Paul Pearce Limited
Chartered Accountant

NEWSLETTER

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INSIDE THIS EDITION

Planning ahead

Did your New Year's resolutions include making significant changes, gaining control over, or simply maintaining your business in its current form? If so, putting a plan in place will help you think through the critical aspects of your business and help you to make good decisions in the year ahead. Like a map, a plan can help you to see where you want to go and will help you feel more confident about how to get there. Two effective tools for planning are budgets and cash flow forecasts.

Preparing a budget is a good discipline as it encourages you to look forward and forecast what your expected income and expenditure will be for the upcoming year. This is very important if you are planning for growth as it enables this to be monitored. If a business grows too fast and payments from debtors are not being received in a timely manner, then payment of everyday business expenses may put a strain on a business's cash flow.

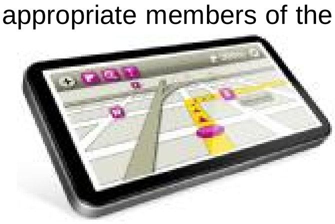
Once the budget is set, regular comparison against actual performance enables you to review variances and take action as necessary. Taking a pro-active approach by planning your cash commitments for the future can help to avoid the risk of spending more money than your business is generating.

However profitable your business may appear to be, cash is still the lifeblood of any organisation. When the cash flowing into your business exceeds the cash flowing out, you can continue to operate. If the opposite is happening, you may eventually run out of money and the business may fail. It is therefore essential that business owners have a forecast of predicted cash flows in the future to ensure the business can survive.
There are five key reasons why a cash flow forecast is important:

- It identifies potential shortfalls in cash balances in advance and enables you to plan accordingly. For example, if your business is seasonal, a forecast will highlight months where you may need to find additional sources of working capital, such as a temporary overdraft.
- It confirms that your business should be able to pay its suppliers and employees on time. Suppliers who don't get paid will soon stop supplying goods to your business.
- It can highlight problems with timing of debtor payments. It may indicate that your debt management system needs to be reviewed to ensure you have robust systems in place. You may need to introduce measures to encourage debtors to part with their cash earlier, such as early payment discounts or penalty interest for late payments.
- It indicates when it is timely to review your current banking arrangements.
- If you have a business bank loan, the bank may request cash flow forecasts at regular intervals. Producing quality budgets and cash flow forecasts demonstrates to the bank that you have a good grasp on your financial situation.

Once prepared, the budget and forecast should be reviewed on a regular basis to take into account any factors that have arisen since they were set. It is also important to make sure the appropriate members of the organisation have input into the budget and forecast process.

When mapping out the future of your business, you need to be able to see the road ahead if you want to get to where you want to go.



Deferring your income for tax purposes

As the amount of income tax you have to pay is determined on an annual basis it is important to ensure items of income are allocated correctly to a particular year. Although common sense will get the right answer in most situations, being aware of some of the concepts around this topic could help you to identify amounts that should be deferred. Deferring income will have the effect of decreasing the amount of income tax payable in the current year, thereby providing a cash flow advantage.

Income needs to be "derived" in a particular year for it to be taxed in that year. However, the point at which income is derived is not specifically defined in the Income Tax Act; therefore its meaning must be determined by case law.

Various cases in New Zealand and Australia, such as *FCT v Arthur Murray (NSW) Pty Ltd [1965]* and *CIR v Farmers Trading Co Ltd [1982],* have developed a number of principles to assist in determining when income is derived.

Broadly speaking, there are three important factors that have consistently been referred to by the courts:

- How is the income treated under ordinary accounting principles and accounting practice?
- Has an enforceable debt been created?
- Has the income earning process been completed?

Accounting principles and commercial practice

Although not always determinative, the courts have given significant weight to a person's accounting treatment and commercial practices when determining their taxable income. The accounting method used by a person should give a fair view of their annual income and produce a substantially true picture of the real profits of the person. Simply because a sale has been made and an invoice has been issued does not necessarily mean that an amount of income has been derived, particularly if a service is to be provided in a future period. For example, it is common for a person in the construction industry to determine their taxable income by following accounting principles, under which income is determined based on a project's stage of completion.

Entitlement to bill / enforceable debt

Whether or not there is an entitlement to bill or an enforceable debt is often quoted as a determining factor for the question of whether income has been derived. Although this factor is relevant and should be taken into account, the broader circumstances should still be considered.

Completion of earning process

A fundamental element of income derivation is that the income earning process must be complete before income can be said to be "derived". To ascertain whether the income earning process is complete it is important to consider the agreement under which the entity performs its obligations. For example, does the agreement stipulate ownership on the receipt of payment, or does a service occur progressively over a period?

An amount is likely to be income when the obligations arising as a result of the receipt have been discharged.

Summary

When reviewing your income for the year, ask yourself, have I done everything I need to do to say that income is mine? If not, it could be worth having a closer look to potentially defer income to a future year.

Year end chores

For many businesses, 31 March is an important date because it is the end of their financial year, and it is the last day their accountant has to file their prior year's tax return. To make the year end process as smooth as possible (at least from a tax perspective), a few "to dos", along with some tax planning opportunities, have been summarised below.

Year end issues

- **Bad debts**: bad debts must be written off before the end of the financial year in order to be tax deductible in that year. Points to consider when writing off bad debts are the age of the debts and the likelihood of the debts being collected. If the debts are then considered to be bad, they should be written off to reflect a more accurate picture of the year's profitability.
- **Accruals and provisions**: as you accrue and provide for expenditure, think about whether the costs are incurred at balance date. In general, an expense should be deductible if you are definitively committed to the expenditure at year end and can reasonably estimate the amount. There are exceptions though, for example, accruals for employment expenditure (such as annual leave) are tax deductible if they are incurred and are paid out in the current year or within 63 days after balance date.
- **Charitable donations**: these are fully deductible up to the company's net income for the year,

provided that they are paid in the financial year. So if a donation is planned before the end of the year, it may be worth writing the cheque sooner rather than later. On the other hand, if you have made a loss for the year, but are expecting a profit next year, it could be beneficial to wait until the new financial year.

- **Shareholder current accounts**: if the company is owed money by shareholders, consider paying commercially justifiable shareholder-employee salaries or paying a dividend to settle the debts. FBT or deemed dividend issues may arise if this is not carried out. Depending on the company, there are some extra timing rules which can apply here.
- **Legal expenses**: business-related legal fees are deductible, provided total legal costs for the year are $10,000 or less. If you are nearing this threshold and the legal work is not urgent, consideration could be given to postponing it.
- **Asset purchases**: these may need to be reviewed to ensure that assets that cost more than $500 are capitalised for tax purposes. This can often be overlooked especially where such assets are expensed for accounting purposes.
- **Entertainment expenditure**: businesses will need to ensure that entertainment expenditure is analysed to determine if the expenditure is 50% or 100% deductible. A GST adjustment will need to be made for entertainment that is only 50% deductible.
- **Closing stock**: if closing stock is held that is worthless, an accounting impairment might be made. This type of adjustment is non-deductible for tax purposes. However, if market data can be prepared that reflects the stock as having no value, the adjustment can be included on the basis that stock is being valued under the "market selling value" method.

New tax bill - allowances & reimbursements

The Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Bill ('the Bill'), was introduced on 22 November 2013 and brings in a number of changes that businesses need to be aware of. Outlined below are some of the key changes that are proposed. The treatment of accommodation provided to employees on secondment has been subject to considerable uncertainty after the IRD released a statement in December 2012 setting out its view that certain situations would be taxable to an employee, but that view contradicted what has been widespread historical practice. The statement also required taxpayers to make voluntary disclosures where their approach has contradicted the IRD's view.

The Bill has clarified the issue and proposes to introduce specific rules to cover a number of other situations.

- Accommodation or an accommodation payment provided to an employee who is expected to work away from their normal workplace for up to two years (i.e. on a secondment) will be exempt from income tax. Effectively contradicting the IRD's earlier statement, this treatment may be applied to arrangements put in place from 1 January 2011. The exempt period may be extended for up to three years for employees working on capital projects, or up to five years for Canterbury earthquake recovery projects.
- If an employee works at more than one workplace on an on-going basis, accommodation or an accommodation payment provided to the employee will be non-taxable. There is no upper time limit for this exemption provided the additional workplaces are beyond reasonable daily travelling distance from the employee's home.
- Accommodation or accommodation payments that relate to a work conference or training course attended by an employee requiring at least an overnight stay will also be exempt. This covers both distant and local accommodation situations, and has no upper time limit.

Where the provision of accommodation is held to be taxable, specific rules have been introduced to determine the taxable value of that accommodation.

Other allowances that will be exempt from income tax include:

- meal payments linked to work-related travel for up to three months at a particular work location,
- meal payments and light refreshments outside of work-related travel (such as conferences),
- payments for distinctive work clothing (to match the outcome where clothing is provided directly by the employer),
- historic allowances for plain clothes if paid to employees who are provided with a uniform but because of the nature of their current duties are required not to wear that uniform, e.g. police.

Once the Bill is passed, the majority of the proposed amendments will come into effect from 1 April 2015.

Buying and selling land – the taxpayer loses

The Taxation Review Authority (TRA) has recently heard a case involving a Trust that had been buying bare land, building houses and then selling them but not treating the proceeds as taxable.

The Trust itself comprised three trustees, Mr and Mrs B, and their solicitor who acted as an independent trustee. Over a 12 year period, the Trust bought and sold 11 properties, of which 10 were purchased as bare sections, with the Trust contracting a builder to construct dwellings to the gib-stopping stage on nine of them. Mr & Mrs B would move into the homes with their family and complete the finishing touches.

Following an audit into Mr and Mrs B and the Trust's affairs, the IRD took the view that the Trust had been carrying on a business of erecting buildings, and therefore income tax and GST applied to seven of the 11 sections that had been sold.

In response to the IRD's position, Mr and Mrs B put forward a number of personal reasons as to why they moved between houses. Those reasons were cited as:

- problems with neighbours, such as having a creepy guy peering into their bedroom from a house next door or, the house next door becoming an IHC house,
- concern that one house was a leaky home and another had carpet that made the taxpayer's asthma worse,
- one house backed onto a railway line, while another was on a busy road and there was concern for the kids crossing the road. The lights from a T intersection also disturbed them at night,
- wanting to move closer to an ill mother or to the daughter's school, and
- one of the taxpayer's work hours were to be cut so they sold to ease their financial burden.

The TRA's decision
The TRA sided with the IRD and found that at the time of purchase the Trust intended to sell each property. The Trust's activities were coherent and organised. The repeated process of buying land, building and selling dwellings on completion created a clear pattern that demonstrated the existence of a business. The Trust was assessed for income tax of $65,422.

It was also found that the Trust's building activity met the statutory test of a "taxable activity" for GST purposes. The Trust was liable to account for $30,164 of GST output tax on the sale of the properties, and a penalty for 'gross carelessness' was confirmed by the TRA at $19,117.

Joint liability
Generally, all trustees are bound by the decision and actions of each other when engaged in the affairs of a trust. The independent trustee was held jointly and severally liable even though the person was not consulted prior to entering into transactions.

Conclusion
It is evident that the IRD is directing additional resources into the property sector. Taxpayers demonstrating a pattern of buying and selling property can expect the IRD to come knocking.

Snippets

Bomb squad needed by the IRD
A $2 coin resulted in the evacuation of the IRD's Lower Hutt building in December last year when a taxpayer sent in a suspicious looking package.

Police were called to the scene where IRD employees were uncomfortable with how the mail item felt. The police reacted by contacting the defence force. Using a robot, the defence force's bomb disposal team opened the letter to find a $2 coin wrapped in foam accompanied by a tax return slip to the tax department.

It is understood that the coin was sent to pay a $2 tax bill. Section 6A of the Tax Administration Act 1994, places an obligation on the IRD to collect the highest net revenue over time – they may have failed on this occasion.

If you have any questions about the newsletter items, please contact me, I am here to help.