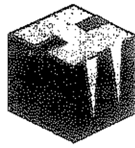

Harvie• Green• Wyatt
Chartered Accountants

Specialists in Taxation, Information Technology & Business Advice

CONTACT DETAILS
Health Board House
229 Moray Place
PO Box 5740
Dunedin

Phone (03) 477 5005
Fax (03) 477 5447

PARTNERS	Email Address
DJ Harvie	dharvie@hgw.co.nz
AC Wyatt	cwyatt@hgw.co.nz
TG Miller	tmiller@hgw.co.nz
BM Challis	bchallis@hgw.co.nz
RP Friedrich	rfriedrich@hgw.co.nz

NEWSLETTER AUTUMN 2010

Tax Reform Looms

The Government has indicated that it intends to introduce a number of reforms to the tax system. It's main areas of concern centred on:

- the amount of funds invested in rental properties which generated a negative taxable return (approximately $500 million in 2008).
- the lack of fairness and integrity in the treatment of different tax entities.
- the reliance on taxes most harmful to growth such as corporate and personal income taxes and
- the risks to the sustainability of the tax base.

The start of these reforms, which are not intended as a on-off exercise, will be announced on Budget Night on May 20th. There have been strong indications that:

- GST, which is perceived as a more efficient way to collect tax, will increase from 12.5% to 15%.
- The increase in GST will be accompanied by across the board income tax cuts and up front increases in benefits, NZ Superannuation and Working For Families payments.
- Depreciation on buildings may no longer be deductible for tax purposes,
- The definition of existing "capital gains" provisions will be improved and their policing increased, and
- The income test applying to Working For Families may be widened to include income earned by other associated parties such as trusts.

In addition, it has been mentioned that the top personal tax rate (currently 38%) and trust tax rate (33%) could be aligned while the company rate could be dropped below it's current 30% to match an expected decrease in Australia's company rate.

However, until the reforms are announced there is no certainty as to the extent of any tax changes nor their application dates. Further, as with all tax changes, the extent to which they apply to different taxpayers can only be determined by examining the detail of changes.

Year End Processing

For most taxpayers the end of March represents the end of the financial year, so now is a good time to check that the books are in order. In some cases 31 March is the crucial date for getting things done. Some of these have been outlined below:

Bad Debts – in order to claim a deduction for bad debts, they must be written off before the end of the financial year in order to get a deduction in that year. Emphasis should always be given to debt collection. However if debts do not look collectable, they should be written off to provide a more accurate reflection of the businesses profitability.

Assets – need to record any assets costing more than $500 as these are capitalised for tax purposes.

Holiday Pay – entities wanting to get a deduction for accrued holiday pay or employee bonus payments must ensure that the holiday pay and bonus payments are "incurred" at balance date & paid within 63 days of balance date.

Imputation Credits and Dividends – if a company has imputation credits that have arisen based on the old company tax rate of 33 percent you need to ask whether or not to declare a dividend to shareholders to utilise those credits. The cut off date for declaring dividends to utilise those imputation credits is 31 March 2010 irrespective of a company's balance date. From 1 April 2010 imputation credits are limited to the equivalent of 30 percent – in line with the current corporate tax rate. Remember that extra tax will be payable if the shareholder receiving the dividend is taxed at the top marginal rate of 38%.

Retentions

Do you have to wait for retentions to be paid to you? Any amount you have invoiced before 31 March but is not due for payment until after that date, can be held over, for income tax purposes, as income for the next year.

Stock

If your sales are less than $1.3 million and your stock (inventory) holding at the end of the year cost you less than $10,000, you do not need to count it. You can use the same stock value as last year.

Livestock - Herd Scheme Election – for farmers wanting to exit the Herd Scheme, the election must be done at least a year and a day before the income year in which the National Standard Cost scheme is adopted.

There are quite a number of issues that need consideration before the financial year end – the above are offered as reminders of some of them.

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. But there is a real danger in doing so from a tax perspective.

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 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.

Expansion of Associated Persons Rules

Transactions between associated persons are subject to special scrutiny in NZ tax law because of a belief that such transactions can pose a substantial risk to the tax base due to the closeness of the relationships of the persons involved.

For tax purposes, they may be regarded as single economic entities because of their community of interests.

The definitions of "associated persons" are mainly used in an anti-avoidance capacity and operate throughout the legislation with specific importance in the area of land sales.

Existing legislation taxes profits on land sales by property dealers and developers if the land is sold within 10 years of acquisition, and by builders if the land is sold within 10 years of completing improvements to it. These provisions also apply if the land is sold by a person associated to the dealer or developer at the time the land was acquired or was associated to the builder at the time the improvements were begun.

Also a person can be taxed on profits from the sale of land if that land was purchased from an associated person and that associated person would have been taxed on the profit if sold by them.

Recent changes to the legislation (passed in October 2009) have rationalized various existing "associated person" definitions into a more coherent provision and, in doing so have simplified the definitions. However the changes have significantly widened when parties may be associated, especially where Trusts are involved. In addition they have introduced a tripartite test associating 2 otherwise non-associated persons, if they are each associated with the same third person.

As a result the land taxing provisions are likely to be more wide ranging and apply to transactions which would not have previously been taxed. In view of this, careful consideration should be given when deciding how a land transaction should be treated.

DON'T BE LATE

TAX CALENDAR

April 7
2009 Terminal Tax
(March Balance Date)

May 7
3rd Instalment 2010
Provisional Tax
(March Balance Date)
GST for March 2010

May 28
1st Instalment 2010
Provisional Tax
(December Balance Date)
GST for April 2010

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