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NEWSLETTER

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INSIDE THIS EDITION

Changes to how SMEs pay tax

The Government has recently announced a package of proposed tax changes that intend to reduce compliance costs and make tax simpler for businesses. The package is part of the Inland Revenue's big picture 'Making Tax Simpler' initiative that aims to modernise and simplify the tax system. While the proposals will generally apply to all businesses, the changes are expected to benefit small businesses the most.

Tax compliance costs are relatively high for small businesses who play a crucial role in the New Zealand economy. Approximately 97% of enterprises in New Zealand are small businesses, who employ around 30% of the workforce. For these entities, the question of whether 'close enough is good enough' is being raised, whereby simplifying the tax compliance process and reducing compliance costs could have wide-reaching benefits for many New Zealanders. The changes proposed within the Governments tax package are outlined below.

Changes to provisional tax
The changes propose to increase the existing use of money interest (UOMI) safe harbour threshold for individuals from $50,000 to $60,000 and allow it to apply to all taxpayers. This effectively means that all taxpayers who calculate and pay provisional tax using the standard or 'uplift' method would only be charged UOMI from their terminal tax date provided their residual income tax is below $60,000. Larger taxpayers, who fall outside the safe harbour threshold and pay tax using the standard option, would instead pay UOMI from their last instalment date.

Small Businesses (turnover of $5m or less) will be able to use an "Accounting Income Method" (AIM) to calculate and pay their provisional tax based on the income to date in their accounting software. Businesses registered for monthly GST returns will pay provisional tax monthly. However, businesses who file their GST returns on a two-monthly, six-monthly basis or who are not registered will pay provisional tax every two months.

Self-management and integrity

The changes propose to let businesses:

- Allow contractors to elect their own withholding tax rate (minimum 10% for resident contractors, 15% for non-resident contractors),
- Extend withholding tax to labour-hire firms, and
- Introduce voluntary withholding agreements where contractors can agree to withhold tax as income is earned to manage provisional tax obligations.

Other changes

Other proposed changes include:

- Removal of the monthly incremental 1% late payment penalty for new debt;
- Increase the threshold for taxpayers to correct errors in returns from $500 to $1,000;
- Remove the requirement to renew resident withholding tax exemption certificates annually;
- Increase the threshold for annual fringe benefit tax returns from $500k to $1m;
- Modify the 63 day rule on employee remuneration to reduce compliance costs; and
- Allow small companies providing motor vehicles to shareholder-employees to make a private use adjustment instead of paying fringe benefit tax.

There are also a number of information sharing arrangements proposed in the changes, i.e. reporting of tax debts to credit reporting agencies and information sharing with the Companies Office.

Most measures are intended to apply from 1 April 2017, with the exception for provisional tax payment changes, which have a proposed implementation date of 1 April 2018. IRD is currently seeking feedback from the public, with submissions due by 30 May 2016.

Holiday pay mishaps

As seen through the media recently, errors within holiday pay calculations are more common than we'd like to think and not just limited to Government organisations. Due to the complexity of the calculations required to monitor and record holiday pay, errors or deviations from the Holidays Act 2003 (the Act) requirements can occur.

This can result in under or over payments to staff.

Common payroll mistakes include:

- Incorrect leave payments for employees returning from paternity/maternity leave.
- Systems incorrectly calculating the amount of leave paid based on hourly rates instead of daily rates (bereavement, alternate, public holiday and sick leave) or weekly rates (annual leave) as required by the Act.
- Previous allowances earned are not included in leave payments (i.e. underpayment).
- Discretionary payments (e.g. bonuses) are included in leave payments (i.e. overpayment).
- Time-and-a-half earned on public holidays is not included in subsequent leave payments (i.e. under payment).

Employee leave entitlements and payment errors are likely to be miscalculated if the information captured within a system is not adequate. Staff members with fluctuations in their normal hours worked are prone to holiday pay mistakes, with the most commonly affected being waged employees.

Often, the correct information within employment agreements, employee master data, hours and type of work is not captured within holiday pay calculations. For example, additional amounts received on top of normal pay (e.g. allowances, time-and-a-half) are often not correctly captured within holiday pay calculations.

Errors may also arise if the payroll system is not intelligent and flexible enough to determine which Relevant Daily Pay/Average Daily Pay (paid leave) and Ordinary Weekly Pay/Average Weekly Pay (annual leave) formula should be used for each employees' individual circumstances.

Relevant and Average Daily Pay and Ordinary and Average Weekly Pay are defined within the Act but are often not correctly and consistently implemented across payroll processes, data and systems. In some instances, the problem is due to companies using payroll software from international providers that is not tailored to meet New Zealand Act requirements.

The implications from incorrectly calculating holiday pay can be significant. Not only might an employee have been paid too much or too little, it also has flow on effects to PAYE, KiwiSaver, Working for Families and Student Loans and breaches to individual and collective employment agreements.

It is important to check your payroll complies with Holidays Act requirements and ensure payroll, finance and people managers understand the implications of the Act on pay and leave calculations. There is likely to be increased mobilisation and focus from MBIE Labour Inspectorate and tensions with payroll providers over the accountability for remediation and resulting liabilities.

Pressures from staff, unions and ex-staff over pay accuracy (real or perceived) can create tension within an organisation and challenges may arise when trying to maintain employee trust and goodwill with unions. The cost to remediate errors can be significant both financially and through management efforts, not to mention the impact this may have on a company's reputation.

Compulsory zero-rating of land

The compulsory zero-rating (CZR) of land rules have applied since 1 April 2011. The rules were introduced to combat a pattern of transactions where Inland Revenue (IRD) was paying GST refunds to land purchasers, but there was no corresponding GST returned by the vendor.

Although simple in principle, mistakes are being made. To recap, the rules require a transaction that wholly or partly consists of land to be zero-rated if:

- The vendor and purchaser are both GST registered; and
- The purchaser intends to use the land for the purpose of making taxable supplies; and
- The purchaser or a person associated with the purchaser does not intend to use the land as a principal place of residence.

The reduced rate applies not to just the land component of a transaction, but to the entire supply. For example, if zero-rating applies to the sale of land and assets, the assets are also zero-rated. Also, the supply of "land" is not limited to the transfer of freehold title, but also includes an assignment of an interest in land. For example, if a business sells assets and an assignment of a lease (of land), zero-rating is likely to apply.

In practice, the standard form Auckland District Law Society (ADLS) agreement includes a statement that the purchaser completes for GST purposes and is used by the vendor to determine whether the sale should be zero-rated. The agreement also includes a question on the front page of the contract asking whether the vendor is registered for the purpose of the supply. A common error is for the question to be answered "no" because the transaction is the sale of a residential home irrespective of the vendor's circumstances. If however, a property developer has built the house in the course of their taxable activity, GST will apply to the sale and the question should be answered "yes".

A fundamental element of the contract is whether to express the price as "Plus GST (if any)" or "Inclusive of GST (if any)". Disputes have arisen because a GST registered vendor understands the buyer is GST registered and the price is agreed as GST Inclusive. The rationale being that the transaction will be zero-rated and the price stated will be received 'in the hand' by the vendor. However, seeing an opportunity a purchaser might at the last minute, nominate a non-registered purchaser. The transaction does not then qualify for zero-rating and the vendor is required to pay GST at 15% to IRD, leaving the vendor 'out of pocket'.

In practice, it is recommended the agreement includes warranties regarding the GST status of the parties and that vendors execute agreements on a plus GST basis. Contracting 'plus GST' provides the right to increase the cash price to fund an unforeseen GST liability, thereby preserving the net amount receivable.

A further pricing misconception is that a "GST inclusive" price means that GST is included at 15% and can be deducted for GST purposes. However, if the transaction is zero-rated, a GST inclusive price simply means there is GST, but the amount of GST is zero.

A GST registered purchaser might contract on a zero-rated basis, because they have failed to understand that they are not purchasing the land to make taxable supplies. For example, the purchase of a residential property by a GST registered purchaser is unlikely to qualify for zero-rating. In this situation, the purchaser would be liable for the GST that would have otherwise been payable by the vendor.

It is normal for a contract to be subject to 'Solicitor's approval'. Having a contract reviewed by your accountant is also worthwhile.

Slammed for gross carelessness

A self-proclaimed tax agent has been found by the Taxation Review Authority (TRA) to have taken an unacceptable tax position and demonstrated a high level of disregard for the consequences of claiming GST refunds over a two and a half year period.

The taxpayer claimed a GST refund for five consecutive six month periods from March 2009 – March 2011, accumulating refunds of almost $10,000. The taxpayer argued he was eligible for the refunds as he was carrying on a taxable activity of "services to finance and investment" by (1) acting as a registered tax agent, (2) holding patent rights as a patentee, (3) devising inventions and patenting them, and (4) supplying services to two trusts.

The Commissioner denied the input tax deductions and deregistered the taxpayer on the basis that he was not conducting a taxable activity and was therefore not eligible to claim GST. The Commissioner argued that the conduct amounted to gross carelessness and therefore sought to impose shortfall penalties.

It is a fundamental rule that in order to claim GST you must engage in a taxable activity that satisfies the following four criteria:

I. There is an activity;
II. The activity is carried on continuously or regularly by a person;
III. The activity involves, or is intended to involve, the supply of goods and services to another person; and
IV. The supply or intended supply of goods and services is for consideration.

On review of the facts, the TRA was highly critical of the taxpayers' alleged taxable activities. In regard to (1) acting as a tax agent, the taxpayer asserted that he provided accounting services to many clients during the disputed GST periods. His evidence however, consisted of six invoices for two clients of small sums that could not be supported by bank statements. The TRA stated that even if they accepted that the taxpayer was acting as a tax agent, the taxpayer did not prove that the activity was being carried on "continuously" or "regularly". The TRA described the activity as spasmodic at best and therefore dismissed the claim that this was a taxable activity.

Regarding (2) holding patent rights as a patentee, the patents the taxpayer referred to expired in 1994 and 2006 respectively, which is before the start of the first disputed GST period. The taxpayer saw his taxable activity as being a "continuous attempt to enforce the equities in the patents" and his position was not affected by the expiry of the two patents. The TRA had difficulty in following this assertion and so found that this activity did not meet the required threshold for taxable activity.

The taxpayer also failed to produce evidence to support his claim that (3) devising inventions or (4) supplying services to two trusts satisfied the criteria of a taxable activity. He produced no evidence of design work or time expended on inventing, no invoices or payment evidence nor any trust deeds or engagement agreements. The TRA found it unclear whether such a trust was even in existence and dismissed both of these claims.

The TRA consequently found that there was no nexus between a taxable activity and the input tax deductions. The taxpayer had taken an unacceptable tax position and demonstrated a high level of disregard for the consequences when he filed GST returns and claimed refunds for each of the periods in dispute. The taxpayers conduct was described as a "flagrant breach of the GST regime".

All input tax deductions claimed were denied and shortfall penalties for gross carelessness were imposed in each of the GST periods in dispute.

No relief for earthquake strengthening expenditure

According to the Inland Revenue (IRD), commercial building owners should be denied a deduction for expenditure incurred in determining whether their buildings meet new earthquake protection standards. IRD's draft Questions We've Been Asked pub00223, (QWBA) publication asserts that expenditure incurred on detailed seismic assessments (DSA's) is capital in nature and therefore non-deductible because it relates to a capital asset.

DSA's are becoming increasingly popular for building owners where a growing number of city councils and bank regulations now require certain buildings to be assessed for earthquake weaknesses. A DSA identifies any vulnerabilities or weaknesses that a building may have to seismic activity, provides recommendations to mitigate or eliminate these weaknesses, and often gives an estimated cost of such an exercise.

To ascertain whether the capital limitation applies, the landmark case Privy Council in BP Australia Ltd v FC of T [1965] 3 All ER 209 formulated a number of factors that serve as a useful guide in determining whether expenditure is revenue or capital in nature. These factors have been applied in numerous New Zealand cases.

However, in the QWBA IRD outlines its opinion that while the approach of the Privy Council has been recognised in New Zealand, it may not always be necessary to consider the BP Australia factors. The Commissionaire cites the recent Court of Appeal CIR v Trustpower Limited (2015) 27 ZTC where expenditure on resource consents were considered capital in nature, and extends this decision to apply to expenditure on earthquake strengthening assessments.

The IRD's viewpoint is that expenditure incurred in obtaining a DSA is to determine the nature, scale, and possibly an estimate of the costs of the seismic strengthening required on an important capital asset; with a view of determining the best action to take on the building, such as, to strengthen, sell, demolish or take no action. The IRD concludes that the DSA expenditure is therefore directed to the future preservation or otherwise of an important capital asset and therefore is incurred on capital account.

For the purpose of completeness, IRD steps through the BP Australia principles and unsurprisingly, arrives at a mixed outcome. In working through the tests, IRD agrees the expenditure does not produce an asset or advantage of enduring benefit to the business, nor does it create an identifiable asset. Further, the cost of obtaining a DSA would be funded from circulating capital expenditure and is likely to be expensed for accounting purposes. Despite these arguments in favour of revenue expenditure, IRD is quick to disregard such arguments, stating that these tests are not a reliable indicator of the nature of the expenditure.

The key factors which IRD heavily weighted include the need for the expenditure to preserve the future of the building, the one-off nature of the expenditure and the fact that the expenditure relates to the business structure rather than day-to-day business operations.

The IRD also dismisses the argument that the DSA is deductible 'feasibility' expenditure.

It referred to the IRD's Interpretation Statement 08/02 on feasibility expenditure where costs relating to the potential acquisition or development of a new asset were considered deductible. It applied the principles to DSA expenditure and stated this situation is different because it relates to an existing asset and therefore the expenditure is not deductible.

The impending appeal of the Trustpower decision to the Supreme Court will provide taxpayers with more clarity on this issue and potentially correct IRD's draft view.

Snippets

Review of New Zealand foreign trusts

The Mossack Fonseca document leak and the major media backlash that followed has been well publicised. However, it remains unclear what role New Zealand plays in the international tax avoidance scandal and how the Government might legislate to tighten up the current rules.

An independent enquiry of our foreign trust rules has been commissioned by the Government. The enquiry will review the foreign trusts' disclosure rules on record-keeping, enforcement and the exchange of information with other tax jurisdictions, to determine whether the rules are fit for purpose or if there are any improvements that can be made. The report will be headed by Mr John Shewan and is due by June 30 of this year.

A separate review of the privacy protection provided under tax legislation is also underway with the Government looking to scale back New Zealand's privacy protections to allow more sharing of taxpayers information. Tax secrecy has traditionally been considered necessary to encourage the compliance of taxpayers, however, the Government is exploring the possibility of allowing the IRD to share more information to improve their internal processes and to prevent tax evasion.

Creative tax deductions

An Australian man has been unsuccessful in his attempt to claim AUD$5,388 in relation to a salary that he paid his son for secretarial services.

The deduction was denied on the grounds that his son was seven and a half years old and did not in fact provide secretarial services to his father.

The judgement found that the man's son:

> *"did virtually nothing for his father by way of secretarial assistance or anything of that nature. Indeed, the evidence established no more than that the son sometimes ran upstairs to the study when the phone was ringing, answered the phone and then handed it to his father."*

The Judge also made the comment that it was quite likely the son was paid some modest amounts of pocket money, however, those amounts would have been completely unconnected with the "minimal" work that he did for his father.

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