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## Improvements for Small and Medium Sized Enterprises

In December 2007 the Government released a discussion document containing proposals aimed at reducing compliance costs for small and medium-sized enterprises. Two sets of proposals were included. The first looked at increasing various tax thresholds. The second involved changes that require greater pre-implementation work, such as proposals to:

- introduce a 'de minimis' threshold under which all legal expenses and entertainment expenses will be deductible
- create a Government database to simplify acquiring information from businesses
- reduce the time for which business records must be held, and
- make changes to GST invoicing.



Draft legislation introduced in July 2008 includes various threshold increases that are likely to take effect from 1 April 2009. The increases have resulted from the submission and discussion document process.

The proposed new thresholds are.

- PAYE returns can be filed monthly, and FBT returns annually, where annual PAYE deductions are less than \$250,000 (formerly \$100,000).
- Closely-held businesses will be able to file their FBT returns annually if their FBT liability arises solely due to 1 or 2 vehicles being made available for private use, regardless of their annual PAYE deduction amount.
- Currently, if an individual's residual income tax payable is less than \$35,000, the tax is not payable until their terminal tax due date. Where this threshold is exceeded, IRD interest is

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effectively backdated based on the provisional tax due dates (depending on the timing and amount of tax credits). This threshold is being raised to \$50,000.

- The compulsory GST registration threshold is increasing from a turnover of \$40,000 to \$50,000.
- Currently, taxpayers may file their GST returns six monthly if their turnover is \$250,000 or less. This is being increased to \$500,000.
- The threshold enabling a person to use their opening stock valuation to value their closing stock is being increased from a

stock value of \$5000 to \$10,000.

- Currently, only a natural person can qualify as a 'cash basis person' under the financial arrangement rules. This concession is being extended to companies and trusts. In addition, the threshold to account for arrangements on a straight-line basis is being increased from \$1.5M to \$1.85M.

These changes are likely to reduce compliance costs and are welcomed. Further changes, as proposed in the discussion document, are expected to be introduced in a Bill next year, and are likely to take effect from 1 April 2010.

## The IRD; Umpiring its Own Game?

Being investigated by the IRD is an unfortunate likelihood for any business. If the IRD proposes an adjustment that a taxpayer disagrees with the 'disputes process' is often the final and only option. The disputes process consists of legislated stages that are designed to produce a 'cards on the table' approach, as follows. The IRD will issue a written Notice of Proposed Adjustment ("NOPA"), outlining its view. Within two months, the taxpayer must issue a Notice of Response ("NOR"), which outlines the taxpayer's position. If a NOR is not issued within two months the taxpayer is deemed to have accepted the IRD's proposed adjustment.



In a recent dispute, the IRD rejected a taxpayer's NOR based on the view of one of its investigators. The investigator "seriously doubted" that the NOR was a valid notice and after discussing the matter with other officers, rejected it. In the IRD's view the NOR did not meet legislative requirements. Based on this rejection, the taxpayer was deemed to have accepted the adjustments.

The taxpayer responded by applying for a judicial review of the IRD's decision. The matter was recently heard before the High Court. The Court not only discussed whether the taxpayer's NOR was valid, but also whether the IRD even had the power to deem the NOR to be invalid.

The Court concluded that the IRD does not have legislative authority to determine if a NOR complies with the legislation, and then to reject it

on the basis that it does not comply. The Court also noted that it would be unusual for the IRD to have such a power when it was itself a party in the disputes process. Whether or not the NOR was valid was a question of statutory interpretation for the Courts. The Court stated that the IRD would need to apply to the Court in order to challenge the validity of a taxpayer's NOR.

The Court reviewed the requirements for a valid NOR and concluded that the taxpayer's NOR was, in fact, valid, despite it being extremely brief. The Court did not appear to consider the NOR's brevity to be an issue. It took a practical approach in assessing the merits of the NOR. The Court noted that the taxpayer's NOR did not have to comprise an arguable case against what the IRD was asserting. The Court stated that a taxpayer is entitled to challenge the IRD's proposed reassessment even if the taxpayer does not have a substantial case. Furthermore, in some cases a taxpayer might not have any more information to put forward in a NOR, however the taxpayer could still have a genuine position to be advanced through the disputes process.

The IRD is a large and powerful organisation and taxpayers often feel overwhelmed trying to deal with it on a day to day basis, let alone in the context of a dispute. Due to the IRD's perceived position of strength it can be easy for taxpayers to feel like they are playing against the umpire. The High Court's decision reinforces the proposition that when push comes to shove, the Court will provide an independent interpretation of the law.

## Income Splitting

In April this year, the Government released a discussion document inviting views on whether

'income splitting' is the most effective way to provide additional support to families with

children. The objective of income splitting is to create greater fairness by ensuring families with the same total income pay the same amount of tax. Currently, because of New Zealand's progressive tax rate structure, one family could pay more tax than another family with the same total income because of who is earning the money within each family.



The discussion document suggests two ways that income splitting could be achieved. These are:

- adding the income of both partners together, splitting the combined income evenly, and then calculating each partner's tax liability based on the standard marginal tax rates
- the use of a separate tax rate schedule for families, that is, not individuals, where the tax rate thresholds are twice as high as the thresholds that apply for individuals

Both these options would provide the same outcome in terms of tax liability.

Income splitting alters the total tax payable by shifting a portion of income from a higher tax bracket to a lower tax bracket. For example, Jack earns \$120,000 per year and Jill earns nil. Currently, Jack's income, which is over \$60,000 is taxed at 39%. Under an income splitting

## Associated Persons Update

Throughout the Income Tax Act, situations arise that require consideration of whether or not two persons are associated. The definition of 'associated persons' differs depending on what part of the legislation is being considered. In March 2007 the Government issued a discussion document seeking feedback on proposed changes to the associated persons rules. The document received considerable negative exposure and feedback because of its proposed changes to the definition of associated persons for land transactions. The Government received 867 submissions, with the majority focusing on the land related aspects of the changes.

Draft legislation introduced in July 2008 builds on the discussion document and looks to introduce some of the proposals in the discussion document as law. The draft legislation proposes one general definition for associated persons, which will have universal application across the Income Tax Act, accompanied by a number of qualifications and exceptions for specific

approach, half of Jack's income, or \$60,000, is taxed in Jill's name at the lower 19.5% and 33% rather than 39%. They are taxed as if they had earned \$60,000 each.

The above scenario represents the maximum possible tax saving of \$8730. This is because any situation where the income for each partner is greater than \$60,000 (currently), will not be able to take advantage of a lower tax bracket, as both Jack and Jill would be facing the tax rate of 39% on any extra income.

A family is likely to be defined as including married, civil union and de facto partners with one or more dependants (children). A child is likely to be considered a dependant until they are 18 years of age, receive a benefit themselves or are in full time employment. Under the proposals, single parents will not be eligible for any form of income splitting.

There has been considerable debate in recent times around the merits of recent increases in family assistance levels and the use of the tax system for social engineering. The prospect of income splitting is likely to add to that debate. Although, in this case, income splitting is likely to provide relief to families that have higher, rather than lower, incomes. The discussion document poses the question "would the introduction of income splitting lead to a fairer income for families than is currently the case?" The only certain answer is that there won't be a unanimous opinion.

circumstances. Consolidating the definitions is aimed at simplifying the law and minimising the opportunity to circumvent the rules through complicated structures.

A number of the unwelcome proposals in the discussion document that related to land have been included in the draft legislation. The friction arises because the current associated persons rules allow a person in the business of dealing in or developing land, or erecting buildings on land, to hold investment property in another entity and not have that property 'tainted'. If a property is tainted it means that it is likely to be taxable on sale if it is sold within ten years of acquisition. The new proposals introduce associated persons definitions that can effectively render land, which is held as investment property, to be taxable on



sale. Taxing land that is in substance held as investment property, such as a rental property, is in effect levying a capital gains tax.

In the context of association, for the purposes of land, key changes include:

- **Trusts** – under the current associated persons rules two trusts cannot be associated. Under the proposed rules, two trusts with the same settlor (or same protector) will be associated, and the settlor of a trust will also be associated with that trust.
- **‘Daisy-chaining’** – currently, in a situation with 3 parties, A and C may not be associated, even though A is associated with B, and B is associated with C. A limited tripartite test will now be introduced where two people will be associated (A and C), if they are both associated with a common third party (B), (i.e. daisy-chaining).
- **Aggregation** – when determining if two companies are associated, shares held by a shareholder in a company will also be deemed to be held by any other person that is associated to that shareholder.

A common current structure involves a development company’s shares being held by a Trust (settled by ‘Mum or Dad’), and for a rental company’s shares to be held by ‘Mum and Dad’. Under the existing rules the two companies are not associated as the same persons (the individuals versus the Trust) do not hold 50% or more of the shares in both companies. Under the proposed rules the individuals as settlors would be associated with the Trust, and therefore the shares held by the Trust would be deemed to also be held by the individuals, resulting in both companies being associated. Due to the association, land purchased by the rental company after the rules come into force is likely to be taxable on sale if it is sold within 10 years of acquisition.

If enacted, these changes will take effect from the 2009 – 2010 income year, although the provisions relating to land will only apply to land purchased, or improved (in the case of builders) from 1 April 2009. Existing holdings of land are therefore unaffected. In isolation, these changes may appear minor. However, their combined effect will have major implications for many taxpayers as illustrated in the example above.

## Snippets

### Personal Tax Rate Change

A significant announcement made during this year’s budget was the alteration to personal income tax rates.

The changes will be introduced progressively from the current income tax year through to the 2011 – 2012 year. Both the rates of tax and the thresholds to which the rates apply, will change.

The changes are as follows:

Date applicable	Threshold (\$)	Rate (%)
<b>Now</b>	0 – 38,000	19.5
	38,001 - 60,000	33
	60,001 +	39
<b>From 01/10/2008</b>	0 - 14,000	12.5
	14,001 - 40,000	21
	40,001 - 70,000	33
	70,001 +	39
<b>From 01/04/2010</b>	0 - 17,500	12.5
	17,501 - 40,000	21
	40,001 - 75,000	33
	75,001 +	39
<b>From 01/04/2011</b>	0 - 20,000	12.5
	20,001 - 42,500	21
	42,501 - 80,000	33
	80,001 +	39

### Recognition of Trans-Tasman Dividend Credit

At present, when a New Zealand company distributes its profits by dividend to an investor across the Tasman, tax credits attached to the dividend cannot be used by the investor; as dividend credits arising in Australia and New Zealand are not recognised by the other country.



On 18 July 2008, Dr Cullen announced that the Australian and New Zealand Governments have agreed to consider proposals for the mutual recognition of dividend credits. This decision acknowledges that the current distortion of investment flows between the two countries does not sit well with wider moves towards a Single Economic Market.

The New Zealand Treasury will make a formal submission on mutual recognition to the ‘Australia’s Future Tax System’ review and is anticipated to issue its final report by the end of 2009.

*If you have any questions about the newsletter items, please contact us, we are here to help*