

NEWSLETTER

May/June 2004

FLOOD RELIEF

The recent disastrous floods have devastated taxpayers in the lower North Island. Where they have experienced a loss of records (either paper or electronic) or they are unable to access their computers, they should as soon as possible be in touch with their local IRD office.

Amending legislation allows IRD to remit UOMI and penalties on tax payments made late because of the flooding and to accept late estimates of provisional tax. Provided contact is made before due date, the IRD will consider installment payment options where tax payments cannot be made by the normal due date. This will reduce penalty exposure and in some cases, IRD may allow a permanent or temporary relief from payment. Taxpayers wishing to seek relief will need to prove they have been significantly affected by the February flooding, or in later years by a natural event that is a gazetted state of emergency.

In addition IRD are considering the deductibility of flood damage repairs, replacement of plant, treatment of insurance proceeds and other compensation, donated stock and cash.

Farmers and other taxpayers with a May or June balance date, who are still to pay the third installment of their provisional tax should consider re-estimating their 2004 provisional tax prior to the due date for that installment. This estimate can be made on a best endeavours basis. IRD

advise that the required standard of care is related to the flood related difficulties and that standard may be lower than normal, which reduces the exposure that might otherwise arise in respect of penalties for lack of reasonable care in the estimate.

Affected farmers or forestry businesses should also consider using the provisions of the Income Equalisation Deposit rules or the Adverse Event Income Equalisation Scheme, to defer the tax obligations that might otherwise arise in relation to the 2004 tax year.

THE FINE PRINT IN LEGAL DOCUMENTS

A recent High Court case *Mortre Holdings Ltd v Starrenburg and Anor*, highlighted the desirability of reading the fine print. A series of sale and purchase agreements contained warranties that both the vendor and the purchaser were GST registered, and that on the basis that the properties were tenanted, the sales were of going concerns and zero rated for GST.

The vendor was shocked to discover that the buyer was not in fact GST registered so that output tax was payable. He then sought recovery from the buyer. The Court said the buyer had breached its warranty and was liable to the vendor for damages for the breach. The Court said the vendor was entitled to

recover the loss it suffered in paying the output tax.

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PLANNING YEAR END TAX

Where clients have a balance date after 31 March 2004, the following planning steps can be applied to reduce their tax costs:

- *Undertake prepaid expenditure* to obtain a tax deduction in the 2004 tax year. As the rules in this area are complex you should obtain advice to ensure the expenditure is not of a capital – non deductible character, that the correct timing is established and that it is able to be deducted in 2004;
- *Holiday pay and employee incentives* should be paid within 63 days of balance date;
- *Bad debts* should be written off in the debtors ledger and appropriately documented as bad prior to balance date;
- *Distributions to beneficiaries of trusts* should be either paid out or a trust resolution to distribute passed within 6 months of balance date;
- *Foreign currency loans* accounted for under the expected value approach and where losses are anticipated, should be realised before balance date by repayment or rollover;
- *Business stock where market value is less than cost* should be sold before balance date to realise the loss in value where tax rules otherwise require it to be valued at cost;
- *Farmers holding stock whose value is less than national standard cost or herd value* should also sell that stock to realise the loss for tax purposes;

- *Resolutions to pay shareholders' salaries* passed prior to balance date.

PROTECTING YOUR AFFAIRS WHEN YOU ARE INCAPACITATED

Most business people have wills dealing with their affairs when they die. However they often overlook what may happen if they are incapacitated or overseas. Existence of a power of attorney is an important document alongside a will. An ordinary power of attorney traditionally deals with property and is commonly used when a person is traveling overseas but is not limited to those circumstances. The ordinary power is cancelled on the death or incapacity of the grantor. That means that if the grantor has an accident or becomes mentally incapacitated through illness or age, no one can deal with the person's property.

In addition it may be necessary for the Court to appoint a stranger rather than a caring family member to make life or death decisions on behalf of the incapacitated person. A solution to both problems is the grant of an enduring power of attorney. This type of power of attorney is not cancelled when a person is incapacitated.

A person to whom an enduring power of attorney is given can make financial, medical and welfare decisions on behalf of an incapacitated person. There are two types of enduring powers of attorney – one dealing with property and the other with personal care and welfare. The property power is often given to a person who has knowledge of and ability to deal with the incapacitated person's assets and business affairs, while the personal welfare attorney is usually entrusted to a person who is closely related to the

incapacitated person. This one must be given to a single person.

If you have a will but no power of attorney, it is desirable to take early steps to establish one on an enduring basis.

AUSTRALIA / US FREE TRADE AGREEMENT AND ITS IMPACT ON NZ BUSINESS

This recently signed agreement comes into effect on 1 January 2005 and will provide Australian business with



some import duty concessions on Australian source goods imported into USA, particularly manufactured products. The most obvious categories that could impact on NZ businesses are mechanical appliances, electrical machinery and precision equipment.

NZ businesses involved in exporting to USA should consider how this may impact on them, and whether opportunities are available to them. Location of manufacturing units in Australia may assist. In comparison the NZ business may find an Australian competitor has a more competitive export position. In addition to the direct effect from tariff reductions various tax factors must be considered. NZ businesses operating in Australia either in the form of a subsidiary company or a branch, face potential adverse tax consequences.

Possible solutions that may be considered are:

- A NZ business may license manufacturing systems to an Australian entity and receive a royalty for the licence;

- A NZ company could operate in a joint venture with an Australian entity;
- Transfer operations to Australia.

Forward planning to accommodate the changing situation would be desirable.

TRAVEL BETWEEN HOME AND WORK – DEDUCTIBILITY AND FBT ISSUES

IRD issued a draft interpretation statement setting out guidelines for determining whether travel between home and work is business travel or work related for deductibility or FBT purposes. This ruling may be relevant for many taxpayers.

The general rule is that travel between home and work is private travel and not an allowable deduction for self-employed taxpayers. Similarly where a vehicle is provided to an employee for travel between home and work it is considered available for private use or enjoyment for FBT purposes. In some circumstances, however, travel between home and work is not private. This occurs where such travel is undertaken in the course of performing work rather than in order to commence work or to return home.

In cases relating to deductibility of travel expenditures between home and work (some of which relate to taxpayers who are employees), the following broad factual situations have been identified as circumstances where travel between home and work is "on work" rather than travel to enable the taxpayer to commence work:

- Where a vehicle is essential for transport of goods or equipment necessary for the performance of employment duties at the home and elsewhere;
- Where the taxpayer carries on an "itinerant occupation" (that is, the taxpayer does not work from a fixed work place and the home is the taxpayer's base of operations);
- Where the taxpayer is required to be accessible at the home for employment duties and is required to undertake travel in response to emergency calls; and
- Compliance with FBT rules particularly requires that appropriate administrative procedures and controls exist if an exemption is to be obtained. One argument that is often used is that a vehicle is taken home for security reasons. IRD do not accept that as sufficient reason on its own.

Common principles relate to deductibility of motor vehicle expenditure and FBT. IRD consider that for both, the issue is whether the need for the work to be performed partly at the home (and, therefore, the need for the travel) arises from the nature of the work. Travel between home and work would be private travel if the work is performed at the home because of personal circumstances, or personal preferences of the taxpayer.

For travel to be work-related travel, it is not sufficient that the employer and employee have contracted on the basis that employment duties would be performed partly at the home.



You should discuss your particular circumstances with your adviser.

FINES AND PENALTIES

The general view is that there is no income tax deduction for any fine or penalty paid for a breach of law. Historically the IRD allowed a deduction for some fines, for instance where a fine was imposed on an employee because of a breach of law while the employee was carrying out their employment duties and the employer reimbursed the employee the amount of the fine. A common example is where a sales representative is given a parking ticket or speeding ticket or a truck operator is fined for overloading.

Recently it has been noticeable that IRD auditors are taking a tougher line on the deductibility of fines and penalties. Specifically their view is "**No deduction for fines or penalties for any reason**". This view is founded on the principle that it is a matter of public policy that there should be no mitigation of the consequence of the fine or penalty.

This view appears harsh and the correct test should be whether there is a connection with the business of the self-employed taxpayer or employer taxpayer who reimburses the employee's fine.

It is accepted that there is limit but that limit can be defined according to whether the fine or penalty is a personal or business structure cost (non deductible), as distinct from having a connection to carrying on the business.

Irrespective of the reasonableness of this view, taxpayers should appreciate that the IRD are currently taking an uncompromising stance.

On the GST front, amending legislation last year indicates that GST does not apply (GST exempt) to the following:

- Penalties or default interest or a charge in the nature of interest that is imposed either under a contract for supply of goods and services or under a statute;
- Late payment penalties imposed by a local authority under the Local Government (Rating) Act for the late payment of rates;
- Finance costs imposed by a local authority under the Local Government (Rating) Act when rates are imposed.

These changes mean that interest and penalties charged by ACC and rates penalties and interest are GST exempt.

ARE YOU ADMINISTERING YOUR FAMILY TRUST TO KEEP IT SAFE FROM CHALLENGE

A common belief is that assets held by a family trust are protected from the claims of people who may be able to successfully claim directly against the individuals who are beneficiaries of the trust.

Claimants include business creditors, the taxman, other state agencies, divorced spouses and other family members. Specific provisions are contained in the Relationship Property Act, Companies Act, Family Protection Act and various other statutes. In most cases the use of a trust is effective, as it is the individual who remains exposed, rather than the trust.

However the protection provided is only effective if the trust is administered correctly and established with the correct formalities.

Claimants and their lawyers will seek any opportunity to overturn the trust as a whole, or trustees' decisions, if either the form or administration is deficient.

A trust or trustees' decision can be brushed aside if there is a sham or invalid situation. The trust may be considered a sham if there is no valid trust settlement i.e. the assets remain in the hands of the intended settlor, rather than handed over to the trustees. To be valid a trust requires an intention to create a trust, existence of trust property and identifiable beneficiaries. If any of these do not exist the trust is therefore not created.

If the trustees do not act independently of the settlor, the trust may not in fact exist. If the trustees' decisions are not made in accordance with the trust deed or are made in breach of their duty to the beneficiaries, the decisions may be ineffective. If decisions are contrary to public policy due to illegal conduct, tax fraud, or as a fraud against creditors, the resulting transactions may be challenged.

On an administrative level there should be:

- a separate bank account;
- a deed of trust;
- decisions substantiated by trust resolutions;
- a proper decision making process undertaken by trustees; and
- evidence that the trustees are acting for the benefit of the beneficiaries and not for the settlor.

If any of these aspects are lacking, your trust could be open to challenge from disaffected or disgruntled parties.

SNIPPETS

Coming up in future tax legislation:

- Deductibility of costs relating to patent and resource consent applications that are not granted or are withdrawn – currently such costs are black hole expenditure and non deductible.
- Allowing the IRD to determine amortisation rates for various types of horticultural plants reflecting their estimated useful lives.
- Closing loopholes involving the sale and leaseback of intangibles such as trademarks and newspaper mastheads.
- Providing a 6.7% tax rebate for early payment of tax on self-employment and partnership income in the first year of business – currently not payable until the second year of business.
- Reducing the non-declaration withholding tax rate for non-resident company contractors from the current 15% to 5%.
- Legislating for self-assessment of GST.
- Establishing penalties for NZ employers who do not withhold tax from contract payments for non-resident contractors.



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