NEWSLETTER

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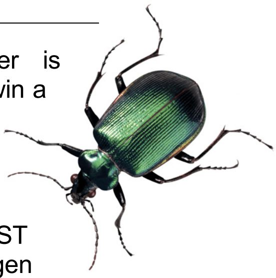
IRD Beaten By The Beetle



Winning a prize by simply being a customer is commonplace. You can win a car at the casino, or win a holiday by opening a packet of chips. It is also quite often possible to sell the prize back to the original supplier to receive the cash equivalent.

In a recent case that went before the Court, a GST registered non-profit sports body won a Volkswagen Beetle from its bank. Having no use for the car, it decided to sell the car by tender. The car was duly sold. Most people would consider this a great windfall for the community-based non-profit body. The IRD took a different view – surprise, surprise! It wanted one-ninth of the tender price. The IRD decided the sale of the car should be subject to GST and went so far as to take the matter to Court.

The rules say that if a non-profit body receives donated goods and services the supply of those goods and services is exempt from GST; so the key issue was whether or not the Beetle was an unconditional gift to the taxpayer. The IRD argued the Beetle was not a gift from its bank but a prize. The approach of the IRD is tenuous at best. The IRD believed the Beetle was received as a result of the sports body doing business with the Bank which is a form of consideration.

The Judge rightly disagreed with the IRD. He said that the fact the vehicle was labelled as a prize merely described the nature of the gift. The Judge characterised the transaction as follows:

The disputant did nothing to earn the "prize" beyond opening the account. It participated in no competition, nor bought any entry ticket. It was the passive recipient of the bank's decision to give away a chattel from time to time. The motives of the donor are irrelevant. It may be activated by considerations or charity or commerce. The result in the hands of the recipient is the same. It receives something for nothing and to which, absent the gift, it would not have been entitled.

The receipt of the Beetle was held to be an unconditional gift and the sale by the sports body exempt from GST.

Result:

Beetle - 1 IRD - Nil

Unfair Taxation Of Minor Beneficiaries

A few years ago the government decided to combat the tax advantage gained by the use of trusts to split income to children who were taxed at a lower rate. Income could be distributed to children where it was taxed at a lower marginal rate. The Minor Beneficiary rule, which was introduced from the 2001 – 2002 income year, required income distributions to a minor of more than a $1,000 to be taxed at the trustees' rate.

Practically speaking, once the rule came into effect, the practice of making distributions of $38,000 per year to minors became a thing of the past. Distributions to minors very quickly dropped to $1,000 per year. As is often the case with new rules, the basics are remembered but some of the detail is forgotten. So, a review of the Minor Beneficiary rule would be useful to clarify the point that it does not apply in all cases.

A "minor" is defined as a New Zealand resident under the age of 16 at the Trust's balance date. A distribution made to a minor is not included in the minor's income tax return. The distribution is declared in the Trust's income tax return and taxed along with the Trustees' income.

Some Trusts will not be subject to the minor beneficiary rules depending on the source of the settlements that have been made on the Trust.

Broadly speaking, a distribution from a Trust is exempt from the rules if all settlements on the Trust are of the following types:

- Settlements that are not made by relatives or nominees of relatives;
- Settlements that are made under a will or intestacy;
- Settlements required by a Court Order or made under a Domestic Protection Order.

It was recognised by Government that inevitably, many trusts will have settlements which are a mixture of the "exempt" settlements (as described above) and other settlements which are subject the rules. To simplify the treatment of these "mixed" settlements, some minimal thresholds have been set to exclude mixed trusts from the rules when:

- Non-exempt settlements of property do not exceed $5,000 in total at the trust's year end;
- Loans on which no interest is charged do not exceed $1,000 in total on any day of the trust's income year.

Although the Minor Beneficiary rules have been around for a number of years, there is still some confusion about how they work.

Therefore, one should be wary of the pitfalls along the way!

Should Employees Get A "Share" In The Business?

That is a question that is often asked – usually when a business is doing well, and employers would like to reward some key staff members for their efforts in contributing to the business' success.

The most common scenario is for a company to allow employees to have equity shares in the company. An employee share scheme ("employee scheme") that is structured properly can have benefits for both the company and staff.

An employee scheme can provide employees with a sense of ownership and also engender a feeling that their efforts have a direct co-relation with the outcomes of the business. Such schemes are seen as a good way to retain key staff. An employee scheme can also be used as an incentive to attract new employees who may be looking for a more stable future and career. The opportunity to participate in an employee scheme could be seen as an investment for their future.

Companies can also use employee schemes to boost a remuneration package, or link to directly to performance measures. One of the things that employers will need to consider is whether the employee scheme is open to all staff, or for selected staff only.

On the downside for employees is the possibility that their equity in the company may be affected if the company suffers downturns, regardless of whether those downturns are within or outside the control of the company.

This, of course, could be seen as a normal risk of participating in business. The employer should note that there are various set-up and administration costs to consider, including compliance costs to meet requirements under the Securities legislation.

However, before employers embark on such a scheme, there are various issues that require consideration, for example:

- Legal requirements, including those under the Securities legislation;
- Tax implications of the scheme for both the company and employees;
- The possible need to create another class of employee shares;
- The proportion of the company that will be held by staff;
- The voting rights attaching to the shares issued under the employee scheme;
- The transferability of the shares.

The issues for consideration are important, but the need to consider them should not deter employers, if such a scheme will be advantageous to the business.

The most important point is that employers should approach this with a clear idea of what the scheme is meant to achieve and how it will fit in with the business' objectives.

When Being Fair And Reasonable Is Not Enough

When the Government introduced the Employment Relations Amendment Act in 2004, there was a very small but highly significant change to the standard of justification for a dismissal.

Under the previous law, to determine whether a dismissal was justified or unjustified, the Court had to decide if the decision made by the employer was one that a "fair and reasonable employer *could* make". This meant that the decision was one option on a range of choices available to **that particular employer** acting as a 'fair and reasonable employer'.

The new law has changed so that the Court now has to determine if the decision is one that "a fair and reasonable employer *would* make". This means that the test is now not what the particular employer could do, but what a "fair and reasonable employer", ie the "perfect" employer, would do. Consequently, the Court has to look at the range of options and then decide which one would have been selected if the employer had been a "fair and reasonable" (or perfect) employer.

This issue was put to the test in a recent judgement involving Air New Zealand and the Judge spent some time discussing the rationale and meaning of the change. Air New Zealand lost the case because, although the decision to dismiss was one that a "fair and reasonable employer could make" the Court decided that the employer's decision was not one that a 'fair and reasonable employer would make', if the employer had followed a more thorough process.

In the surrounding discussion the Judge used the philosophical principle of the 'the reasonable man' as a guide to the standards which apply to a fair and reasonable employer. The standard of behaviour expected of 'the reasonable man' is defined as "the embodiment of all the qualities we demand of the good citizen and if not exactly a model of perfection, yet altogether a rather better man than probably any single one of us happens, or perhaps even aspires to be."

It will be interesting to monitor the effect of this on future judgements. It seems to be an almost impossible standard that will be much tougher on employers.

Meanwhile, if you are making decisions about your staff, err on the side of caution and get advice from a skilled employment law practitioner or consider the risks and manage them to minimise the damage to the organisation.

Sacrificing Salaries

Employer contributions to a superannuation scheme for an employee are subject to tax in a similar manner to PAYE. The employer must deduct specified superannuation contribution withholding tax (SSCWT) from the total amount of the contribution and pay it to the IRD. The SSCWT rate applied to the contributions is based on a person's salary received, rather than the total remuneration package. Therefore, if an employee is earning a salary of $40,000, any superannuation contributions over and above the $40,000 salary (regardless of the amount) paid by the employer will be based on the tax rate of the $40,000 salary, rather than the combined total of the salary and superannuation contributions. The ability to use a lower tax rate for the superannuation contributions is a perceived loophole in the legislation that is being exploited.

To provide a bit more detail, SSCWT can be deducted in one of three ways – a flat rate of 33% (which is the most common), a flat rate of 39% (which is hardly ever used) or banded rates of 15%, 21% or 33% (depending on the employee's income). The banded rates are applied to SSCWT deductions based on the previous year's income.

It works by a person opting for their employer to pay enough of their income as superannuation contributions in year one, to drop their salary to a lower tax band, so that in year two the SSCWT rate, which is based on the previous year's salary (post superannuation contribution) also drops to the lower tax bracket. The tax advantage is not reversed because superannuation contributions paid by the employer to a superannuation scheme are not classed as salary or wages, and are therefore, not taxed in the employee's hands.

For example, an employee who earns $100,000 will pay tax of $30,270 (with $40,000 being taxed at 39%). If the employee arranges for his salary to be reduced to $9,500, with the balance paid to a super fund, in the first year $1,425 ($9,500 @ 15%) of income tax and $29,865 ($90,500 @ 33%) of SSCWT, will be payable, remembering that SSCWT will be deducted at 33% based on the previous year's salary received of $100,000. Therefore in the first year of SSCWT deductions, the total tax would be $31,290 ($1,425 + $29,865), which would be more than the $30,270 that would have been payable if the $100,000 were to be returned as the employee's salary. The advantage arises in the next year as the SSCWT payable will be based on $9,500 (the salary received in the preceding year). The superannuation contribution of $90,500 will be taxed at the rate of 15%, being the applicable tax rate based on the salary of $9,500. The total income tax and SSCWT payable will be $15,000, a saving of $14,250.

In February 2006, the IRD published a paper entitled "Countering extreme salary sacrifice: ensuring that employer superannuation contributions are taxed fairly", the paper discussed remedies to fix the loophole. More recently the government has moved to the next step, with provisions to eliminate this loophole being included in the May Tax Bill.

Under the proposed new rules the applicable SSCWT rate will be based on the aggregate of the employer superannuation contributions and the respective employee's salary. The rates and thresholds for SSCWT will be as follows:

Total employer Superannuation contributions & employee's salary	**SSCWT rates**
Up to $10,925	15%
Between $10,925 and $43,700	21%
Over $43,700	33%

Therefore, using the $100,000 salary example, the employee would continue to have SSCWT deducted at 33%, which would not produce a saving.

The new rules are intended to come into effect from 1 April 2007.

Little Snippets

A Shake up for Partnerships

A shake up of the rules surrounding partnerships has commenced with the release of a discussion document which outlines a number of proposals. The changes are proposed to come into effect from the start of the 2008 – 09 income year. Some of the more prominent aspects of the issues under discussion are discussed below.

A new "limited partnership" regime will introduce a number of changes including giving separate legal personality to the partnership. Some of the changes will apply to all partnerships, others specifically relate to limited partners.

One of the key changes for limited partners is that the amount of loss that can be claimed will be limited to their economic investment. The rationale is that as the liability of a partner in a limited partnership is limited to their investment, their tax losses should also be limited to their economic losses.

One of the biggest problems under current law is that if a partnership's membership changes, either by admitting a new partner into the partnership, or having an existing partner exit the partnership, it technically results in the dissolution of the partnership and the creation of a new one.

Provision is included under the GST Act for changes to partnerships to be ignored, but there is no such treatment for income tax.

Under the proposed new rules, the partnership will be treated like a company. New partners and exiting partners will be treated as if they are either buying or selling "shares" in the partnership.

Therefore, the partnership will continue for income tax purposes irrespective of the partnership change.

If you have any questions about the newsletter items please contact us, we're here to help.