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CLIENT NEWSTALK

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Recession - Business Response

"The end of 2008 has proved testing, with unprecedented turmoil in both local and international financial markets, and an increasing level of uncertainty in the New Zealand economy. Clearly 2009 will be an extremely challenging year for many with global uncertainty likely to continue for the foreseeable future and the vast majority of commentators not seeing any form of sustained recovery until 2010.

Like any period of turmoil, the environment presents both opportunities and risks. Either way, my sense is that fortune will favour those who proactively deal with change who take stock of the situation, and both plan and react as they see fit (or can afford to). Like any explorer in unchartered territory, it's a good thing to have options or perhaps to 'build the well before you need to drink from it"…

The real danger in my personal view is in sitting still. It's hard to believe that any business will remain unaffected by the present environment. As such, few can afford the luxury of status quo. I urge each of you to try to find the time to take an hour, or several, out from the day-to-day business bustle to consider both the short and medium term possibilities for you business. To proactively identify any issues or constraints and to consider who you might engage to help remove hurdles, solve problems or tackle opportunities as they exist".

The above is an extract from an email received in December from a senior corporate manger at ANZ National Bank. The underlying proposition is that if business owners and directors ignore the potential effects of the international recession they do so at their peril. To continue to trade in the belief that there will be a modest or no impact on business is to ignore the reality. All the indicators are that we are at an early stage of potentially a prolonged recession. To survive it is crucial that detailed planning and financial modeling is undertaken in order to ensure your business can withstand a significant downturn in the volume of business.

Regardless we are going to see banks becoming very cautious and conservative lenders plus an "increasingly tough regulatory environment".

Cameron & Partners, investment bankers, published in December as part of their 'Insight Series' a paper entitled "Surviving and Thriving in the New Order". Well worth reading at www.cameronpartners.co.nz/media/insight.php. Their view is that businesses will fall into four categories in the next 12 months which they describe as 'road kill' 'the walking dead', 'the survivors' and 'the thrivers'.

Limited Partnerships

A Limited Partnership regime was introduced during 2008. The form of the legislation follows that was introduced in a number of other countries including Canada and Australia. Since 1908 New Zealand has seen partnership law enacted and in particular the use of "ordinary partnerships". This ownership vehicle provides a business structure widely used in legal practices, accounting practices and property investment ownership. The disadvantage of an ordinary partnership is that the liability of partners is not limited and in fact,

each of the partners are jointly and severally liable for all of the partnership debts.

Consequently the introduction of legislation that permits the use of Limited Partnerships is to be welcomed. A Limited Partnership is a hybrid vehicle that provides for the normal characteristics found in the case of an ordinary partnership but also provides for limited liability for certain of the partners in the partnership.

A Limited Partnership consists of at least one general partner and one limited partner. The general partner is responsible for the management of the partnership and ordinarily a company will be incorporated to act as the general partner. Limited partners on the other hand are passive investors whose liability is limited to the extent of their capital contribution. They are not permitted to take part in the management of the partnership. However there are several activities that they may engage in without breaching the management limitation rule.

To establish a Limited Partnership structure does involve an application being made to the Registrar of Companies and in turn a partnership agreement is required to be prepared covering various business matters relating to the partnership. The limited partner details are not lodged at the Companies Office thereby providing a level of confidentiality regarding the identity of the limited partners (the financial contributors).

The legislation was initially introduced as a means of attracting venture capital and was therefore seen as a mechanism for facilitating investment into greenfield ventures. There are however a number of other sensible commercial uses that a limited partnership can be utilised for including investment into commercial property, where capital gains can be distributed tax free, investments in areas such as forestry which are likely to generate losses in the early years and where the underlying income taxation characteristics of individual partners may be different e.g. offshore investor versus local investor versus charitable trust.

In our view this is a helpful piece of legislation and it does provide a legal entity structure that has tax features that will provide benefits to certain classes of investors in limited circumstances.

Tax Act Changes

On 15 December the new National led government passed various changes to the Income Tax Act. The most significant of these are as follows:

a. Personal tax cuts For the year ended 31 March 2010 the rates of personal income tax are at 12.5% upto $14,000, 21% from $14,001 to $48,000, 33% from $48,001 to $70,000 and 38% above $70,001. For the year ended 31 March 2011 those rates are then amended to 12.5% upto $14,000, 21% from $14,001 to $50,000, 33% from $50,001 to $70,000 and 37% above $70,001.

b. Research and development tax credits - this legislation introduced with effect from 1 April 2008 is repealed with effect from 1 April 2010.

c. Kiwi Saver contribution rates - employee and employer contribution rates are both reduced with effect from 1 April 2009. Employees can elect to reduce their contribution rate to 2% while the compulsory employer contributions rate has been capped at 2%.

d Independent Earner tax credit - a credit of $10 a week from 1 April 2009 increasing to $15 a week from 1 April 2010 has been introduced.

Liquidations and Capital Reserves

Current income tax legislation provides two mechanisms whereby capital reserves can be distributed to the shareholders of a company, on a tax free basis. The first circumstance is if a company has elected to enter the “qualifying company” regime and the second circumstance is “on liquidation” of the company.

There are a number of broader based issues to be taken into consideration before a company elects to join the qualifying company regime. However if a company owns an asset in respect of which a substantial unrealised capital gain is likely to be made on sale it would be sensible for the shareholders of the company to consider entering the qualifying company regime in respect of the financial year in which the asset is likely to be sold. Once the asset realisation has occurred and the gain distributed the company can then in the year subsequent to the asset being sold elect to exit the qualifying company regime. There are stringent timing issues around the date of entry into the qualifying company regime which will need to be adhered to in order to achieve the outcome described above.

The second alternative to distributing a capital reserve tax free is on liquidation. Section OB 1of the Income Tax Act describes the events of liquidation and includes, “anything occurring during the period that starts with a step that is legally necessary to achieve liquidation”. There is a process for removal of a company from the register under section 318(1)(d) of the Companies Act 1993 pursuant to which the shareholders request the Registrar to remove the company from the Register. This process is sometimes referred to as a “short form liquidation” and is a cheaper and simpler option than appointing a liquidator and going through a formal liquidation process. The issue is whether the request to the Registrar meets the definition of “on liquidation” set out in the Income Tax Act. Inland Revenue consider that it does not as the basis of making a request to the Registrar is that the company has ceased to carry on business and has discharged in full its liabilities and distributed its surplus assets or it has no surplus assets after paying its debts in full or in part. This means therefore that the company must already have distributed its surplus assets before making the request to the Registrar therefore any amounts distributed on short form liquidation and relying on the request to the Registrar will not be exempt from income tax.

Provisional Tax Finance

Provisional Tax Finance has been approved as a tax intermediary by IRD. They provide a facility to fund payment of provisional tax (in excess of $5000) for up to 12 months. The application process is very simple and no security is required. We can process the application on your behalf.

Use of Money Interest

The following article is taken from a newsletter issued by nsaTax Limited.

"The Adjudication Unit of the IRD has recently made a number of determinations involving the deductibility of Use of Money Interest ("UOMI") for individual taxpayers.

The IRD's view is that individuals, whether in business or not, will not be allowed a deduction for use of money interest where this arises out of a reassessment of tax that leads to a tax shortfall, which in turn triggers the liability for use of money interest to the IRD. This is a somewhat new approach and could affect significant numbers of individual taxpayers and qualifying companies. It appears as though it will become official IRD policy. It is most certainly a departure from the previous policy which effectively allowed such a deduction for all taxpayers in business.

Previously the IRD approach was to allow a deduction of UOMI where there was an appropriate nexus between the liability for UOMI and the income earning activities of the taxpayer in question. Generally for individuals in business, such as partners in a law firm, a deduction for UOMI was allowed.

However the IRD's view, as propounded by IRD's Adjudication Unit, is that the traditional view of UOMI being deductible is incorrect, as deductibility cannot be approached on the basis that one looks to the purpose for which the capital (to which the UOMI relates) is used.

The effect of this is that the IRD's approach is that no nexus can ever be established in cases where the Commissioner re-assesses an individual's tax return and UOMI results. Accordingly individuals in business will be denied any claim for a deduction for UOMI by IRD. The IRD are promoting this view notwithstanding comments made by the Adjudication Unit that in their view it is "not clear how practical or workable such an approach is". We consider the decision to be incorrect, and that individuals in business can generally establish a direct nexus to the income earning process, thereby entitling them to a deduction for UOMI.

We have been approached by a number of concerned clients in order to facilitate the filing of a 'test case' challenge in the Taxation Review Authority. In terms of the provisions of section 138Q of the Tax Administration Act 1994, the IRD are able to designate a particular challenge as a test case if the issue or issues in one case can be determinative in a number of other challenges. If there are sufficient taxpayers involved, the legal costs can be spread so that they do not become prohibitive but ultimately it will depend on the amounts at stake for particular taxpayers.

We may consider taking this further and seeking a test case status if the numbers warrant such an action. Accordingly we would be interested in hearing from individuals in business or companies that are within the QC or LAQC regime which have received notification from IRD of the denial of a deduction for UOMI."

We have discussed this matter with a director of nsaTax Limited as we have several clients that will be affected by this approach. NsaTax Limited have now consulted with a specialist tax barrister with a view to bringing a test case. Watch this space for developments.

The Tax PIE

What is a PIE?

A PIE (portfolio investment entity) is an investment vehicle with special tax rules. The tax rules relating to PIE's effectively allow each fund to pay tax on behalf of its investors at each investor's Prescribed Investor Rate (PIR) (with a maximum tax rate of 30%).

In respect of tax treatment there are two categories that apply to investors, those that have:

- the zero rate correctly applied to their income (zero-rated portfolio investors)
- a prescribed investor rate greater than zero.

Zero rated portfolio investors are:

- those that can only have a zero rate such as companies
- trustees that do not choose the 30% rate.

The income allocated to these investors is not excluded income and will be included in their income tax return.

Investors that have prescribed investor rates greater than zero are:

- natural persons who are residents
- all non-residents
- trustees that have notified they have chosen the 30% rate.

Where an investor has had their actual prescribed investor rate applied to their income, i.e. they have correctly determined they qualify for the 19.5% or the 30% rate, the allocated income is excluded income and does not get included in the return. This applies to natural persons, non-residents and trustees that have notified the 30% prescribed investor rate.

It does not apply to trustees that did not notify their prescribed investor rate.

All investors can have the default rate of 30% applied where they do not notify the PIE of their prescribed investor rate. For natural persons the default rate becomes a final tax and the income is excluded income and does not get included in the investor's taxation return.

For investors that have a 0% prescribed investor rate (under the default rate this includes trustees) the income is not excluded income and must be included in the investor's tax return.

Tax treatment for trustees

There are three situations that can apply to trustees. They can:

- have the default rate of 30% applied
- choose the 0% prescribed investor rate
- choose the 30% prescribed investor rate.

If the trustee has the default rate applied or notifies the 0% prescribed investor rate, the income is not excluded income and must be included in the trust's return. A credit for the tax either paid directly by the PIE or as the separate allocated tax credits shown on the investor statement, is available using the standard tax credit treatment. PIE tax paid is a non-refundable tax credit.

A trustee that elected the 30% rate cannot include the income and tax credits in the trust return or treat it as beneficiary income and include it in the beneficiary's tax return.

Natural persons

Natural person investors who have chosen 30% or had the 30% default rate applied but actually had a PIR of 19.5%, cannot include the income in their return to obtain credit for the higher rate of tax paid by the PIE. The income or loss will only be included where a rate lower than the investor's prescribed investor rate has been applied. This will occur where they have notified an incorrect rate or where the PIE they invest into zero rates their income when they exit the PIE. Only the details for the period that has had the lower rate applied is included in the return.

Losses allocated by the PIE

Investor statements may show the PIE has allocated an investor a loss for the 2008 income year. For investors that have all their income or loss taxed at their PIR, the PIE will have already credited the investor with the tax value of the loss. For example an investor that has an allocated loss of $500 with a PIR of 33% will have a tax credit of $165. The PIE files their PIE return seeking the refund and then applies the refund back to the investor. The PIE has the choice of how to give the credit, some may issue additional units, while others may increase a cash distribution.

For investors that have the zero rate applied to their income/loss or a part of the income/loss the loss flows through to their income tax return and can be offset against other income.

Quote of the Month

A fine is a tax for doing wrong.
A tax is a fine for doing well.

Little Snippets

- Retail deposit guarantee scheme: The Government announced a retail deposit guarantee scheme facility in October. To see who has signed up go to: http://www.treasury.govt.nz/economy/guarantee/retail/approved.

- Donations rebates: The maximum refund limit has been lifted from the existing $630. This means that a refund of 33.3% of the total donations made is available from 1 April 2008, up to the maximum of your taxable income.

- Use of Money Interest: The rate has now reduced to 11.93%

- Private use of vehicle: If you have a company vehicle which is a "work-related vehicle" (for example, a ute) and you run your business from home, you are permitted to stop on your way home to shop. The vehicle must not travel significantly from the direct route. The rules are different for a car. You may not stop on your way home for shopping. This constitutes availability for private use and fringe benefit tax (FBT) applies.

  A sole trader or someone in partnership is not working for a company. FBT applies only to the staff they employ. The sole trader or partner driving a car, which is used partly for business and partly privately, accounts for private travel by keeping a log book in the usual way.

- PAYE deductions: If you run into cash-flow problems, don't use PAYE to pay creditors. A director of a company has recently been convicted of aiding and abetting an offence by knowingly allowing PAYE deductions to be used by the company for some other purpose. Inland Revenue might also succeed if it prosecuted an officer of a company. The person aiding and abetting not paying PAYE does not have to be a company director.

TAX CALENDAR

15 January
Provisional tax second instalment
GST return & payment for two month ending
30 November 2008

20 January
Third quarter FBT return to be filed

28 January
December monthly GST Return

7 February
Terminal Tax Payment due for March balance date (no tax agent) or no extension of time

28 March
GST return and payment for period ended February

7 April
Terminal tax payment due for March-September 2008 balance date (with tax agency)

7 May
GST for two month period to 31 March 2009
& one month period for 31 March 2009

Provisional tax third instalment for March balance date

Disclaimer
The information contained within this newsletter is of a general nature only and readers are advised that even minor differences in factual circumstances may result in significantly different tax consequences. This newsletter is not intended to replace specific tax advice. As always, specific advice should be obtained for the particular factual circumstances. We accept no liability for persons relying upon information contained within this newsletter.