

Tax Alert

A focus on topical tax issues – March 2010



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Be aware – tax avoidance in private business

By Darren Johnson

In the past two months, three TRA decisions have been released involving small business taxpayers in which tax avoidance has been alleged by the Commissioner. The Commissioner has won two of these cases.

One of these cases in particular appears to shift the boundaries of when an arrangement amounts to 'tax avoidance'. The case goes to the heart of New Zealand small to medium business and practice. The case challenges traditional thinking around what is acceptable behaviour and creates an uncertain environment for taxpayers and practitioners.

The case in question is case TRA No. 03/08, Decision No. 3/2010 and involved a series of transactions that until now most experienced tax practitioners would regard as rather benign and outside of the boundaries of tax avoidance. Rather surprisingly, the TRA not only held there was a tax avoidance arrangement, but also, with relative ease, found that a penalty for adopting an abusive tax position should be applied.

This case probably supports the maxim that bad facts make bad law. The facts were that a property developer received a series of loans (mostly from trusts)

over a 12 year period, while at the same time drawing only a small salary. The trading entities themselves operated in a way so that virtually no tax was payable, as the income from one project was generally offset by the costs of the next project.

Notwithstanding that the underlying trading entities did not derive taxable income, the TRA found that the receipt of loans by the taxpayer and held on "loose" terms, rather than a salary, amounted to tax avoidance.

The taxpayer had repaid part of the loans out of capital distributions from the entities. On this point the TRA noted that the Commissioner was generous in assessing only the net balance of the loans.

What does this decision mean for taxpayers and tax advisors?

While the case has quite a unique fact pattern, a number of aspects are very common in the SME context, namely:

- The non-payment of salaries to 'owners' in the absence of taxable income in the trading entity
- Drawing off and living on capital gain amounts
- The use of current accounts within family structures to transfer money
- The use of journal entries to record movements in current accounts.

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It is common and accepted practice in New Zealand that owners of closely held businesses receive 'owner' salaries to the extent of the taxable income in their business entities. It is also common practice for those owners to live off built up capital value during the times where the business entity does not derive taxable income.

What is not clear is in what circumstances the Inland Revenue will be looking for some form of market based salary to be paid to the 'owner operator' of a private business to mitigate an avoidance challenge. There has never been a requirement in New Zealand tax law to pay a salary to an 'owner' of a private entity. This position was confirmed in the recent High Court decision of *Penny & Hooper*. Although it should be noted that *Penny & Hooper* is currently before the Court of Appeal and the facts in this case are much more provocative in the sense that they involve a restructure that had the effect of sheltering income directly earned by the taxpayer's services.

That as it may, there are many aspects of the current decision that are unsatisfactory, including the lack of signposting provided to define the avoidance boundary.

That penalty!

Of probably even more concern is the amazing ease (and little detail) by which the TRA decision upheld a penalty for an abusive tax position. The base penalty for abusive tax position is 100% with a possible good behaviour reduction to 50%.

In general terms, the abusive tax position penalty is an upgrade of unacceptable tax position penalty where the unacceptable tax position involves tax avoidance. To have an abusive tax position, the tax position (when viewed objectively) must fail '*to meet a standard of being about as likely as not to be correct*'.

The troubling question for taxpayers and practitioners is the successful application of this penalty, which was only ever intended to apply in extreme situations, to a transaction that in certain respects would have been seen as relatively benign.

The author's view

Businesses require certainty and the elimination or mitigation of risk. This case follows a consistent theme of recent avoidance cases that have resulted in the avoidance boundary having become even more elusive.

Of probably more relevance is that the avoidance question is becoming more main stream amongst the SME market and not simply the domain of large corporates and complicated financial arrangements.

Such cases raise fundamental issues for business owners which should be dealt with through clear and prospective legislation, early identification and dispute resolution, rather than the lottery of retrospective avoidance litigation.

It is also not lost on many practitioners that in this case had the arrangements all been undertaken directly by the requisite property developer in his or her own name (admittedly commercially not viable), the same tax outcome would have resulted. That is, he or she would not have paid tax as no taxable profit was derived.

But again, the principal issue is the uncertainty created by this entire debate. An uncertainty that, through cases like this TRA decision, permeates mainstream NZ SME operations.

Where to now?

There is no doubt that practitioners and taxpayers in the SME market must reassess the filing position they have traditionally adopted in light of this apparent shift in the tax avoidance boundary. However, it is by no means clear where the boundary now falls.

It is important that the taxpayers have a clear understanding of the tax environment in which they now operate and the potential risks they face from the constantly moving boundaries as to what is an 'acceptable' tax position.

We live in a new world / paradigm on this matter and to assume otherwise is to live in denial.



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All my business should do is change the GST rate... right?

On 9 February 2010 the Prime Minister provided some indications of the Government's thinking on the package of proposals contained in the Tax Working Group's report released in January. Although the rate increase has not been confirmed, GST is likely to rise to 15% if there are to be any personal income tax cuts. The expected start date of 1 October 2010 does not leave much time for business if they do have changeover issues and with a 20% increase in the GST rate (i.e. from 12.5% to 15%), one can certainly expect a 20% increase in focus from Inland Revenue.

Although some transitional rules are already included in the GST Act from the last rate change in July 1989, there may be some new changes in respect of the transition period. We have highlighted below some high level practical issues to consider.

General Implications

Pricing Points

For businesses selling directly to end consumers on a GST inclusive basis the most significant issue is the impact on profit margins and pricing points. For example, if a product sells for \$9.95 under the 12.5% rate and stays at \$9.95 under the 15% rate, a decrease in 'after GST' revenue of 2.2% will be experienced by the vendor. To maintain the gross profit under the 15% rate, the product would need to be sold for \$10.17 which is likely to dampen end consumer spending.

Transitional Issues

Clients accounting for GST on the payment basis should carefully monitor and record sales and purchases over the transition period to ensure GST is accounted for at the correct rate.

The impact on cash flow and clients operating a Deferred Payment Scheme for imports should also be considered before goods are unexpectedly delayed (you may need to increase the Customs DPS account limit by 20% if you want to clear the goods without any delays).

Acquiring second-hand goods and the timing of notional input tax claims (such as land) should also be considered between now and the time any rate increase comes into effect.

Bad debt write-offs and recoveries can also create various issues. For example, where a vendor writes off two invoices (one subject to 12.5% GST and the other subject to 15% GST) and decides to write these off as a bad debt, the vendor will only be allowed to claim the GST that the vendor has previously accounted for.

The current GST transition rules for long term contracts apply to modify existing contracts so that pricing increases are in line with any rate change unless the contract expressly contemplates a change in the rate. Consideration should be given to long term service agreements and contracts for the supply of goods and services (particularly the impact on 'inclusive of GST' contracts).

Systems Implications

Multiple GST rates

A new GST code or rate will need to be created within the accounting system in addition to retaining the 'old' 12.5% rate and both rates will need to be in the system for a period of at least several months. Most modern accounting systems should be able to cope with multiple GST rates, but custom legacy systems could have issues.

Reporting

Say goodbye to 'divide by 9' and hello to 'divide by 7.6666* (*repeating)'...or perhaps just grab the calculator! Most purpose built reporting tools used to assist in the recording or reporting of GST such as spreadsheets and reconciliations will need to be changed to reflect the new rate of GST.



Industry Implications

Financial Services Industry (significant impact)

Partial exempt entities should factor in a 20% rise in GST cost (being the unrecoverable GST amounts) in forecasts and the budgeting process. GST should also carefully be tracked over the transition period to ensure that change of use adjustments and yearly apportionment calculations / wash-up calculations are performed using the right rate.

Supplies to End Consumers (significant impact)

As mentioned above, consideration should be given to the 'price elasticity'. If a decision is taken to increase prices, the 'sticker price' or 'shelf price' of products will be required to be changed (potentially thousands of items). Marketing material such as brochures should also be changed.

Rolling multiple billing or 'real time' billing to customers that cross the transition date (e.g. suppliers in the telecommunication and utilities industries) is likely to create difficulties and reporting issues.

Supplier to Business Entities (less impact)

Although suppliers to business entities should experience a lesser impact, consideration should still be given to systems, Deferred Payment Scheme, bad debt write offs / recoveries, rebates, incentives, and support payments that span supplies over the rate increase period.

Conclusion

From our initial discussions with clients it is clear that the increase in GST will often have a greater impact on clients than what was first thought. Given the short timeframe before the proposed effective date clients should consider the effect of an increase in GST on their business.

For more information, please contact anyone in the Deloitte Indirect Tax Team.

FBT returns – recent changes may give rise to opportunities

We remind readers of the legislative and ruling changes that impact the calculation of FBT for the year to 31 March 2010. As the final quarter of the 2010 FBT year approaches, it is also timely to consider options available for reducing FBT payable. This may include performing year-end attribution calculations and reviewing previous quarter returns.

Legislative changes

A brief reminder of the changes in legislation which impact FBT for the year to 31 March 2010:

- The FBT single rate has dropped from 64% to 61%;
- The de minimis threshold for FBT on minor unclassified benefits has increased. FBT is only payable if the total taxable value of all unclassified benefits provided in the quarter to an employee is more than \$300, or the total taxable value of all unclassified benefits provided to all employees in the last 4 quarters including the current quarter is more than \$22,500 (i.e. in effect this is a rolling calculation);
- The FBT annual return filing threshold has increased from \$100,000 to \$500,000 of payroll taxes. Elections into this option for the 2010-11 year need to be made by 30 June 2010.

Generally, if FBT has been paid using the alternate rate option of 49% for each of the first three quarters, then a multi-rate attribution calculation will be required for the final quarter. If the single rate option of 61% has been chosen, then this rate is used for all four quarters, with the option in the final quarter to perform the attribution calculation. We have found in these cost cutting times that employers who have traditionally preferred the easier but more expensive option of paying FBT at 61% for all quarters are now opting to spend a little more time to perform the attribution calculations and so reduce the FBT payable. We have seen significant savings in some cases. The final quarter return is not due for filing until 31 May 2010 to give employers more time to perform the attribution calculation.

Revised ruling

Late last year, the Inland Revenue released a public ruling which has clarified the definition of the "cost price of the vehicle". A significant change in this ruling is that the cost of signwriting the vehicle in the employer's colours is no longer included in the cost of the vehicle, as such costs are deemed to be purely of a business nature. This retrospective change is effective from 1 November 2008 and will, in most instances, provide a reduction in the cost price of the vehicle for determining the FBT payable. A review of whether these costs have been included in the past quarterly returns is extremely relevant to determine whether FBT has been over calculated.

FBT reviews

FBT reviews can be worth the investment in terms of reducing risk and increasing savings. Common areas of misunderstanding include:

- Not picking up all unclassified benefits such as gifts and vouchers and not understanding how to perform the de minimus tests (see above).
- Lack of supporting paperwork surrounding pool cars which are taken home.
- Lack of awareness around options for pooling fringe benefits and how to minimise costs.

Quarter four therefore provides a timely opportunity to review FBT in your organisation. If you would like more information on what attribution entails, the rate changes or wish to see a demonstration of Deloitte's *FBT Partner* software solution, please contact your usual Deloitte advisor. You may just find those much needed cash savings you were looking for.

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New rules for paying dividends paid to non-residents now in force

As reported in our December issue, new rules which impact the payment of dividends to non-resident investors commenced on 1 February 2010. Broadly these changes affect who a supplementary dividend (aka FITC dividend) can be paid to as well as the rate of non-resident withholding tax [NRWT] payable on certain types of dividends. It is important to note that these new rules apply to dividends paid by New Zealand companies to non-residents regardless of the country the shareholding recipient is tax resident in.

From 1 February 2010 supplementary dividends can only be paid to non-resident shareholders that hold less than 10% of the direct voting interests where the post-treaty tax rate is 15% or more. Non-resident shareholders who hold 10% or more of the direct voting interests will instead be eligible for an exemption from NRWT to the extent to which the dividend is fully imputed. In this case, therefore, there is no need to resort to a tax treaty for relief.

Companies whose shareholders comprise a mixture of portfolio and non-portfolio investors will have to consider the impact of these restrictions when paying a dividend given the different rules that apply for each type of holding. Template dividend documentation used in the past to pay regular dividends should be reviewed to see if it needs to be updated to accommodate these changes.

If the dividend paid to a non-resident is unimputed it will be subject to a NRWT rate of 30%, which may then be eligible for reduction under the relevant tax treaty. Currently most tax treaties drop this to 15%, however the recently concluded but not yet in force treaties with Australia and the United States contain articles which will further reduce this to 5% or zero where certain criteria are met once they are in force. Depending on certain circumstances, these new rules may now provide opportunities to return unimputed reserves or capital gain amounts returned on a liquidation, tax free. For more information about these new rules, please contact your usual Deloitte advisor.

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