

# NEWSLETTER

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## 2013 BUDGET

The 2013 Budget continued the recent pattern of making small changes to New Zealand’s tax framework, which implies the Government is broadly happy with how it is operating. The changes that were announced are intended to strengthen the tax base and support the business environment. A brief overview of the proposed changes is provided below.

### TAX REFUNDS FOR R & D INTENSIVE START-UP FIRMS

Typically, if a company incurs a loss it is carried forward and offset against income in a future year. The Government has commenced consultation on allowing R&D intensive start-up companies to cash-up losses, rather than carrying them forward. For example, a company could cash-up a \$100,000 tax loss and receive a \$28,000 tax refund. The initiative is intended to assist with cashflow, encourage investment and promote growth in R&D.

### THIN CAPITALISATION RULES

The thin capitalisation rules limit interest deductions for certain entities (such as foreign owned companies) if their debt burden is above certain thresholds. This inhibits the extraction of profits from New Zealand in the form of interest payments; with the advantage being that interest is subject to a lower tax charge than the standard 28% corporate rate.

The current rules have a gap as they do not apply to groups of foreign investors ‘acting together’. This gap is to be filled through updated legislation to be enacted from the 2015/2016 year.

### LAND ACQUISITION

If a taxpayer acquires land with the intention or purpose of disposal, then any profit made from the disposal is taxable. There has however, been uncertainty regarding when land is acquired and therefore when a person’s ‘intention’ or ‘purpose’ is determined. At this stage, the IRD has proposed that the acquisition date should be either (A) when an agreement is entered into; or (B) when an agreement becomes unconditional.

**“BLACKHOLE” EXPENDITURE**

Expenditure that is capital in nature and does not result in an asset that is depreciable is typically referred to as “blackhole” expenditure, because no tax deduction arises and it effectively drops into a blackhole. To address this, the following types of blackhole expenditure are to be specifically deemed deductible:

- deductions for legal and administrative costs in applying for patents
- certain fixed-life resource consents will be depreciable
- costs of abandoned resource consents that haven't been lodged
- the cost of paying dividends (but obviously not dividends themselves)
- stock exchange listing fees
- the costs of annual general meetings (but not special general meetings)

A stable legislated environment is a positive place to be, as it allows business owners to focus on their core business and not get distracted by compliance changes.

**STUDENT LOANS**

Due to the poor repayment habits of student loan borrowers residing overseas, a number of measures are to be introduced to not only increase repayments, but provide the Government with ‘teeth’ when dealing with overseas defaulters. The changes include:

- An information matching arrangement between the IRD and the Department of Internal Affairs to gain access to an individual's passport contact details.
- A fixed repayment obligation threshold will be introduced requiring overseas-based borrowers with higher loan balances to make higher loan repayments.
- To knowingly default on your student loan while based overseas will become a criminal offence. The IRD will have the power to request an arrest warrant, preventing non-compliant borrowers from leaving New Zealand.

## CHANGES TO FINANCIAL REPORTING FOR SMES

Draft legislation is in the process of being finalised that will change the level of detail required in an entity's financial statements, depending on its size.

Currently, if a New Zealand company meets two or more of the following criteria, General Purpose Financial Reporting (GPFR) requirements must be met when financial statements are prepared:

- annual turnover of more than \$2 million
- total assets of more than \$1 million
- have more than 5 employees

GPFR requires certain key information to be included in a set of financial statements and is intended to provide information to stakeholders (such as the bank or the IRD) for decision making purposes or accountability purposes where they would generally be unable to obtain the information themselves. GPFR is a legal requirement and standards are set by the External Reporting Board.

Companies who fall below the above requirements are exempt and may report using Special Purpose Financial Reports (SPFR), which are basically a simplified form of financial statements that enable companies to choose what information is included.

In an attempt to reduce compliance costs for SMEs, it is proposed that GPFR will not have to be complied

with if an entity has:

- annual revenue of less than \$30 million, or
- total assets of less than \$60 million.

Note: these changes do not apply to Issuers.

It is expected that 98% of New Zealand's Companies would fall into the new SME definition. The New Zealand Institute of Chartered Accountants (NZICA) has created a working party to develop a recommended accounting framework for SMEs. The framework will be in a simple language format, and include industry based model financial statements.

The IRD is also working on a minimum reporting standard for its purposes to ensure consistency in its requirements. As the IRD is the single biggest user of financial statements in New Zealand it is important that taxpayers do not have to amend their statements after they have been prepared, to meet the IRD's needs. Draft legislation is being finalised that will provide the IRD with the legislated basis for setting these requirements. The IRD will initiate public consultation later in the year.

The changes are to apply from the 2013 / 2014 income year or 1 April 2015 at the latest. The reduction in the requirements for SMEs should hopefully bring a welcome reduction in compliance costs.



## THE IRD GETS IT WRONG AND SUES

Because New Zealand's tax regime is comprised of various taxes imposed for a variety of reasons it can be a costly and time consuming exercise for a taxpayer to meet their tax obligations. The IRD produces a large number of tax forms, guides and other publications to help taxpayers meet those obligations. But what happens if the IRD makes a mistake...

When an employer pays an employee or a self-employed individual (depending on the particular service provided), tax in the form of PAYE or Schular tax (respectively) is required to be withheld and paid to the IRD. To confirm the rate of tax to be withheld a "Tax Code Declaration IR330" is completed by the recipient based on their own personal circumstances and provided to the employer/payer.

In the recent High Court decision, *Chye Heng Lim v The Commissioner of Inland Revenue (2013)*, the taxpayer had relied on the IR330 to determine whether or not to withhold tax on payments made to painting subcontractors. The problem was that the form referred to "labour only" contractors in the building industry, while the legislation refers to services that are wholly or substantially for the supply of labour. In the majority of cases the taxpayer used painting subcontractors that supplied their own paint and materials, and in these cases, based on the form, no tax was withheld.

The error was later identified by the IRD, which did not accept reliance on an inaccurate form as a valid reason for the mistake. The IRD alleged the taxpayer's reliance on the IR330 took advantage of a minor error and in doing so, they deliberately chose not to comply with their tax obligations. The total unpaid tax was assessed at \$602,669 and the IRD sought to impose a penalty for gross carelessness of \$120,533.

The IRD's argument is somewhat unexpected given that from the employer's perspective there is no tax

benefit i.e. whether the tax is withheld or not the employer faces the same cash cost. In addition, assuming the painters declared the income, there would have been no tax shortfall from the IRD's perspective. A simple review of the painters' income tax position could have confirmed if this was the case.

For the purpose of the hearing, the parties agreed to have the Court determine whether the taxpayer *honestly* relied on the IRD forms, and if not, then they would have been liable for the tax not withheld. After evaluating a number of factors, the High Court ruled in favour of the taxpayer and took the view that he had honestly relied on the form.

This case is a harsh reminder of the emphasis the IRD is increasingly placing on taxpayers to get their tax



positions correct; especially with regard to withholding obligations. It is also concerning that the IRD would go through the exercise of attempting to dispute and penalise a taxpayer:

- for a tax position that provides no tax advantage,
- following a mistake by the IRD, and
- where there might be no net tax loss once the subcontractor's tax position is taken into account.

It begs the question, if the IRD had won the case would it have reassessed the painters' tax positions to refund the tax that they might have paid 'on the other side'?

## A MAN'S SALARY IS FROM MARS, A WOMAN'S SALARY IS FROM VENUS

A large professional services firm in the United Kingdom conducted a survey in 2012 of 4,219 people over the age of 18 to examine their views about the world of work for women and the prospects for women entering the workplace in the future.

The results highlighted some interesting and contrasting views between the men (49%) and women (51%) that responded. Some noteworthy findings were:

- 53% of women and 29% of men consider that a pay gap between genders will continue and women will never be on equal terms with men.

- 60% of women believe that childcare will always hold them back despite the majority acknowledging that traditional gender roles in the home are changing.
- Women identified work experience as being the most important factor in being successful at work (49%), followed by working in a profession (47%) such as accounting, law or teaching, and having a good university education (38%).



Both men and women respondents consider the IT sector will offer women the most opportunity in the future; reflecting the opportunity to work more flexibly and remotely.

New Zealand's equal pay legislation for the private sector was established in 1972 - so how do New Zealand women fare after 40 years of legislation?

One helpful guide is the World Economic Forum's 2012 Index of the Global Gender Gap ('the Index') that showed New Zealand holding its 2011 ranking of sixth place behind the Nordic countries Iceland, Finland, Norway and Sweden with Ireland just ahead of New Zealand, and a further 129 other countries ranked below New Zealand.

The Index provides year-on-year trends and compares national gender gaps on economic, political (opportunity in government), education and health criteria. Overall, the Index's measure of 111 countries between 2006 and 2012 has shown that 88% of countries have improved their performance and have closed the gap between the genders with only 12% of countries measured showing a widening gap.

New Zealand and the Philippines continue to lead the way in the Asia-Pacific region and New Zealand's ranking compares favourably against the United Kingdom who ranked 18th and Australia 25th.

The Index summary argues that there is a strong correlation between a country's gender gap and its national competitiveness, income, and development.

On the basis that women account for one-half of a country's workforce it is argued that gender equality is better for a country's competitiveness and development.

So while New Zealand employers should be relatively pleased with this country's global standing, the New Zealand Council for Trade Unions is of the opinion that more can be done and highlights examples where disparity exists.

In conclusion, there are a number of actions an organisation can take if they suspect they may have inequity between genders:

- Start by examining your organisation's demographic data to get an understanding of whether a gender gap exists, beginning with a review of remuneration and benefits that are provided.
- Research what leading organisations do – information can be sourced from websites or their Financial Statements.
- Talk to your employees to confirm whether they feel a gender gap does exist and seek feedback regarding what type of changes would help.
- Implement policies in your organisation that make pay and other conditions more equitable and review those policies periodically to ensure they remain effective.

If an initial investigation reveals an undesirable trend, help could be sought from an external HR specialist.

## SIMPLIFYING TAXES ON FOREIGN SUPERANNUATION SCHEMES

The idea of retiring at a ripe old age free from financial pressures is a pleasant vision for many. As the benefits of saving for retirement are recognised globally, it is becoming more common for individuals to migrate to New Zealand with superannuation funds from their previous country of residence.

Generally, once an individual is deemed a New Zealand resident for tax purposes, all of their worldwide income is subject to New Zealand's tax rules - including their foreign superannuation funds. The tax rules relating to foreign superannuation funds are known for their complexity, which has resulted in a lack of awareness and confusion regarding how the rules apply and ultimately non-compliance and inconsistency.

Under the current rules a number of different regimes could apply to foreign superannuation funds. For example, if a person's fund has been invested into an entity that is deemed to be a company for tax purposes, there could be an annual tax liability under the Foreign Investment Fund (FIF) rules, which broadly taxes their

'share' in the company, and any withdrawal from the fund could be deemed to be a taxable dividend.

In recognition of the problem, the Government released an Officials' Issues Paper in July 2012 that proposed a number of options, and draft legislation has now been introduced to apply from 1 April 2014. The new rules are intended to apply to people who contribute to a foreign superannuation fund while working overseas and other specifically defined "foreign superannuation schemes".

The following summarises key elements of the draft legislation:

- The FIF rules will no longer apply to foreign superannuation schemes.
- The value of a person's foreign superannuation fund will no longer be taxed on an annual basis. Instead,



lump sum amounts will either be wholly or partially taxed when withdrawn or transferred to a New Zealand or Australian scheme, using one of two calculation options. The amount of tax will depend on how long a taxpayer has been New Zealand resident.

- Withdrawals in the first four years after a person *first* becomes a New Zealand resident will not be taxable.
- Receipt of a pension or foreign social security payment will be taxed as many have always been – at the individual marginal tax rate.

Note: withdrawals from Australian superannuation funds will generally be exempt from tax under the New Zealand / Australia Double Tax Agreement.

To avoid disadvantaging some taxpayers during the transition to the new rules, the Government has proposed that:

- Foreign superannuation funds transferred into KiwiSaver schemes are allowed a withdrawal from the scheme to pay their tax bill.
- Those who complied with the FIF rules before the introduction of the bill (20 May 2013) may choose to continue to use the FIF rules.
- Those who made a lump-sum withdrawal or a transfer to another superannuation scheme between 1 January 2000 and 31 March 2014, but did not comply with their tax obligations at the time, will have an option to pay tax on only 15% of the lump sum amount.

The proposed new rules appear simpler to understand so there should be a greater level of compliance.

## SNIPPETS

### INTEREST DEDUCTIONS – A REMINDER

A recent Taxation Review Authority ('TRA') case serves as a reminder not to be complacent when it comes to lending arrangements between associated entities. One of the fundamental questions to be asked is "what has the entity used the funds for", to determine whether or not there is the required connection between the expenditure and income derived.



In a recent TRA case, the taxpayer was a farming company that borrowed funds from the bank and on-lent them to other companies in which the company had an interest. The funds were subsequently used to purchase additional farms, which were then operated by the taxpayer. Resolutions were signed by the shareholders and director, but there was no written agreement in respect of

the on-lending itself. Interest was payable on demand, but no demand was made.

The taxpayer claimed a deduction for interest paid to the bank. The interest deductions were disputed by IRD and were the subject of the TRA case - and the IRD won.

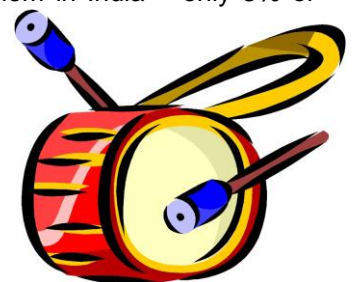
The taxpayer argued that the interest expenditure had been incurred in the income earning process, in the form of a reduced lease charge for the farm land by way of a barter type arrangement. The TRA disagreed, finding that there was not a sufficient nexus between

the interest expense and any benefit to the business activities of the taxpayer. Any additional income would come as a result of the increased farming activity and not the borrowed funds.

### INDIA BEATS TO A DIFFERENT DRUM

Ever had that gnawing feeling in your stomach after receiving a letter from the IRD advising of overdue tax? What if instead, the IRD sent a band of musicians to stand outside your property and drum loudly for all to hear? If you live in Bangalore, India, that could happen.

Tax evasion is a major problem in India – only 3% of India's population of 1.2 billion people pay any tax at all. The city of Bangalore is fed up with companies and individuals refusing to pay their tax bills, so a new recovery method has been introduced.



The city has started hiring bands of drummers to encourage the payment of tax by embarrassing local tax avoiders. Those targeted will find a band of drummers in matching shirts and bright bandannas playing outside their property for all to hear. The approach appears to be effective as many companies have reacted to the embarrassment and apparently 50% of the targeted firms have paid up.

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