the right read

May 2010

Hi all,

We apologise for the late release of this newsletter. We have included a few extra articles this time to compensate!

Another 31st of March has passed and the normal chain of events starts to occur. The days start getting shorter and colder, the Hurricanes make another late run towards the semi finals and the time comes to start organising your year end accounts!

As always, if you require your accounts completed urgently, please send in your information as soon as possible and let us know when you require them.

This month will also see the government announce one of the most anticipated Budgets in recent years. In this edition we look at the implications of an increase in GST.

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

INCOME SPLITTING FOR FAMILIES

In April 2008 the Government released a discussion document that looked at the merits and possible methods of "income splitting" as a means of providing additional support to families with children.

Submissions received in response to the discussion document have been considered by Government, and in December 2009 an issues paper was released. The release of the Issues Paper reflects the next step in the public consultation process which typically precedes the introduction of draft legislation. The issues paper considers the following in more detail: how the scheme would work, eligibility, its administration, and seeks further public feedback.

New Zealand's personal marginal tax rates place a lower tax burden on low income earners. Income splitting seeks to take advantage of those lower marginal tax rates by shifting income derived by one parent, which is taxed at a higher rate, to the other parent and taxing it at a lower rate. The difference between the tax payable before and after the income is divided is refunded to the primary caregiver.

For example, Mr Brown earns $60,000 and tax of $12,850 is deducted. Mrs Brown earns $10,000 and tax of $1,250 is deducted. Their total family income is therefore $70,000, and $14,100 of tax has been deducted. Under the scheme their income is split 50:50, i.e. $35,000 each, and their total tax liability would be $12,320. The difference of $1,780 ($14,100-$12,320) is refunded.

As the tax credit is based on the year-end total income of the family, the credit will be calculated the same regardless of whether the family's income is generated by salary/ wages or self-employment.

If parents are separated and there is a shared-care arrangement for a child, both parents (if in new relationships) may be entitled to receive a tax refund. An entitlement would arise if the child was in each parent's care for at least one-third of the tax year based on the proportion of time each parent cares for the child. In the example above, if Mr and Mrs Brown were separated, were in new relationships, and

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shared the care of the child equally, they would receive $890 each at the end of the year (50% of $1,780).

It is expected that the scheme would cost approximately $450 million a year.

The submissions received from the 2008 discussion document show that while individual taxpayers support the idea, most submissions from professional institutions are against the proposal. Their concerns included inequity arising from different family structures, potential disruption of family life with the primary earner having the incentive to work longer hours, potential for abuse, and the fact that the fiscal cost will need to be transferred to other taxpayers.

GST INCREASE – BE PREPARED

As a business owner/operator it is worth taking the time to consider what effect a GST increase will have and what planning can be done to minimise any disruption.

The change in the GST rate should be considered from various angles. There is the mechanical aspect, i.e. the methodology of preparing and filing a GST return through the "change" period. Also, the behavioural aspect, such as, will the rate increase affect patterns of supplier and customer behaviour? Finally, there are other points, including cash flow issues, which will be helpful to keep in mind. The following looks into these various aspects.

If a GST rate increase comes into effect part way through a business's GST period, two GST returns have to be completed. For example, with the rate increase expected to be effective from 1 October 2010, a GST return that ordinarily covers the two month period ending 31 October 2010, will need one GST return for the month to 30 September and another for the month to 31 October.

The process of transitioning to the new rate varies depending on whether a person is on the payments or invoice basis.

Payments basis - debtors and creditors existing at the time of the change are subject to a notional 2.5% conversion and then all payments or receipts are subject to 15%. The notional conversion has the effect of deeming payments or receipts relating to transactions prior to the rate increase to be at a net 12.5%.

Invoice basis – the transition process for those working on an invoice basis may be more complicated. Most accounting packages are set up with a default GST rate of 12.5%. However, in various circumstances an accounting package will need to simultaneously cater for GST at 15% and 12.5%. For example:

- Purchases subject to GST at 12.5% may be claimed after the rate increase, along with other purchases that are subject to GST at 15%, or
- Credit and debit notes need to be issued or are received at the old rate because of when the original supply took place.

As this transition process is potentially complex, it is advisable to seek guidance from an accountant so that it is navigated correctly.

Systems set up to automatically code repeat transactions will need to be reviewed or switched to manual coding during the transitional period. If an accountant is completing the GST return(s), the client will need to specify which rate applies to every transaction, especially in the periods immediately after the change.

It is likely that businesses will experience an increase in sales to consumers prior to the increase coming into effect. This increase in activity could be in the form of purchases, purchase arrangements where the old rate is "locked-in" or the pre-payment of recurring expenses. Where possible steps should be taken to meet, or take advantage of this demand.

Other points to keep in mind include:

- Reviewing contracts with suppliers and customers to confirm that the effects of the rate change will be neutral. Generally, the GST Act deems a contract to be altered to align with a GST rate change, unless the contract specifies otherwise, or the contract is entered into more than three months after the rate increase.
- Increasing the amount of a deposit when selling large value assets to avoid having to fund the GST output liability to the IRD prior to full payment being received.
- The increase from 12.5% to 15% represents a 20% impact on cash flow when waiting for a GST refund to be released by the IRD.

As it is widely anticipated that the change to the GST rate will take place later this year, planning should be undertaken now to determine if your business and your GST return process are properly geared up for the transition and new GST rate. It may be helpful to consult an accountant to enable a smooth transition.

RENTING FROM YOUR LAQC

If a Loss Attributing Qualifying Company ('LAQC') incurs a taxable loss, that loss is deemed to be incurred by its shareholders in proportion to their shareholding. This unique blending of the separate entity concept and the ability to attribute losses from a company has led to a practice of people living in houses rented from LAQC's in which they own the shares.

To start the process, a company is incorporated and an election completed for that company to be an LAQC. A house is purchased by the LAQC and rented to its shareholder(s) who live in the house. A taxable loss is incurred as the expenses associated with owning and renting the house, such as rates, insurance and interest, exceed the rental income. That loss is attributed to the shareholder(s) and offset against the shareholder(s) income typically resulting in a tax refund. For most tax and accounting professionals this is not an acceptable practice as the

situation is essentially a way of claiming, for tax purposes, expenditure that would normally be of a private nature. However, the practice has persisted and is even encouraged, as some professionals take a different view.

Taxation Review Authority ('TRA') case Z20 recently settled whether the practice is acceptable. The case involved a taxpayer that had incorporated an LAQC with her as the sole shareholder, and her accountant as sole director. The LAQC, with funds borrowed from a related trust, purchased a house and rented it to the taxpayer (shareholder) to live in. Losses incurred by the LAQC over a four year period totalled $70,801. The losses were attributed to the taxpayer and resulted in tax refunds totalling $27,612.

The taxpayer argued she had merely exercised her right to structure her affairs within the law and followed advice not to own the house personally for protection against relationship property claims, and eventual retirement needs. As the expenses were incurred to derive rental income they were correctly deductible and the resulting loss was attributable to the shareholder as the company was an LAQC.

The IRD argued that, even though the various components of the arrangement came within the black letter of the law, when viewed as a whole the arrangement was put in place to enable personal expenses to be claimed to reduce the tax liability and was therefore tax avoidance.

The Judge agreed that in isolation the components of the arrangement fell within the black letter of the law but when taken as a whole the arrangement was not of a kind that would have been contemplated by Parliament and the combined effect gave rise to a tax avoidance arrangement. The Judge was of the view that Parliament would not have contemplated that a taxpayer would be able to obtain deductions related to the shareholder's personal domestic accommodation and for the shareholder to gain a tax advantage from those deductions by utilising an LAQC in such a way. The fact that rental income was not derived from a third party added to the artificial and contrived nature of the arrangement.

The taxpayer also attempted to argue that any tax avoidance purpose or effect was merely incidental to the reasons for which the arrangement was entered into (as referred to above). On this point the Judge stated: *"While the disputant may put forward other non-tax purposes and effects in this case, the purpose and effect of tax avoidance is just too obvious to be merely incidental."*

Although the tax in dispute was considerable, the implication of this decision is the key issue as it confirms that such an arrangement is tax avoidance. There will be instances that will not be as clear cut, such as when a shareholder of a LAQC lives for a short period of time in a property owned by a LAQC that was previously, and will in future be, rented to third parties. However, in this instance the IRD have correctly taken the matter to the TRA to provide certainty – the only question is why it wasn't settled years ago.

EXPANSION OF ASSOCIATED PERSONS RULES

Until the recent passing of legislation in late 2009, it had been reasonably easy to hold land in entities that are not associated with land dealers, land developers or builders, and in doing so, ensure that any future profit on the sale of that land is not likely to be taxable. The recent legislation passed by the Government greatly expands the "associated persons" rules. The intent of the new legislation is that property dealers, developers, builders, and their associates are generally taxed on all gains on property sold within 10 years of acquisition.

Given the clear intent of the rules, a structure that appears to deliberately circumvent the new rules may be viewed by the IRD as a tax avoidance arrangement. However, gains from the sale of land may not necessarily be taxable even though a person is tainted by association. Generally, if a person holds land for more than ten years, any profit on its sale should not be taxable. If a person is associated to a builder, the land will be taxable on sale only if it is sold within ten years of improvements being completed. If no improvements are made the land will not be subject to tax on sale if sold within 10 years.

In order for an entity to taint a person, that entity must be in the business of developing or dealing in land when the land was acquired by the person. An entity in the business of erecting buildings will taint a person if the person commences building improvements on land while associated with the builder. Whether an activity amounts to a business is a question of fact based on case law.

Finally, there are exemptions to the land taxing provisions to provide relief in specific scenarios. If a property is used by a taxpayer principally as a place of residence then any gain on its sale should not be taxable. In certain scenarios whether the exemption applies will be unclear, for example, where a property has been used as both a residence and to derive income (such as rental income). There is also an exemption for land used as business premises.

With the tightening of the associated persons rules, more land sales will be subject to tax. Application of the exemptions will need to be considered on a case by case basis. Given that the land taxing provisions are now more wide ranging, disputes with the IRD about the application of the new rules and possible exemptions are more likely to occur. In view of this, careful consideration should be given when deciding how a land transaction should be treated.

PAYING INCOME TAX FROM TRADING

It is well known that the IRD have comprehensive powers to request information for the purposes of enforcing the collection of tax. A recent project by the IRD saw those powers directed at identification of online traders (using auction websites such as TradeMe) who collectively had not paid over $1.2 Million of tax over the past three years.

The IRD website advises that as a "general guide", business income from trading online should be declared (and taxed) if:

- the goods were acquired for the purpose of on-selling,
- the purpose of the activity is to make a profit, or
- the business involves dealing in these goods.

It is important to note that, despite the fact that the IRD's message is specifically in the context of on-line trading, the same principles can be applied to all types of trading activities.

Irrespective of what a person is doing, whether it is on-line or otherwise, the IRD is likely to apply one of two criteria, namely:

- have goods been purchased with a purpose of resale, or
- does the level of activity indicate that a business exists.

If either criterion applies all profits from the trading are taxable.

In order to determine "purpose", the IRD is likely to rely on documentary evidence. Without evidence it becomes an argument over a person's intention, which is difficult to establish at the best of times. If a person does not have a purpose of resale the IRD could instead argue that a business exists, which case law has shown can be proven on the facts of a particular case. As stated in the Court of Appeal decision of *Grieve v Commissioner of Inland Revenue* in 1984, "whether a business existed turned on the intention of the taxpayer as evidenced by his conduct".

In the *Grieve* case the taxpayers had to prove that their farming activities were a business in the 1976 and 1977 income years, even though it had been operating at a loss. The result was a thorough analysis of what, in the context of the Income Tax Act, is meant by the term "business". The tests arrived at by the Court were:

- statements by the taxpayer as to their intention
- the nature of the activity
- the period over which the activity is engaged
- the scale of operations and the volume of transactions
- the commitment of time, money and effort
- the pattern of activity
- the financial results
- whether the activity is run in the same way as other businesses in that particular trade

It is better to consider the tests above, reach your own conclusion and gather evidence that a business exists, before the IRD come knocking on your door.

CASHFLOW FORECASTS AND BUDGETS

It is often said that "failing to plan is like planning to fail". In today's economic climate the need to plan is critical to the ongoing success, and in some instances survival, of your business. Two effective tools for planning are budgets and cash flow forecasts.

A budget encourages you to look forward and forecast what your income and expenses will be for the upcoming year. Once the budget is set, regular comparisons against actual performance will enable you to investigate any variances and take action where necessary. This pro-active approach will help you to make informed decisions.

The budget can be used to help you start planning for your cash commitments. However profitable your business may appear to be, cash is still the lifeblood of any organisation. Common questions asked by business owners are, "if the business made a profit for the year why does the bank balance not reflect this?" and "where has the money gone?" Unfortunately sales do not always equal cash and this can make it difficult when it comes time to pay the bills. Collection of cash from customers can at times prove challenging. Likewise, business owners need to be able to live, and often drawings are overlooked when it comes to cash management.

A cash flow forecast enables you to anticipate any shortfalls that may occur and to make plans accordingly. For example, if it looks like cash is going to be tight when a taxation payment is due, there are various options available to you to minimise underpayment penalties and interest – whether it be organising a payment plan with Inland Revenue or purchasing tax from a tax intermediary. The cash flow forecast can also indicate whether you may need to review your current banking arrangements. Perhaps you may need to re-negotiate payment terms with your suppliers or introduce measures to encourage debtors to part with their cash earlier, such as early payment discounts or penalty interest for late payments.

Regularly reviewing your liquidity and where your business is at financially will also mean that when the bank manager requests this information you have it on hand. As banks are becoming more cautious with their lending, there has been an increase in the request for up-to-date financial information. If you are able to produce budgets and cash flow forecasts for your bank manager in a timely manner it demonstrates you have a good grasp on the financial state of your business. Of course the quality of this financial information is crucial. It would be a wise move to engage us to assist you with this process.

There are numerous tools that can be used to prepare budgets and cash flow forecasts, whether they are part of your current accounting system, an excel spreadsheet or a more sophisticated specialist piece of software. What is important is that they do become an integral part of your business planning.

SNIPPETS

Sensible Sentencing Trust's Charitable Status at Risk

The concept of what qualifies as a charitable entity is one that has developed over hundreds of years as the needs and values of society have changed. That history has been encapsulated in the Charities Act 2005 which provides a definition of what a "charitable purpose" is, and it is this definition that the Charities Commission has been applying to the applications received since the Commission's commencement.

Broadly, an entity will qualify as being charitable if its purpose is the relief of poverty, the advancement of education or religion, or any other matter beneficial to the community. The Act allows an entity to have an advocacy purpose but this cannot be its primary purpose.

The Charities Commission has indicated that the Sensible Sentencing Trust's application for charitable status may not be approved because the Trust's main purpose is political and not beneficial to the community. The Trust recognises that it is involved in political advocacy but maintains its primary purpose is to provide various forms of assistance to victims of violent crime.

IRD Changes its View on Business Relocation Costs

In 2005 the IRD issued a draft interpretation statement setting out its view on the deductibility of various types of costs incurred when relocating business premises. Recognising that relocating business premises can be an ordinary incidence of running a business, most types of expenditure in the statement were concluded to be revenue in nature and deductible. However, the statement advised that costs associated with relocating fixed assets are capital in nature and non-deductible, but those costs may be depreciated.

Following public consultation the IRD has re-released the draft interpretation statement in late 2009. The updated statement concludes that where a business relocation occurs to maintain and preserve the business, and not to operate a new type of business or operate the business in a different way, all business relocation costs will be deductible. This would include the costs associated with relocating fixed assets.

However, the statement provides that where a business relocation is capital in nature (e.g. to expand into a new business venture or operate in a different way) the associated expenses will not be immediately deductible or depreciable, i.e. it will be a "black hole" expenditure.

KiwiSaver and Business Transfers

On the sale of a business from one company to another, or when companies amalgamate, existing employees are often employed by either the purchasing or amalgamated company. Typically, automatic enrolment into KiwiSaver occurs on commencement of new employment. However, this type of situation is excluded from being treated as "new employment" for KiwiSaver purposes.

Specifically, "new employment" does not include situations where the employee remains on the same payroll or where an employer carries on the "same business", as long as the employee was previously employed on that payroll or in that business. The "same business" is defined as a business that in substance carries on the same or a similar role and includes an amalgamated company or a business taken over as a going concern.

IRD Recording Interviews

The IRD is increasingly conducting interviews using audio recording technology, and has recently sought feedback on its Standard Practice Statement (SPS) for recording interviews with taxpayers.

It is important to note that most interviews are voluntary. The only exception is a compulsory interview under section 19 of the Tax Administration Act (provision for the IRD to require a person to give evidence). These are always electronically recorded, using video recording technology in appropriate cases, and the interviewee's consent is not required. However, attendance by the taxpayer at initial investigation meetings and follow up meetings is generally voluntary in nature.

Excluding section 19 interviews, a taxpayer will be asked before the interview if they consent to the interview being recorded. The taxpayer has the right under the Privacy Act 1993 to not consent to the interview being recorded. The reasons behind the refusal are not important and the taxpayer is not required to justify their decision to refuse. The draft SPS advises that the IRD will respect the taxpayer's decisions.

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