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# Tax Time

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## Income Tax Rates Fall

In the Government’s budget of the 20th May 2010, the Government announced, as widely predicted, that the personal tax rates will fall from the 1st October 2010. The rates adjustments and the weekly affect of these are set out below:

| *Income* | *Old* | *New* |
|---|---|---|
| $0 - $14,000 | 12.5% | 10.5% |
| $14,001 - $48,000 | 21.0% | 17.5% |
| $48,001 - $70,000 | 33.0% | 30.0% |
| $70,001 - | 38.0% | 33.0% |

For a taxpayer earning $40,000 per annum, the tax reduction will amount to $1,190 per annum or $22.88 per week.

Whilst the reduction in the income tax rates is designed to counteract the increase in GST, those who choose to save will benefit particularly if they invest in a savings vehicle.

The company tax rate will also fall from 30% to 28% from the start of the 2011/12 income year. This rate drop will also apply to Group Investment Funds, unit trusts, Portfolio Investment Entities, life insurance and superannuation funds. We expect that a transitional period will apply for imputation credits earned at 30%. The trust tax rate will remain at 33%.

The main driver behind reducing the top tax rate from 38% to 33% is to remove any benefit obtained from sheltering income in a trust, which was identified as a key weakness in the tax system by the Tax Working Group.

In conjunction with the income tax rate changes, increases have been made to Government superannuation and benefit payments, and working for families. Investment losses will no longer be included in working for families calculations.

Consequential changes to FBT, PAYE, ESCT and RWT rates to align with the new income tax rates will also occur. Whether the RWT on company dividends issue is addressed following the change remains to be seen.

### *How it affects you*

A reduction in income tax is always a positive measure. However, whether you will gain any significant benefit from this will depend on what you do with the additional income in your back pocket.

As the personal income tax changes apply from 1st October 2010, a set of composite rates will apply for the 2010/2011 income tax year. As such, we encourage wage and salary earners to check whether a tax refund will be available to them for the 2011 tax year.

- From WHK Sharp-As Tax

## Redundancy Tax Credit

Redundancy can be a difficult time and any employees who have recently lost their job should know about the redundancy tax credit.

Employees may be eligible to receive the redundancy tax credit if their employment ceased because their position was no longer available and they received a redundancy payment.

The tax credit is 6% of the redundancy payment up to a maximum tax credit of $3,600 on each redundancy payment. Claims can be backdated on redundancies paid on or after 1 December 2006. You can apply for a tax credit up to four years after a redundancy payment. Eligible employees don’t need to wait until the end of the year—the redundancy tax credit can be claimed in that year.

## Tax Deductibility of Legal Expenses

The Income Tax Act 2007 was amended in 2009, introducing a new piece of legislation (section DB 62) that affects the deductibility of legal expenses, effective from the 2009-2010 income year.

This section states that legal expenses are deductible -

a. where a person's total legal expense for the year is equal to or less than $10,000;

b. where the legal expense is for legal services provided by a person holding a practising certificate issued by the New Zealand Law Society or an equivalent body in Australia;

c. and can include legal expenses incurred both in relation to capital expenditure as well as revenue expenditure.

The last point effectively means that if a person's legal expense for the income year totals $10,000 or less, there is no requirement to identify that portion of the legal expenses which relates to capital. This will no doubt reduce the compliance time in analysing the legal fees.

A couple of points to note though -

- The $10,000 is an annual threshold and not an annual allowance. Therefore, if a person incurs legal expenses during the year that collectively total more than $10,000, there still remains the requirement to analyse the expenditure that relates to capital items as opposed to those relating to the revenue items, as only the fees relating to the revenue items are deductible.
- The general permission criterion still has to be met to allow the deductibility of legal fees. This requires a nexus between incurring the deduction and deriving assessable income or carrying on a business for the purpose of deriving assessable income. For example, selling a business does not normally generate income. It may generate depreciation recoveries, but as the earning process of the business is the actual operation of the business, and not the buying and selling of businesses, no assessable income is derived from the sale. Therefore, there is no tax deduction for legal fees that might be incurred on the sale of a business. This is supported by Case G50 (1985) 7 NZEC 1,1212.

## "Tax Advantages" for Property Eliminated

It was widely signalled that the Government would make changes to how residential rental properties were taxed to ensure that the $200 billion residential rental property sector was contributing to the Government's tax base, rather than being a $150 million drain, as it was in the previous year.

Following the Tax Working Group's recommendations, the Government has removed depreciation from all buildings, not just residential rental properties, with an expected life of 50 years or more from the start of the 2011/12 income year. The 20% depreciation loading for the purchase of all new assets has been removed for assets purchased after today.

The rationale for removing building depreciation is that, in the Government's view, buildings appreciate in value and this is contrary to the purpose of depreciation, which is intended to recognise that the value of an asset declines over its useful life.

Taxpayers can apply for a depreciation rate to apply to a class of buildings if they believe that the class of building does depreciate.

As depreciation was a non-cash expense for landlords, it had the effect of ensuring that a cash flow positive property did not give rise to taxable income to the extent that the depreciation deduction exceeded the cash generated from the rental activities.

Accumulated depreciation that has been carried forward from previous income years will continue to be carried forward and, upon the eventual sale of the property, may give rise to depreciation recovery income.

The removal of depreciation has simply taken away the income deferral that results from depreciating property and is likely to cause a cash flow consequence for many taxpayers, particularly those who are highly leveraged.

The Government has also announced that it will review the tax treatment of commercial property fitout in line with the changes already made to the treatment of residential rental property depreciation. Any changes resulting from the review would apply from 1 April 2011.

***How it affects you***

With the removal of depreciation from all buildings from the start of the 2011/12 income year, all property owners should contact their usual advisors and review their business structures and arrangements to ensure that ownership of the property continues to be a viable business venture. If it is not they should carefully consider the options available to them.

- From WHK Sharp-As Tax

## GST Transitional Rules

As noted in previous articles on the Budget announcements, taxpayers registered for GST on a payments basis will face unique challenges with the increase in the rate of GST to 15% from 1 October 2010.

Taxpayers who are registered on a payments basis will need to make transitional adjustments in their GST return for the period ending on 30 September 2010. If the period straddles the GST rate change, they will be required to effectively file two returns; one to 30 September and one for the remaining part of the period.

The adjustment to be made will take into account supplies where the time of supply has been triggered, but payment is yet to be made or received. An adjustment is required because in later return periods when a payment is received or made, those payments must be dealt with at a GST rate of 15%, even though GST at 12.5% was charged on those supplies. The adjustment in the period ending 30 September 2010 will ensure that any amount that would be subsequently overpaid or overclaimed for GST at a later date is dealt with by way of an adjustment in one GST period.

Completion of the adjustment will ensure that payments basis taxpayers are not required to continue to make adjustments for supplies at 12.5% in later return periods.

To illustrate this, a farmer registered for GST on a payments basis sells a milking cow for $1,125 including GST on 5 September 2010. Payment is not received until 10 November 2010. When payment is eventually received, GST of $146.70 is required to be returned instead of $125 dollars had payment been made before 30 September. Accordingly, an adjustment is required in the special GST return for the period ending 30 September 2010, whereby a GST input credit of $21.70 is allowed. This puts the taxpayer back into the same position that they would have been had payment been received before 30 September.

If no adjustment is made, then the taxpayer will ultimately be out of pocket when they are forced to return GST at the rate of 15% on the eventual receipt.

***How it affects you***

Taxpayers registered on a payments basis will need to make adjustments with respect to debtors and creditors that exist as at 1 October 2010. Taxpayers with poor or incomplete records will likely incur additional GST costs as a result of the transition. We suggest that you consult with your advisor prior to 30 September 2010 to ensure that the transitional adjustment is made and that your additional costs are minimised. - From WHK Sharp-As Tax

## Penny & Hooper v CIR

On 4 June 2010 the Court of Appeal delivered its eagerly awaited judgment in the case of Penny & Hooper v CIR. The case was an appeal by the CIR from the High Court where the taxpayer had been successful in arguing that the business restructuring that was carried out in each of their businesses was not tax avoidance.

The facts of the case are complex, but very briefly, Mr Penny and Mr Hooper were orthopaedic surgeons who initially conducted their practises on their own account and later traded through companies in which Trusts were shareholders. Mr Penny restructured his business in 1997 to trade through a company. In 1999 a salary of $300,000 was paid to Mr Penny. His salary dropped to $125,000 in 2000 following the increase in the top personal tax rate to 39% and to $100,000 per annum thereafter. The company continued to earn significant sums, which were paid to the Trust as dividends. Mr Penny borrowed a total of approximately $1.2 million from the Trust on interest free terms to meet the personal expenses of his family between 2001 and 2004.

Mr Hooper restructured his business in 2000 and traded through a company. Mr Hooper derived income of approximately $650,000 per annum prior to restructuring. After the restructure his salary was reduced to $120,000 per annum. The remaining profit was taxed in the company and dividends were paid to the shareholder trusts. The Trusts invested those funds in cash and bank deposits, the Hooper family home and a holiday home. The Hooper's did not borrow any funds from the Trusts.

In the High Court, MacKenzie J accepted that the formal structures adopted by the taxpayers were a legitimate choice for the conduct of their businesses. He found that the way in which they conducted their affairs did not constitute tax avoidance and that the arrangement was not contrary to the scheme and purpose of the Income Tax Act and that the allocation of a commercially realistic salary was not a concept recognised by the Act.

On appeal, the Court of Appeal in a 2:1 judgment found that although the structures are within the law, and there is no taxation rule requiring salaries to be paid that an arms-length market rate in situations such as these, that overall the structures were still tax avoidance.

***How it affects you***

While an appeal to the Supreme Court is likely, this decision has wide implications for all family owned or closely held businesses. - From WHK Sharp-As Tax

## IRD Debt and Bankruptcy

Whilst the recession continues to hurt many businesses it is important to continue to make an effort to meet your taxation liabilities. Some tax relief is on the way in the form of tax cuts, but there will be many who find themselves with a bigger tax bill than expected because of the changes to depreciation and possible changes to loss attributing qualifying companies.

In a recent court case a taxpayer was adjudicated bankrupt for failing to meet his taxation liabilities. The likely consequence is that he will lose his source of income which relied on a supply contract that could be cancelled immediately if he were to be declared bankrupt.

The facts are of course more detailed but not uncommon. He first failed to meet his tax liabilities in 1998, and then from 2000 onward had not paid any personal income tax. His core tax liability was $77,298, but at the time he was declared bankrupt that had increased to $213,848.92 because of penalties and interest. He had a conditional sale of his business that would have freed up approximately $100,000 to be paid to the Inland Revenue Department ("the IRD"), but he had not made enough effort, or earlier enough effort to complete that sale for the court to hold off bankruptcy.

The court said that he had effectively done nothing to meet his taxation liabilities for 10 years and that showed a blatant disregard for his legal obligations to the IRD. He had had two years from the time judgment was first entered against him until the adjudication hearing and still only took action to sell his business just before going to court.

### *How it affects you*

The IRD do not want to bankrupt people, but where there is blatant disregard for the law it is left with little choice but to follow through to the maximum extent of its power.

We suggest that if you are having trouble meeting any taxation liability, that you discuss the matter with your advisor and make arrangements with the IRD as soon as you can. Quick action can ensure that you avoid the outcome in the above case.

The IRD has the ability to grant relief in some circumstances, and readily does so for those who meet the criteria. If you need more time to pay, contact the IRD before the payment is due and make arrangements to pay the tax off over time.

If you are in "financial difficulty" the IRD can "write-off" all or part of the debt owing. Relief can also be granted in other circumstances if you apply. Your advisor can assist you in all of these circumstances.

- From WHK Sharp-As Tax

## Quick Bits

- The Employment Relations (Rest and Meals breaks) Amendment Bill had its first reading. The Bill proposes to allow greater flexibility in relation to meal and rest breaks by allowing compensation to be made (such as later starts, earlier finishes, or accumulation of time in lieu).
- The IRD is ringing taxpayers at night to discuss their tax arrears. If you receive a call, make sure you speak to your advisor before making any commitment to the IRD.
- The IRD has released the National Average Market Values of Specified Livestock Determination 2010 which is to be used for the valuation of specified livestock for the 2009/10 income year under the National Standard Cost method.

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