



NEWSLETTER

March 2005

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AND THE FAMILY HOME

The IRD has warned that taxpayers who are selling their private home to a loss attributing qualifying company ('LAQC') and then claiming tax deductions on resulting losses have come under scrutiny. Under this arrangement the taxpayers pay rent to the LAQC, which then enables the taxpayers to generate a loss they then claim as a tax deduction against their personal income. The IRD considers this type of arrangement as possible tax avoidance.

A number of advisors have recommended the use of an LAQC structure to hold residential investment properties as this structure offers greater flexibility. There appears to be no issue if these properties are being rented out to tenants on an arms length basis. The concern is with the taxpayers' family homes that are not investment properties.

In this situation the IRD would look at the underlying reasons for the LAQC to consider whether there is a commercial reason for its operation or, whether it appears the main purpose for the LAQC is to obtain a tax advantage or benefit.

The reason the arrangement is considered tax avoidance is that the tax deduction is claimed for expenditure that is effectively of a private and domestic nature. If the arrangement is considered tax avoidance the taxpayer will be liable for the tax avoided, any use of money interest and penalties of up to 100% on the amount payable. The existence of a LAQC structure that owns the family home and appears to have no investment or business activity is likely to attract the attention of the IRD.



TAX CALENDAR

March 7
 3rd Instalment 2005
 Provisional Tax
 (March balance date)
 1st Instalment 2006
 Provisional Tax
 (November balance date)

April 7
 1st Instalment 2006
 Provisional Tax
 (December balance date)
 Terminal Tax 2005
 (March, April, May and June
 balance dates)

QUOTE FROM THE EMYTH REVISITED

"People who are exceptionally good in business aren't so because of what they know, but because of the insatiable need to know more." KEEP LEARNING!!

TAX AVOIDANCE, LAQC'S



BUYING AND SELLING PROPERTY

The IRD is currently reviewing the results of searches of the property register. This means the buying and selling of property, whether you live in the property or not, needs closer scrutiny. Where a search of the property register indicates a pattern of five or more property transactions in a three-year period, the IRD may request reasons for the transactions to determine whether any gains will be taxable.

The provisions in the Income Tax Act 1994 relating to land transactions provide the IRD with a basis for looking at the tax treatment of transactions which involve the buying or selling of property, even if there has been no development before the property is sold. One issue to consider is whether the land has been purchased with the purpose or intention of reselling the property. To determine the purpose or intention, or to help prove otherwise, reference to documentation including correspondence with or notes made by the bank, real estate agents or professional advisors will assist.

If the taxpayer had a number of different intentions at the time of purchase and one of those intentions was a crystallised intention of resale, the sale will be taxable. However, if the purpose of resale is remote or unsupported by evidence this will not be enough to establish intention of resale. The Courts have indicated that the mere fact that at the time of purchase of the property the taxpayer did not expect to hold the property forever and contemplated the possibility of sale does not establish conclusively that there was a purpose of resale.

Another avenue the IRD may pursue to determine whether there is any taxable gain is where the taxpayer (or someone associated to taxpayer) is engaged in the business of dealing in land. The Courts have found that 'dealing' refers to buying and selling or exchanging land. This would mean the act of buying and selling without altering the land in any material way.

Whether a taxpayer is in the 'business' of dealing in land is dependent on a number of factors to see whether the transactions amount to a business activity and there is the necessary intention to make a profit.

The factors to consider include:

- * Whether there is a series of repetitive transactions in respect of blocks of land;
- * The timeframe and period over which the transactions occur;
- * Commitment of time, money and effort;
- * The scale of the operations and whether the activity is organised in a commercial manner;
- * The financial results that are achieved.

The business of dealing in land must have been carried on by the taxpayer (or associate) at the time the taxpayer acquired the land for the gain to be taxable.

If the taxpayer lives on the property will any profit still be taxable under these provisions? There is an exemption that may apply where the taxpayer or any member of their family lives at the property. However, the exemption will not be available if a regular pattern of buying, living and selling in the properties concerned has occurred. Therefore, care needs to be taken if there is a possibility of a pattern emerging when buying and selling property.

SALARY SACRIFICE

Given recent debate about savings for retirement in the workplace, it may be a good time to consider benefits obtained by "salary sacrifice". There are advantages to careful planning of salary arrangements to allow contributions on behalf of employees that can be applied to a number of benefits such as employee share plans, entitlements, plans or superannuation schemes. Salary sacrifice refers to the concept that an employer and employee agree that a reduction in salary is taken in return for the employer making a contribution on behalf of the employee; commonly to a superannuation fund. In other words, by sacrificing part of their wage or salary so that it is not available as cash, the employee is building up a savings investment for retirement. The agreement with the

employee to sacrifice part of their pre-tax salary needs to be made prior to the employee earning the salary.

Benefits from salary sacrifice provide added incentives for individuals to save for their retirement. Since the recent increase in taxes many employers have sought advice on the use of salary sacrifice for employees in higher income brackets. The key to reviewing benefits of salary sacrifice is that pre-tax income is being used.

Superannuation contributions by way of "salary sacrifice" are taxed under the Superannuation Scheme Contribution Withholding Tax (SSCWT) provisions, which currently can apply variable tax rates in individual circumstances. An employer can now elect to deduct SSCWT at the employee's marginal tax rate. The tax rate may be as low as 15% depending on the salary paid. The rate of SSCWT that will apply is determined according to the salary paid to the employee in the previous year. The salary 'sacrifice' is not counted as part of the salary derived by the employee. As the salary will be lower once it has been 'sacrificed', the savings will come through the year after the agreement is entered into. To ensure no FBT is payable, the salary sacrifice contributions must go into a registered superannuation scheme.

Aside from the tax advantages, there are two critical economic issues to consider here. Firstly, the employee's cashflow position. Can they afford the salary sacrifice or do they need that money for their day to day living? How long is it before they will want to access the funds invested? If withdrawals are required before retirement a 5% Fund Withdrawal Tax will apply unless one of the limited exemptions are available. The second issue is how the risk and return of the particular superannuation scheme compares with other investments the employee could make with those funds.

CHANGES TO DEPRECIATION RULES

A Depreciation Issues Paper released in July 2004 proposed changes to the depreciation regime including the depreciation of patents, special tax depreciation rules, plant variety rights and losses on disposal or destruction

of buildings. These changes have been included in the Taxation Bill released on 16th November 2004. The depreciation proposals included in the Bill are:

- * Deductions for losses on destruction of buildings if the destruction is due to events that are beyond the taxpayer's control, for example, as a result of a natural disaster. Currently no deduction claim can be made.
- * Plant variety rights (granted under the Plant Variety Rights Act 1987) and the right to use them will be included as depreciable intangible property. The rights granted generally relate to new varieties of cultivated plants. As a result of this change, any amounts that are received on the grant of plant variety rights will constitute a taxable royalty.
- * Currently, depreciation on patents is allowed from the date a patent is granted; however, legal protection applies from the date when an application is lodged. The Bill introduces a new provision, which allows depreciation to be claimed from the date the patent is given legal effect (when the completed application is lodged). Depreciation will be deductible from the date of application to the date the patent is granted, in the income year in which the patent is first used or available for use in earning income.
- * Amendments to the special tax depreciation rate rules to allow the IRD more flexibility in determining a special tax depreciation rate when requested by a taxpayer. The bill also proposes to extend the special tax depreciation rules to fixed-life intangible property if the taxpayer believes that the economic life of the asset will be significantly less than the legal life of the asset.

PRISON SENTENCE FOR TAX EVASION

The Tauranga District Court recently imposed a 21 month prison sentence on a taxpayer who pleaded guilty to two charges of tax evasion. The taxpayer was in the fruit picking industry and had not accounted for approximately \$158,584 of GST, PAYE and income taxes. The prison sentence followed an increased focus by the IRD on tax evasion in the fruit picking and contracting industries. The IRD has focused on the Bay of Plenty,

Hawkes Bay, Waikato, Otago and Marlborough areas and have indicated that currently there are approximately 60 investigations underway in these areas. The sentence sends a clear warning that the Courts see tax evasion as a serious crime.



MORE MONEY FOR YOUR BUSINESS

Small business owners are among the most lax when it comes to conserving cash. Why borrow money unless you really need to? Here are some easy ways to improve your cash flow.

Debtors (Accounts Receivable or Money Owing to You)

Never give credit unless you need to. A vineyard received an order for some wine. They dispatched it with an invoice. They wrote on it "Please pay by the 20th of the month following date of invoice". Why? They were very trusting giving credit to all. Payment by the 20th of the month following is merely a convention. Why not seven days? Why not by return mail?

Small businesses are notorious for not chasing their slow payers. No wonder they have bad debts. Get a system going for managing debtors and stick to it. Don't put off chasing bad payers. Every time you ring a customer note down the date and time. Nail down your customer to an agreement. If he says he will pay by the end of the month, check on the first of the following month and get on the phone right away if the payment has not been made. "You said..." can be the best way to shame the customer into letting you have your money.

You may lose an occasional customer by being tough on credit. Do you really want these customers anyway? Many bad payers actually cost you money because they take away valuable time which could be used to derive more income elsewhere.

- don't give credit unless you have to;
- do a credit check with a debt collector, if in doubt;
- keep your credit terms as short as possible;

- be systematic in pursuit of slow payers;
- send your bills out as soon as you can.

Stock

Manage your stock. Getting deliveries "just in time" is cost-effective business.



Cull your stock. A client kept detailed records of her stock. In December 2004 she reviewed when everything had originally been put up for sale. Some of the stock had not moved since 2001.

If it is not moving, you should cut your losses and get rid of it. Have a sale, sell it on Trade Me. If it won't sell, why not give it away and claim the tax loss?

Some retailers pay for some of their stock when it is sold.

In furniture and appliance businesses, finance companies will fund stock using what is termed a Floor Plan. They supply money based on the value of stock on the shop floor.

Work In Progress

Contractors should always aim to get paid as the work progresses. Build progress payments into your contract and ensure the document is signed before you start. The more carefully you document what you are going to do, the less room there is for a misunderstanding. Avoid doing further work under the contract until the progress payment has been received.

Ask for a deposit. It demonstrates good faith on the part of the customer. You will be amazed how willing people are to pay a deposit.

Credit Card and Eftpos Facility

Plastic cards are a convenient way to avoid giving credit. This service comes at a cost. If you are selling from a distance and wish to avoid this expense, like the vineyard mentioned above, why not ask for payment by internet or telephone banking?

RENTAL PROPERTY EXPENSES



The deductibility of expenditure relies on both a timing test and a relationship test to your taxable income earning activity. Clients who have rental properties typically incur expenditure on “repairs and maintenance” type expenses after a tenant has caused damage to a property or shortly before they intend to sell a property.

Be careful with your intention when the expenditure is incurred. Only expenditure incurred on a rental property **which is intended to be re-let** after the repairs have been completed, will be deductible. If you do not intend to re-let the property, your taxable income earning activity has stopped and you cannot claim any expenses.

Clients who rent their home must carry out any repairs **before the tenants move out**. It is no good claiming the tenant did the damage and trying to justify the cost as business related. If your tenant has gone you cannot comply with the timing test.

YOUR ANNUAL ACCOUNTS

Here is a checklist of things to do before your balance date:

Bad Debts – write off bad debts before this deadline. Record the date so you could demonstrate to IRD when you did the write-offs.

Provisional Tax – if your taxable activity (you and your company, if you have one, combined) is likely to exceed \$112,000, you may need to increase your Provisional Tax payment to minimise IRD interest.

If you have a company and expect to leave a profit in excess of \$7,550 in it, after allowing for your wages, review your provisional tax payments for the company now, or risk Use of Money Interest Charges.

Stock on Hand – If your stock is worth more than \$5,000 you will have to count it at balance date. Get rid of dead stock before this time or you will need to include it at cost.

Dividends – If most of your company shares are owned by your family trust, pay a dividend before March 31 so it can be distributed to beneficiaries in their 2005 tax year.

Bonuses – You have 63 working days from balance date to **pay** staff bonuses, to claim a deduction in your 2005 accounts.

Other – Other ways to reduce 2005 tax are:

- sell equipment likely to make a loss on sale, before balance date in preference to after.
- Better to buy new equipment before year end if you want to claim depreciation on it (If you buy in the last month only one month's depreciation can be claimed).
- Buy travel before year end.
- Do maintenance early.

Imputation Credit Account – Ensure tax credits attached to dividends have not exceeded tax paid by the company. Reduce the risk by paying year end tax due on 7 April by 31 March.

BUSINESS PLANNING BASICS

The information you can put into a business plan is unlimited.

One of the benefits of writing down your plan is it clarifies your thinking. It forces you to be more specific about your rough and woolly ideas.

Visualise your business as you want it to become in, say, five years. If you can write it down clearly and can stay focused on it, you will improve your chance of success. I stress the word focus. Many people are undisciplined in business, so they never achieve real success.

Start your planning by thinking of your business under these six headings:

1. **Products** – can you specialise and become an expert in one aspect of your field? Pick something which others find difficult to achieve. You can charge more because you will have less competition: the greater the difficulty, the greater the reward. For

example, a builder seeks out the most complex jobs from architects. He enjoys the challenge and seldom has to compete based on price. You'll find accountants specialising in liquidations and lawyers who do only workplace law.



2. Customers – not everyone is a possible customer, especially for small businesses. A city plumber will service a restricted area because it will be uneconomical to

travel from one end of the city to the other. Be selective. Your objective is to make a profit and a good one. Start by culling customers who are slow to pay their bills. You may have heard of the Pareto principle: 80% of your customers will provide only 20% of your income. Try to increase the 20% of big spenders. The smaller your market the more easily you can become well known in it.

3. Equipment – make a list of the plant you will need. You do not need to buy all of it. See Finance, below.

4. Premises – will you be working from home or have an office or factory? Will you have premises at several different locations? If you decide in five years' your business will be run from home, then plan suitable facilities, storage, etc, as part of your home. If you plan to open several shops, start thinking about their location and the best order for creating them.

5. Staff – describe the staff you will need; it will help you in your selection process. Consider all the **functions** you will want carried out, group them and finally allocate the people. Do not start with the people, even if you already have a sizeable staff. Go for talent and attitude in your staff selection. Often staff are chosen on the basis of what they know – a big mistake. Anything which can be taught is less important than attitude. List the essential skills and then list those which are desirable but not absolutely necessary. You should refer back to this part of your plan when engaging new staff.

6. Finance – list your finance requirements. Unless you can afford to pay for everything you need, consider all the ways you can think of to get funds. When the Body Shop started, the owner gave away a half shareholding in the business to establish her second shop – an enormous price to pay

for finance! Outsourcing is often a useful way of using other people's equipment. You might also be solving an employment problem at the same time.

VANBURWRAY TEAM NEWS

Angell Team



Congratulations to **Michelle Ross** on passing two papers at WITT. She now has completed the academic requirements to be an Accounting Technician.

Darney Team

Karen Winch – Karen is taking on new responsibilities within the Darney Team. She will now be the Darney Team Administration Manager.

Leanne Griffiths – Leanne joins the Darney Team as a fulltime Administration Assistant. She has left the Merrilands New World office to join us. Welcome Leanne.

Eichstaedt Team

Catherine Robinson – Catherine has left to further her studies at Victoria University. We wish her well with these studies.

Raewyn Krutz – Raewyn is back on deck three days a week after having some time off to be a Mum to young Anton.

Whitmore Team

Phil Fleming – Phil will be leaving VBW on 31 March 2005 to take over the accounting practice of Graham Armstrong in Waitara. He has been with us since May 2000 and we would like to thank him for his contribution over this period. We wish him all the best for the future.



Stephen May – Stephen sat and passed a Taxation paper late last year. Well done Stephen.

Vanburwray Reception

Raewynn Hodge – Raewynn is off to pursue her Spanish Teaching career. Raewynn will be leaving us on 4 March 2005. We wish her all the best for her future.



Finally, we wish you and yours a very Happy and Safe Easter 2005.