

NEWSLETTER

February/March 2004

TAX & BALANCE DATE MILESTONES

The calendar milestones of Christmas and New Year have gone. Holidays are over and key dates in the business and tax year loom. These dates are reminders to plan for the 2004 accounting year end and the year ahead.

Each year we send out an **Annual Questionnaire**. The questions are designed to prompt you to think about key business areas. Please pay particular attention to: bad debts, fixed assets, holiday pay, inventory and work in progress. Some key areas require action **before** your balance date arrives.

Bad Debts: In order to claim a tax deduction bad debt must be written out of your ledger before the year end, and all practical efforts taken to collect the debt.

Fixed Assets: Fixed assets should be reviewed. Where a fixed asset is no longer in use and not intended for use in the future, it should be scrapped or sold unless the cost of disposal outweighs the value of the asset. Once this action is taken, the asset can be written out of your ledger and a tax deduction obtained.

Inventory and Work in Progress (WIP): A stocktake should be undertaken and WIP involving a labour element should be valued based on the labour cost at balance date. Taxpayers with a turnover of less than \$1.3m who estimate the value of their closing stock at less than \$5,000 may be able to use a specific provision in the stock rules to avoid carrying out a stocktake.

Holiday Pay: Holiday and bonus payments made within 63 days of your balance date are deductible in the 2003/4 year where the payments are related to the 2003/4 financial year.

Subvention Payments: 31 March is a critical date for completion of subvention payments between commonly owned companies.

Qualifying Company Election Paperwork: Certain election paperwork for companies wishing to enter or exit the regime must be lodged with the IRD before year end.

TAX PAYMENTS

March 7 is the final 2004 provisional tax date for businesses with a 31 March balance date. This provides an opportunity to review your year to date results and ensure that you have sufficient tax paid to prevent the application of use of money interest and penalties.

Getting your provisional tax right is important for both cashflow and planning. Please call if you would like advice on the appropriate payment amount.

Terminal tax is due on **7 April** (For taxpayers with no tax agency arrangement with the IRD, terminal tax was due two months earlier on 7 February).

If you think that you may not be able to meet your tax payments, please contact us **before the due date**.

CONTENTS

TAX & BALANCE DATE MILESTONES.....1

TAX PAYMENTS.....1

FBT & MOTOR VEHICLE MULTI-LEASES.....2

KNOWING TRUST "JARGON".....2

THE DANGER WITH TRADING TRUSTS.....3

FARM CONVERSIONS.....3

DEALING WITH EMPLOYEES ON A BUSINESS SALE.....4

LITTLE SNIPPETS.....4

FBT Changes.....4

Non-trading Trusts.....4

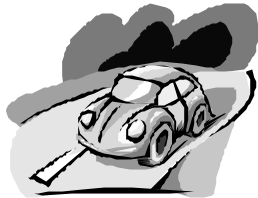
Reward for Good Behaviour.....4

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 a senior representative of the firm before acting upon this information.

We can talk to the IRD on your behalf and may be able to arrange an instalment payment plan to reduce your exposure to penalties.

FBT & MOTOR VEHICLE MULTI-LEASES

The IRD has issued a draft ruling on the FBT treatment of “multi-leases” for motor vehicles.



The ruling confirms the accepted understanding about the treatment of these leases.

Many businesses lease motor vehicles on “operating leases”. These leases involve the payment of simple rent in exchange for the right to use the vehicle. At the end of the lease period, the vehicle reverts to the lease company. The lessee does not own the vehicle. Typically operating leases run for any period up to 45 months* (i.e. 75% of the car’s estimated useful life).

The FBT payable on a leased vehicle is based on the value of the motor vehicle at the **beginning** of the lease period. Although most vehicles drop in value over time, the FBT calculation continues to look back to the original vehicle value. This means that, as the vehicle ages and declines in value, the FBT cost remains the same.

Lease companies have been offering leases for shorter periods, e.g. 1 year. At the end of these shorter leases the lessee can reassess their requirements and either return the vehicle or enter into a new lease. If the lessee decides to take out a new lease, the FBT calculation will be based on the value of the car at the commencement of each new lease. If the same car is leased under the new lease the FBT cost will decline in parallel with the reduced value of the car. These leases are commonly called multi or 1x1x1 leases.

While the draft ruling confirms the current treatment of multi leases, the IRD’s wide ranging review of FBT proposes that the FBT treatment of leased vehicles changes to align with owned vehicles. This will give a different result, removing the reduction in FBT cost available under the multi lease ruling. The FBT review is also considering the advantages gained under 9-to-5 leases.

Taxpayers currently using 9-to-5 or multi leases may face changes. Once the exact wording and impact can be determined, we will advise you of the outcome.

*Leases that run for more than 45 months are regarded as “finance leases” under the tax rules. Finance leases are treated differently for tax. The lessee is regarded as having purchased the car under a financing arrangement.

KNOWING TRUST “JARGON”

With the rise in use of trusts comes “jargon” that is peculiar to trusts. Increasingly clients ask about trusts and how they operate. Simple explanations follow for words and phrases that are part of trust jargon.

- Trust - a legal relationship where a person or persons (the trustees), holds property for the benefit of another person or persons (the beneficiaries).
- Trustee - the person or persons appointed to look after the assets that belong to the trust. The trustee’s powers are outlined in the Trust Deed.
- Settlor - the person who creates a trust.
- Discretionary beneficiaries - a group of people who have been nominated to share in the trust income, and where specified in the Trust Deed, also in the trust’s capital. The trustees decide who gets what from the trust.

- Final beneficiaries - a group of people nominated to share in the assets left in the trust at the time the trust is wound up.
- Settlement sum – This can be a nominal amount, say \$10.
- Trust deed - the document creating a trust. Its contents indicate who created the trust (settlor), who the trustees are, what the settlement sum is, the powers of the trustees, the group of people who may be able to share in the income and capital earned by the trust, and the group of people who are to share in the trust assets on wind up.

The creation of a trust can be explained as follows: A person (the settlor) creates a document (the trust deed) which entrusts the management of certain assets (the settlement sum, to begin with) to a person or persons (the trustees) for the benefit of people (the beneficiaries) that the settlor nominates within the trust deed. The ability of the trustees to “grow” the trust is defined within the powers given to them by the trust deed.

The main reason for creating a trust is to set aside and maintain assets for specific people (the beneficiaries). The assets may generate an income that can also be allocated to the beneficiaries.

Another area which creates some confusion is the difference between an estate and a trust.

- Estate - when someone dies, all their assets and liabilities go into an estate. An estate is a trust which administers the assets of a deceased person. The estate has a trustee (referred to as an executor) appointed (usually by the will) to administer the estate. The estate is a special type of trust that is created only at the time of a person’s death.
- Trust - usually an entity that is created by a living person who contributes a sum (settlement sum) to start the entity.

Who "owns" the trust's assets? All the assets of the trust are legally held in the joint names of all the trustees. If "A" and "B" are the trustees, then any shares owned by the trust will be in the name of "A & B". However, the assets do not belong to the trustees. The trustees are holding the assets for the beneficiaries, until the time those assets are distributed to the beneficiaries.

Trustees must act with diligence and prudence. This means that they must act in a manner that any prudent person would, if dealing with his/her own assets. Trustees are personally liable for their actions.

THE DANGER WITH TRADING TRUSTS

In August 2002 we reported the issues that the IRD had taken up with a Dentist that decided to restructure his practice from a partnership into a trading trust with a company as the trustee (referred to as a corporate trustee).

Historically, the trading trust has been used as an alternative to the "normal" corporate structure without censure; however, in recent times, the Inland Revenue has taken an interest in trading trusts on the basis that they are tax avoidance structures.

The beneficiaries of the dentist's trading trust were the dentist, his wife and their children. The trust then commenced its dental practice, using the dentist to provide the required dental services. The dentist became an employee of the trust.

The income from trading in the new structure was earned by the trust, rather than the dentist. The income from the trust was allocated to beneficiaries by the trustee company on a discretionary basis, and a salary was paid to the dentist for his services provided to the trust.

For the year in question, the trust earned income of approximately \$212,000. The dentist was paid a salary of \$80,000.

The Inland Revenue took issue with the structure and reassessed the dentist for the entire amount of the trust's income, on the basis that the structure was in part, designed to avoid tax. Their view was that all the \$212,000 earned should have been the dentist's income.

The judge in the case held that at least one of the purposes of the structure was for tax avoidance even though the primary purpose was for asset protection. The judge also felt that the \$80,000 salary paid to the dentist was below market rates. The dentist was free to reconstruct his partnership into another business structure but the salary paid had to be at market. In the end, the judge said that a market salary level of \$120,000 was appropriate for the dentist.

The judge did not think it was necessary to dismantle the structure for tax purposes, but it needed to be "fixed" so that the structure no longer resulted in tax avoidance. This was achieved by setting the dentist's salary at a market rate.

Where the effect of the tax avoidance is "merely incidental", tax avoidance will not apply. In this case, the judge decided that the fixing of the salary at an artificially low figure did not have a "merely incidental" effect.

This case is interesting for two reasons:

1. This is the first time that the use of a trading trust has been challenged through our Courts. The Inland Revenue's challenge focused on tax avoidance. Their success suggests that there will be no hesitation in challenging (whether in Court or otherwise) the ability to use trading trusts as a legitimate business structure where a tax saving is achieved by an artificially low salary.
2. Of wider implication is the suggestion by the Judge that payment of a salary at below market rates as part of a rearrangement may constitute tax avoidance. There is an

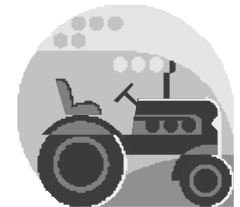
incentive when using such structures to limit payments for those working in the business to \$60,000, given the difference between the top tax rate of 39% (for income over \$60,000) and the trust tax rate of 33%. This Court decision indicates that where the salary is less than the "market rate" (whatever that may be), the Inland Revenue may have the ability to challenge the salary on the basis of tax avoidance.

Prior to this case, Inland Revenue (or the Courts) has not required a market-based salary to be paid to those working in "family" businesses. How broad the application of this case will be has yet to be determined.

This case may yet be appealed, and if so, we will look forward to the result with bated breath.

FARM CONVERSIONS

Inland Revenue recently published a draft document setting out the income tax treatment of certain expenditure on



conversion of land from one farming or agricultural purpose to another.

In summary, the document takes the view that costs related to the conversion of land from one use to another are capital in nature. In some instances this includes costs which would have been part of the normal farm operations had the conversion not happened. For example, an activity such as re-grassing is usually part of the normal farming operation, and is treated as a deductible expense. For a dairy conversion the tax treatment changes. The entire conversion is capital in nature and the whole expenditure cannot be separated into parts which are deductible and parts which are not.

In conversion situations, expenditure will need to be depreciated/amortised and the tax deduction claimed over a number of years. Limited relief is provided by special rules allowing an up-front deduction for some costs on land used for farming or agriculture, albeit that these costs are normally capital in nature.

Undertaking a conversion is usually a significant and costly exercise. It follows that the tax implications will also be significant. Getting the right answer is important. If you are contemplating a conversion we suggest reviewing the tax consequences with us first.

DEALING WITH EMPLOYEES ON A BUSINESS SALE

Often, when a business is sold, the employees in the business are “taken over” by the purchaser as part of the whole business purchase. When the purchaser takes over the business, the employment relationship between the employees and the employer (vendor) is effectively at an end. The vendor of the business needs to give notice to employees that they will no longer be employed from the date of the business takeover.

If the purchaser wishes to re-employ certain employees, there must be a new offer of employment made to those employees. The employees can then choose whether or not to accept the purchaser's offer. The purchaser cannot assume that all the employees will want to continue to be employed by the business.

However, the situation for a purchaser considering re-employment of existing employees may change if certain provisions in the new Employment Relations Law Reform Bill are adopted. These provisions aim to protect the position of employees who are deemed to be “vulnerable” in a

restructuring situation. “Vulnerable” employees include cleaning, catering and laundry staff. The nature of the protection is the right of the affected “vulnerable” employees to elect to transfer to the new employer on their existing terms and conditions of employment. Alternatives to transfer may be negotiated.

LITTLE SNIPPETS

FBT Changes

Another recently published document from the Inland Revenue contains proposed changes to the FBT regime. These changes are intended to reduce compliance costs for taxpayers. The proposed key changes are:

- Fringe benefit value of motor vehicle is reduced from 24% to 20%, if using the vehicle's cost.
- Fringe benefit value of motor vehicle provided is 36%, if using the vehicle's depreciated book value.
- Aligning the treatment of leased vehicles with owned vehicles.
- All employee carparks subject to FBT, unless under a threshold value.
- The multi-rate calculation to be retained, but with streamlined options such as the Inland Revenue multi-rate calculator.
- Increasing the non-taxable threshold for “other benefits” provided from \$75 to \$200 per quarter per employee, and from \$450 to \$2,000 per quarter for all employees.

Non-trading Trusts

In the past, the Inland Revenue required all trusts to file annual tax returns, whether or not the trust had been active or earning income. Inland Revenue has now changed its stance, so that where a trust clearly has no prospect or intention of earning income; it will not be required to file a tax return. It will

be up to the trustees to demonstrate that the trust is inactive.

However, if the trust starts to receive income, e.g., interest, the trustees of the trust must file a tax return regardless of the amount of income earned.

To stop filing trust tax returns, the trustees will need to contact the Inland Revenue to advise the name and IRD number of the trust, and confirm that the trust will not be filing tax returns. If the trust has a tax agent, then the advice and confirmation can be made by the tax agent. If, in the future, the trust receives income, tax returns will be required from the year in which income is received.

Reward for Good Behaviour

Hidden in the depths of the tax penalties regime is a provision which rewards taxpayers for “good behaviour”. What does this provision do? The gist of it is that if you are stung with a shortfall penalty, you will be able to get a 50% “discount” on the penalty if you have exhibited “good behaviour” within a “probation” period. The discount generally does not apply to tax evasion offences.

The discount applies if:

- For income tax purposes, there has been no penalty for a breach of the same type within the last four years.
- For GST, PAYE, fringe benefit tax and resident withholding tax purposes, there has been no penalty for a breach of a similar type within the last two years.

Therefore, if you are on the receiving end of a penalty, and you have been behaving yourself, you should remind the Inland Revenue that you are entitled to a 50% discount.

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

