



NEWSLETTER

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MIXING BUSINESS WITH PLEASURE – DEDUCTIBILITY OF COMPANION'S TRAVEL EXPENSES

Taxpayers often travel away on business and take a companion to accompany them. As a taxpayer, travel expenses incurred in the course of earning assessable income can be deductible provided there is sufficient connection between the expenditure incurred and the taxpayer's business activities. However, what may not be so clear cut is whether a taxpayer can deduct the costs associated with taking a travelling companion with them.

In October 2013 the IRD released *Exposure Draft QWB0130 – Income Tax – Deductibility of a Companion's Travel Expenses* ('Exposure Draft'), which will update and replace several outdated documents once it is finalised.

The Exposure Draft states that in most cases, a companion's travel expenses will not be deductible if the companion is accompanying the taxpayer simply for companionship or to attend social functions. This expenditure will not have a sufficient connection with the assessable income of the taxpayer's business.

For example, Steve is a doctor and he attends an international medical conference in London. The purpose of the conference is to discuss new developments in medicine and to network with colleagues. The conference is directly relevant to his medical practice. The organisation presenting the conference expects that attendees will bring their partners, so his wife Sarah accompanies him. She meets with the other attendees' partners and accompanies Steve to dinners and cocktail functions held as part of the conference.

Applying the principles in the exposure draft, Sarah's travel expenses are not deductible. The Commissioner of Inland Revenue (CIR) states that it is irrelevant that the organisers of the conference expect Sarah to accompany Steve to conference functions. There is insufficient connection between Sarah's companionship and the business activities undertaken by Steve.

The CIR's position would remain the same even if:

- Steve was a presenter at the conference,
- Sarah was employed as a bookkeeper in Steve's medical practice,
- Steve had a medical condition that required the support of Sarah while he travelled.



WHEN WILL A DEDUCTION BE PERMITTED?

A deduction may be permitted where the companion supports the taxpayer to a reasonably substantial degree in the business being undertaken. This can be demonstrated where the companion, who does not need to be an expert in the affairs of the business nor do they need to be an employee, has some knowledge of the business being undertaken or possesses some special skill or expertise allowing them to contribute in a material way to the business being undertaken on the trip.

Returning to the earlier example, had Steve been running the conference and Sarah been running the registration process and organising the cocktail functions, then her travel expenses would likely be deductible as she has provided support to a reasonable degree in the business undertaken.

The CIR does not comment on to what extent an expense will be deductible if it provides a benefit to both parties (e.g. accommodation charged per room). Given the uncertainty that exists in this situation, it would have been useful if the CIR had also commented on this.

Mixing business with pleasure can indeed be a delicate balance. Be sure to check the role and the contribution a companion makes, and the connection with the taxpayer's business when determining deductibility for tax purposes.

GROUPING COMPANIES FOR GST PURPOSES

Many businesses that have multiple, related companies overlook the opportunity to be able to form a group for GST purposes. Whether this is due to a lack of awareness or otherwise, it may be of benefit to take a moment and consider the benefits and implications of forming a GST group.

For those unfamiliar with the notion of 'grouping' for GST purposes, the idea is to allow related companies to return GST as if they were a single entity. Two or more companies can be registered as a GST group provided the same persons hold at least 66% of the voting interest of both companies.

The process of registering as a GST group entails one company being nominated as the representative member of the GST group. A single GST return is filed for that group in the name of the representative member. Each group member remains responsible for issuing tax invoices with their own GST registration number and complying with GST record keeping requirements. All members, once grouped, will have the same GST taxable period and GST accounting basis. Turnover calculations used to determine the available filing frequencies and whether the payments basis can be applied are calculated on a GST group basis.



There are several advantages in forming a GST group, the key advantage being that taxable supplies between members of the group may be disregarded. This allows for goods and services to be supplied within the group with no GST implications. This can provide cash-flow advantages as GST does not have to be paid on any intra-group taxable supplies, and does not have to be captured within the group's accounting system.

Administrative costs may also reduce because a single GST return for the group in the name of the representative member is filed, instead of individual returns for each company.

However, it is important to note a potential downside to GST grouping is that all group members are jointly and severally liable for GST payable by any member of the group and will continue to be liable for the period whilst it was a member, if it leaves the group.

Given the potential advantages, a GST group is something that should be considered if you are running multiple related companies. Applications for GST group registrations can be made by applying to the IRD.

IS IGNORANCE BLISS?

In relation to corporate failure, there are some common misconceptions about the liability of company directors. Operating as a limited liability company does provide a level of protection to

shareholders, however company directors can be held personally liable for debts of the company if they have breached their director's duties. These

duties are set out in Sections 131 – 137 of Part 8 of the Companies Act 1993.

When a company is placed into liquidation, the liquidator will examine whether the company's directors have breached their duties, including the duty to avoid trading recklessly, and the duty to avoid incurring debt unless there were reasonable grounds at the time to conclude that those debts would be met by the time they fell due.

The objective test for reckless trading is if the business has been carried on in a manner likely to create substantial risk of serious loss to the company's creditors. This does not have to be a deliberate intention. It can be through simple carelessness, which is commonly demonstrated by a director continuing to operate while insolvent. When considering the duty to avoid incurring debt that the company is unable to subsequently pay, the question that needs to be considered is 'were the actions that the directors took (or neglected to take) reasonable in the circumstances'? Directors often neglect to meet this duty of care if they have

put their head in the sand and not closely monitored the financial health of the company.

When weighing up whether to take an action against a director, the liquidator will consider the value of the loss (total amount of the company's creditors) compared with the value of the potential gain (amount recoverable from the director personally and potentially their associated trusts).

Failing to comply with 'director's' duties leaves directors exposed to financial claims and can result in the loss of their personal assets or worse, being adjudicated bankrupt. Any such claim is generally capped at the value of the company's total creditors.

If you are a director of a company, ignorance is no excuse. You need to know your duties as you could be personally accountable for the company's debts. If you know, or suspect, a company is insolvent, always seek competent advice as to how this may affect you.

PERSONAL GUARANTEES PROVIDED IN COMMERCIAL LEASES

In taking on a commercial lease for a business premises, there are many things for a business owner to consider. One of these could be a request from a landlord for a personal guarantee. Generally a landlord will require a combination of a security deposit/bond or bank guarantee as well as a personal guarantee, as security. The higher the risk or weaker the 'covenant strength' the landlord perceives the tenant to be, the more security the landlord will likely require before committing to a lease.



For example, a company (tenant) signs up to a five year lease in a new shopping centre, and the shareholder, who owns a house in their own name valued at \$450,000, has provided a personal guarantee to the landlord. After two years it is evident that the business is not profitable and the decision is made

to cease trading and exit the premises. As the lease still has three years to run, the tenant is liable for the remaining three years of rental payments and operating costs; and is only limited by the landlord's obligation to take all measures to mitigate the tenant's losses by securing a replacement occupant.

A guarantor, in the context of a commercial lease, is a person who gives a written undertaking to provide payment for a debt in the event that the tenant company to the lease defaults in its obligations. If called upon, the guarantor could be required to cover many costs that they may not have considered. These costs could include, but are not limited to, any unpaid rent and operating expenses, rent and operating expenses for the remainder of the lease, and other expenses incurred by the landlord such as legal fees, penalties, agent's fees and financial inducements to secure a replacement tenant. Unless the tenant and landlord can come to an agreement as to an exit strategy, the landlord can apply to the court and the guarantor's personal assets could be forcibly sold through a court order to recover any outstanding amount.

Let's assume the landlord agrees that the tenant may exit, on the condition they pay \$200,000 to cover six months' rent, legal fees and agent's fees to find a new tenant. As might be expected with a financially challenged business, the tenant simply has no money to cover this payment. The landlord has the legal right to apply to the court to liquidate the tenant. As the shareholder has provided a personal guarantee to the landlord, the shareholder could lose their home to meet the \$200,000 liability.

In practical terms, when negotiating a lease, a landlord will always want to include a personal guarantee as part of the lease. If the requirement for a personal guarantee seems unreasonable, based on the tenant's circumstances (financial

position etc), the tenant should push back on the requirement, given the potential for loss. The result will ultimately depend upon the bargaining power of each party, such as how desperate the landlord is to secure a tenant, or how much a tenant wants to operate in a particular location.

So beware when signing a personal guarantee whether for your own business or someone else's, you may be putting at risk more than you anticipate. Legal advice should be obtained to determine the best course of action to protect your assets when entering into such an agreement.

INCENTIVISING STAFF

In 2011, Dr Alexander Pepper of the London School of Economics and Political Science, in conjunction with PwC UK, carried out a global survey of 1106 Executives from 43 countries. While New Zealand executives did not participate, the outcomes provide insights into basic human behaviour that could translate to other employee situations.



One survey finding of interest was that executives in the financial sector were slightly more risk averse in their preference for salary over the more riskier incentive pay. While this finding might appear to be just human nature to some, others will reflect on the risks taken by executives in financial firms during the Global Financial Crisis ('GFC') and breathe a sigh of relief. When the findings were analysed by country, gender and age, it was the executives in South America who were more inclined to take risks, while overall results show that men were more inclined to take risks than women. Significantly, men aged over 60 were the most likely to put their pay at risk, which may reflect a stage in life where they are more financially secure.

An organisation that wants to incentivise executive performance should ensure that the targets, which are set to result in the payment of an incentive, are worth the cost to the organisation. Incentives of less than 10% of salary were not considered worthwhile by executives.

When it comes to measuring success, executives favour simplicity and certainty. If the incentive scheme is too hard to understand or if they are written in an ambiguous manner it will not motivate the individual.

Shareholders and governance bodies have generally assumed that deferring incentive payments to a future date is a safe way of influencing executives to make decisions in the long-term interests of the organisation. However this does not hold for younger executives who appear to favour money today over money tomorrow.

One of the strongest and perhaps more surprising results from the survey is that executives were concerned to be paid fairly in relation to the hierarchy of their organisation and comparably to those on a similar level in competitor organisations. This result is somewhat counter-intuitive to the "greed is good" themes reported

in the media about large scale financial organisation failures during the GFC.

The survey also asked about benefits other than money, in particular whether an individual would take a pay cut to get their dream job, and then tested how much an individual would be prepared to reduce their pay by. Individual responses varied between a pay cut of 24% and 35%. The realities of this are being experienced globally by employees in the financial sector whose remuneration, although still high compared to other sectors, has fallen since the GFC. The significance of this is that executives may be open to a reduction in remuneration for an enhanced job.

Finally, given the overall impact of the GFC, it would be reasonable to expect that executives would be less enamoured with long-term incentives, however survey results showed that two-thirds of executives valued the opportunity to earn a long-term incentive provided the scheme remained achievable, that is the "goalposts are not shifted", and that the rules for achieving targets are simple to understand.

Organisations need to understand what motivates their executive(s), and a one size fits all approach for incentive style pay is not the answer. For example, executives in some countries or of certain ages will be more prepared to take the risk of incentive pay than others.

Executive incentive pay schemes should reflect value back to the organisation and the organisation needs to test whether evidence exists that the value is really being received and should focus on getting the measures right.

SNIPPETS

CLOSE COMPANY SHAREHOLDER ELIGIBILITY FOR IN-WORK TAX CREDIT

In the past, in order for a principal caregiver to receive an in-work tax credit there was a requirement for the person to be a full-time earner receiving income from a work activity such as salary, wages, or a shareholder-employee salary.

However, legislation passed last year has changed this. Assuming other requirements are met to qualify for the in-work tax credit, a person no longer has to receive "income from a work activity". Rather, the person will now qualify if they are a major shareholder in a close company in which they are a full-time earner, and the company derives gross income in the income year.



This change resolved a common problem that arose when shareholder employees did not draw a salary from 'their company'. Because they weren't receiving income from the company, they were not entitled to the in-work tax credit even though they were working actively in the business.

Going forward, the company's income (or a proportion of it depending on the number of the person's shares in the company) is taken into account to calculate the amount of the credit.

This change has retrospective effect from 1 April 2011.

TAX – THE WAY IT WAS

There have been many ways in which tax has been imposed throughout history.

Albert Einstein once said "The hardest thing in the world to understand is the Income Tax". Given some of the unusual tax rules set out below, it is easy to understand Albert's confusion.

Tax avoidance was in full force in England in the late 1600's. In 1660, people were taxed on the number of fireplaces they had, which led to people covering them with bricks to conceal them and avoid paying tax.



Later on in 1696 a window tax was introduced which taxed the number of windows in a house. This led to houses being built with very few windows. This tax was eventually repealed in 1851 when it was apparent that people were suffering from ill health due to the lack of air.

In 1705, the Russian Emperor Peter the Great hoped to force men to adopt the clean shaven look that was popular in Western Europe, and placed a tax on beards.

In the United States, the state of Alabama imposes a 10c tax on the purchase of playing cards. However, the state of Nevada issues a free deck of cards with every tax return filed.

Will our great great great grandchildren look back at our tax system with the same amusement....?

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