# NEWSLETTER

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## Tax Avoidance, LAQC's And The Family Home

The IRD has warned that taxpayers who are selling their private home to a loss attributing qualifying company ('LAQC') and then claiming tax deductions on resulting losses have come under scrutiny. Under this arrangement the taxpayers pay rent to the LAQC, which then enables the taxpayers to generate a loss they then claim as a tax deduction against their personal income. The IRD considers this type of arrangement as possible tax avoidance.

A number of advisors have recommended the use of an LAQC structure to hold residential investment properties as this structure offers greater flexibility. There appears to be no issue if these properties are being rented out to tenants on an arms length basis. The concern is with the taxpayers' family homes that are not investment properties.

In this situation the IRD would look at the underlying reasons for the LAQC to consider whether there is a commercial reason for its operation or, whether it appears the main purpose for the LAQC is to obtain a tax advantage or benefit.

The reason the arrangement is considered tax avoidance is that the tax deduction is claimed for expenditure that is effectively of a private and domestic nature. If the arrangement is considered tax avoidance the taxpayer will be liable for the tax avoided, any use of money interest and penalties of up to 100% on the amount payable. The existence of a LAQC structure that owns the family home and appears to have no investment or business activity is likely to attract the attention of the IRD.

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## Buying and Selling Property

The IRD is currently reviewing the results of searches of the property register. This means the buying and selling of property, whether you live in the property or not, needs closer scrutiny. Where a search of the property register indicates a pattern of five or more property transactions in a three-year period, the IRD may request reasons for the transactions to determine whether any gains will be taxable.

The provisions in the Income Tax Act 1994 relating to land transactions provide the IRD with a basis for looking at the tax treatment of transactions which involve the buying or selling of property, even if there has been no development before the property is sold. One issue to consider is whether the land has been purchased with the purpose or intention of reselling the property. To determine the purpose or intention, or to help prove otherwise, reference to documentation including correspondence with or notes made by the bank, real estate agents or professional advisors will assist.

If the taxpayer had a number of different intentions at the time of purchase and one of those intentions was a crystallised intention of resale, the sale will be taxable. However, if the purpose of resale is remote or unsupported by evidence this will not be enough to establish intention of resale. The Courts have indicated that the mere fact that at the time of purchase of the property the taxpayer did not expect to hold the property forever and contemplated the possibility of sale does not establish conclusively that there was a purpose of resale.

Another avenue the IRD may pursue to determine whether there is any taxable gain is where the taxpayer (or someone associated to taxpayer) is engaged in the business of dealing in land. The Courts have found that 'dealing' refers to buying and selling or exchanging land. This would mean the act of buying and selling without altering the land in any material way.

Whether a taxpayer is in the 'business' of dealing in land is dependent on a number of factors to see whether the transactions amount to a business activity and there is the necessary intention to make a profit.

The factors to consider include:

- Whether there is a series of repetitive transactions in respect of blocks of land;
- The timeframe and period over which the transactions occur;
- Commitment of time, money and effort;
- The scale of the operations and whether the activity is organised in a commercial manner;
- The financial results that are achieved.

The business of dealing in land must have been carried on by the taxpayer (or associate) at the time the taxpayer acquired the land for the gain to be taxable.

If the taxpayer lives on the property will any profit still be taxable under these provisions? There is an exemption that may apply where the taxpayer or any member of their family lives at the property. However, the exemption will not be available if a regular pattern of buying, living and selling in the properties concerned has occurred. Therefore, care needs to be taken if there is a possibility of a pattern emerging when buying and selling property.

## Salary Sacrifice

Given recent debate about savings for retirement in the workplace, it may be a good time to consider benefits obtained by "salary sacrifice". There are advantages to careful planning of salary arrangements to allow contributions on behalf of employees that can be applied to a number of benefits such as employee share plans, entitlements, plans or superannuation schemes. Salary sacrifice refers to the concept that an employer and employee agree that a reduction in salary is taken in return for the employer making a contribution on behalf of the employee; commonly to a superannuation fund. In other words, by sacrificing part of their wage or salary so that it is not available as cash, the employee is building up a savings investment for retirement. The agreement with the

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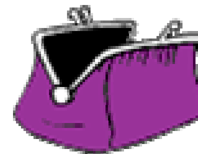
employee to sacrifice part of their pre-tax salary needs to be made prior to the employee earning the salary.

Benefits from salary sacrifice provide added incentives for individuals to save for their retirement. Since the recent increase in taxes many employers have sought advice on the use of salary sacrifice for employees in higher income brackets. The key to reviewing benefits of salary sacrifice is that pre-tax income is being used.

Superannuation contributions by way of "salary sacrifice" are taxed under the Superannuation Scheme Contribution Withholding Tax (SSCWT) provisions, which currently can apply variable tax rates in individual circumstances. An employer can now elect to deduct SSCWT at the employee's marginal tax rate. The tax rate may be as low as 15% depending on the salary paid. The rate of SSCWT that will apply is determined according to the salary paid to the employee in the previous year. The salary 'sacrifice' is not counted as part of the salary derived by the employee. As the salary will be lower once it has been 'sacrificed', the savings will come through the year after the agreement is entered into. To ensure no FBT is payable, the salary sacrifice contributions must go into a registered superannuation scheme.

Aside from the tax advantages, there are two critical economic issues to consider here. Firstly, the employee's cashflow position. Can they afford the salary sacrifice or do they need that money for their day to day living? How long is it before they will want to access the funds invested? If withdrawals are required before retirement a 5% Fund Withdrawal Tax will apply unless one of the limited exemptions are available. The second issue is how the risk and return of the particular superannuation scheme compares with other investments the employee could make with those funds.



## Changes To Depreciation Rules

A Depreciation Issues Paper released in July 2004 proposed changes to the depreciation regime including the depreciation of patents, special tax depreciation rules, plant variety rights and losses on disposal or destruction of buildings. These changes have been included in the Taxation Bill released on 16th November 2004. The depreciation proposals included in the Bill are:

- Deductions for losses on destruction of buildings if the destruction is due to events that are beyond the taxpayer's control, for example, as a result of a natural disaster. Currently no deduction claim can be made.
- Plant variety rights (granted under the Plant Variety Rights Act 1987) and the right to use them will be included as depreciable intangible property. The rights granted generally relate to new varieties of cultivated plants. As a result of this change, any amounts that are received on the grant of plant variety rights will constitute a taxable royalty.
- Currently, depreciation on patents is allowed from the date a patent is granted; however, legal protection applies from the date when an application is lodged. The Bill introduces a new provision, which allows depreciation to be claimed from the date the patent is given legal effect (when the completed application is lodged). Depreciation will be deductible from the date of application to the date the patent is granted, in the income year in which the patent is first used or available for use in earning income.
- Amendments to the special tax depreciation rate rules to allow the IRD more flexibility in determining a special tax depreciation rate when requested by a taxpayer. The bill also proposes to extend the special tax depreciation rules to fixed-life intangible property if the taxpayer believes that the economic life of the asset will be significantly less than the legal life of the asset.

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## Privilege For Tax Advice

'Privilege' in legal terms refers to the right of non-disclosure of certain information communicated in giving or obtaining of advice between lawyers and their clients. The government introduced a Bill on 16 November 2004, which will extend this privilege to professionals such as Chartered Accountants when providing tax advice to clients. If the main purpose of communications between clients and advisors is to receive or give tax advice on tax laws, these communications will be privileged. The advisor will need to be approved by the IRD as a tax advisor.

Privilege will not extend to the following:

- Factual information relating to the transaction;
- Accounting and tax workpapers that support financial statements and tax returns;
- Debt recovery matters;
- Other non-tax advice such as valuation and investment advice; and
- Documents that are created for the purpose of promoting or committing an illegal act.

Information regarding the facts of a transaction will need to be disclosed to the IRD in the form of a statutory declaration. The right to privilege lies with the client. A client may waive the right to privilege, for example, if they feel the disclosure of certain information will not adversely affect the tax position they have taken. This extension of the right to privilege is a welcome change to the law as it now encompasses advice given by non-lawyers on what is essentially advice on legal issues and the interpretation of tax legislation. The changes may hopefully encourage clients to be more open with their non-legal tax advisors with the security of knowing the communication will be privileged. The extension of privilege to approved non-legal professional tax advisors will apply from the date of enactment.

## Little Snippets

### Prison Sentence for Tax Evasion

The Tauranga District Court recently imposed a 21 month prison sentence on a taxpayer who pleaded guilty to two charges of tax evasion. The taxpayer was in the fruit picking industry and had not accounted for approximately $158,584 of GST, PAYE and income taxes. The prison sentence followed an increased focus by the IRD on tax evasion in the fruit picking and contracting industries. The IRD has focused on the Bay of Plenty, Hawkes Bay, Waikato, Otago and Marlborough areas and have indicated that currently there are approximately 60 investigations underway in these areas. The sentence sends a clear warning that the Courts see tax evasion as a serious crime.

### Beware of Pre-Incorporation Contracts

Agreements entered into to bind a company in contemplation of its pending incorporation are usually referred to as pre-incorporation contracts. Pre-incorporation contracts are commonly entered into on behalf of the company, to ensure the company has legal rights to take over business undertakings once incorporation is completed. Therefore, if there is no incorporation contemplated when the agreement is entered into, it will not be a pre-incorporation contract. The High Court recently held that a sale and purchase agreement was not a pre-incorporation contract because at the time the agreement was entered into there was no 'specific or ascertainable' company in mind, and the agreement was entered into on behalf of a company or trust yet to be formed. As there was no specific company in mind, the agreement could not have been entered into in contemplation of its incorporation. Pre-incorporation contracts are quite often ratified after the company is formed, to confirm that the new company intends to adopt and perform the pre-incorporation contract.

### Pre-emptive Rights and Trustee Changes

In the previous newsletter, the case Calan Healthcare Properties Limited was mentioned in relation to a change of trustees. The Court, in that case, held that a change in trustees triggered other shareholders' pre-emptive rights, which was a bizarre outcome, as there was only a change in legal ownership, not beneficial ownership. The case was appealed and since our last newsletter, the Court of Appeal has overturned the decision.

The result is that the pre-emption rights are triggered only where there is a change in both legal and beneficial ownership. Changing trustees, which only entails change in legal ownership is not sufficient to trigger pre-emptive rights.

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

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