year). There is also a possibility (subject to certain criteria) of a first home deposit subsidy of up to $5,000 (the maximum subsidy is for those who have been KiwiSaver members for 5 years).

What are the drawbacks?

The deductions of 4% or 8% of wages could be quite a burden in some cases. Some employees may not realise the effect of having less cash in the hand for each pay period until it is too late. Employees have a window of opportunity of six weeks to opt out of the scheme or they will automatically be included in the scheme until retirement.

Employees can opt out, at the earliest, on the 14th day of employment (after two weeks) and must opt out by the 56th day (8 weeks). What this means is that even if employees want to opt out from day one of their employment, the employer must deduct the KiwiSaver contribution for any pay that falls within that 14 day period. Any deductions that have been paid to the IRD will be refunded if an employee opts out. After contributing to the scheme for a minimum of 12 months, employees can apply to have a "contribution holiday" of up to five years.

As previously mentioned there is an inability within the scheme for employees to access their savings until they reach the superannuation qualification age. Whilst the age is currently 65, it may be pushed out to age 70 by the time individuals from Generation Y reach their twilight years.

Also of major concern would be the lack of guarantees in place to safeguard employees' savings and the fact that there is no guaranteed minimum rate of return on the savings.

Before deciding whether or not to join the KiwiSaver scheme, all potential participants need to have as much information as possible in order to make an informed choice.

For further information please contact us or visit www.sorted.org.nz for calculations and financial information, or www.kiwisaver.govt.nz for specific information.

TAX THY NEIGHBOUR

In March 2007 the Policy Advice Division of the Inland Revenue Department (IRD) and New Zealand Treasury released an issues paper suggesting changes to the definition of "associated persons" in the Income Tax Act 2004. It is the first step in a consultative process in which feedback is sought. The second step will be the introduction of draft legislation in Bill form. The purpose of the "associated persons" provisions is to prevent the use of entities, which are entirely or substantially under the control of a taxpayer, as means for avoiding a tax liability of that taxpayer.

At present the "associated persons" definitions are found in four different sections covering various situations including petroleum mining, depreciation, land sales and international tax. The paper proposes to repeal the various associated persons sections and replace them with one section to provide a standardised definition, with limited modifications for certain circumstances. Solutions to 'perceived' shortcomings of the current definitions are also discussed in the paper.

The issues paper recommends a number of important changes, particularly in the area of land sales. For example, at present a person is not associated to a trust if that person is a settlor of that trust, and two trusts are not associated where both trusts have the same settlor. The issues paper characterises these scenarios as loopholes and proposes to "close the loopholes". The expanded definition of "associated persons" will make it virtually impossible for land dealers, developers or builders to hold other property that earns passive income, such as rental properties, in separate

entities without the proceeds from the sale of those properties being taxed if they are sold within 10 years.

With the current "associated persons" rules, a common structure for a business that derives income from dealing or developing land or building is to be operated through a company, with the shares being held by individuals. If the individuals acquired rental properties, those properties would be held in a trust. At present the trust and company are not associated. Under the proposed changes the trust and company would be associated. This will be, in part, due to the introduction of what is known as a "tripartite test". The tripartite test will associate any two individuals/entities if they are also associated with the same third party. Therefore, in this instance the trust will be associated to the individuals who settled the trust, and the individuals will be associated to the company due to their shareholding in the company. The tripartite test (under the proposed changes) will mean the trust and the company are associated.

This change will also bring about other side effects. The tripartite test would also associate partners in a partnership. For example a partner in a law firm who is also a property dealer, will taint the other partners. What this means is that other partners selling investment property could be taxed, simply because they are associated (through the law firm partnership) to another partner who happens to also be a property developer. If the proposals are not modified then this is exactly the sort of scenario that will arise. Surely this type of outcome could not have been intended by the legislators.

A person holding property that is not used to earn income or that is not acquired for the specific purpose of re-sale should be able to sell that property and not be taxed on the sale. The issues paper does not go into detail on the policy rationale for the proposed changes. Once draft legislation is prepared its effect will be clearer. This is a fundamental change to the current rules, and will affect the way businesses and investments need to be structured. This move could signal the descent down the slippery slope towards capital gains tax.

SNIPPETS

IRD Interest Rate Rises

From 8 March 2007 the IRD increased the interest rates it applies to unpaid and overpaid taxes. The rate applying to unpaid taxes rose from 13.08% to 14.24%. The interest rate paid by the IRD on overpaid taxes also rose from 5.71% to 6.66%.

GST Due Dates

The first of a number of changes regarding GST and provisional tax discussed in previous issues has come into effect. GST returns and payments were previously due on the final working day of the month. For GST periods ending on or after 31 March 2007, the GST return and payment are due on the 28th day of the month (or the next work day) following the return period. There are two exceptions, being the returns for the periods ending 30 November and 31 March, which are due on 15 January and 7 May respectively.

Minor Beneficiary Rule Clarification

It is stated in the income tax legislation that income received from a trust by a beneficiary who is a minor is not subject to the minor beneficiary rules if the income is $1,000 or less for the year. There has been some confusion as to whether the $1,000 referred to relates to the total distributions a beneficiary receives for the year or whether the $1,000 amount relates to the distribution the beneficiary receives from each trust.

The IRD has released in draft form its view that the exemption for trust distributions to minors of $1,000 per annum applies to each trust's distribution to a beneficiary and not all trusts' distributions to a beneficiary. This means that a minor's marginal tax rate will apply to each distribution of $1,000 received from each trust of which he/she is a beneficiary. Therefore, a minor who is a beneficiary of say, three trusts, is able to receive up to $3,000 per annum (no more than $1,000 per trust) and pay tax at his/her individual marginal tax rate.

CONTACT US

Please contact us if you have any enquiries.

Level 7 44 Victoria Street
P O Box 10788
WELLINGTON

P: 04 472 3560
F: 04 472 3564
E: accounting@pocockhudson.co.nz
W: www.pocockhudson.co.nz