

Withholding Payment Regulations - Confused?

In November 2007 Mohammad Wasim received a prison sentence of 5 years nine months for his role in what the Inland Revenue called the biggest horticultural industry tax fraud they had ever prosecuted. The scheme, carried out between 1 April 2004 and 31 October 2006, involved contractors evading their tax liabilities by claiming they subcontracted work to another company or having another company issue an invoice for work completed by their employees.

The horticultural industry has been the subject of considerable IRD scrutiny due to it historically being an easy target for tax evasion. The

Withholding Payment Regulations (WPR) currently require tax to be deducted from payments made to fruit pickers (individuals and companies). However, prior to 1 April 2006 if these services were carried out by a company for an orchard owner, withholding tax did not have to be deducted. Due to this exemption, companies were setup to carry out the work, with no withholding tax being deducted from the income earned. The individuals who set up the companies simply walked



away without the tax being paid. From 1 April 2006 the rules were changed specifically to counter this scenario. Withholding tax is now required to be deducted from payments to companies that carry out work of this nature.

The problem with the WPR is that they can be confusing, as they appear to overlap the PAYE rules. This makes it hard to distinguish whether a WPR tax code or a generic PAYE tax code should be used. The mechanism used by an employee to select the correct tax code is the Inland Revenue form, IR330. The form itself requires a WPR rate (withholding tax rate) to be used if a person is operating under a "contract for service" and "not

for salary or wages", but the form does not explain the distinction. The basis for the distinction lies in the difference between how employees are taxed versus the self-employed. A person employed under a "contract of service" is an employee and their income is taxed through the withholding of PAYE by their employer. The self-employed on the other hand are employed under a "contract for service" and are responsible for meeting their own tax obligations as they are required to calculate their income and expenses and file an income tax return.

Whether a WPR rate or a generic PAYE rate applies will depend on the circumstances under which the person is to work. The WPR are not relevant if a person is an employee, i.e. the person is employed under a "contract of service".

Indications that a person is an employee include an entitlement to annual and sick leave, having set working hours, no financial risk, and having a high level of control by their "employer". If a person is an employee and therefore is receiving a salary or a wage, the WPR do not apply and the generic PAYE rates are followed. If a person is self-employed the WPR apply and withholding tax must be deducted at the rate of 20%.

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"Success is not the key to happiness. Happiness is the key to success. If you love what you are doing, you will be successful"

Albert Schweitzer

Transferring Assets Between Associated Persons

Depreciation is generally claimed on an asset when it is used in business. The basis on which depreciation is calculated is typically an



item's cost. However, specific rules could apply if the asset has been purchased off an associated person (individuals or companies linked through company ownership, partnerships, interpersonal relationships or shared eligibility to benefits held in trust), requiring depreciation to be calculated based on what the seller originally paid. If the asset has increased in value, which is generally the case for assets such as buildings, the purchaser's depreciation claim will be of a lower value.

The Commissioner of Inland Revenue (CIR) has the discretion to allow the actual asset transfer cost to be used. The IRD has recently released a new Standard Practice Statement providing guidance for when this discretion

will be exercised. The statement applies to decisions made by the CIR from 14 September 2007.

The statement has effectively narrowed the circumstances in which the discretion by the CIR will be exercised, in comparison with what has previously been understood to be acceptable practice. In determining whether or not to exercise this discretion the following factors will be considered:

- whether the transfer is genuine
- the commercial or non tax-related reasons for the transfer of the property
- whether the transfer is made at no more than the fair market value
- whether there is a permanent transfer of legal ownership of the property
- whether the associated vendor (or its controllers) continues to retain virtual ownership of, or beneficial interest in, the transferred property, through any of the following:

- ~ power over or control of the associated purchaser, or
- ~ a leaseback or similar agreement, or
- ~ continued actual use of the transferred property for income-producing purposes.

The discretion is likely to be exercised where the CIR is satisfied that the transaction is undertaken for business or commercial reasons and not just to achieve a tax advantage. The Statement provides the example of a former family home being transferred to a loss attributing qualifying company to make it available for rental. The Statement concludes that in this situation the discretion would not be exercised.

The statement also states that if the taxpayer wishes the CIR to exercise his discretion, a request for approval by the CIR should be made before depreciation is claimed. This should be kept in mind the next time you're purchasing an asset from an associated person.

Your Business – a Goldmine or a Coffin

There are about 325,000 small to medium sized enterprises (SMEs) in New Zealand. That's over 96 per cent of the country's total number of businesses.

The average age of business owners in New Zealand is 58 years old. Forty per cent of them plan to sell their business in the next five years. That's about 130,000 businesses on the block during that period. Most of them won't stand up to a great deal of scrutiny. However some could be potential gold mines for the right purchaser.

So what are the options for small

business owners who want to fund their retirement by exiting their business?

To be frank, there are not many. They include:

- prepare it for sale to another business or would-be business owner,
- transfer it to the next generation of the family,
- sell it to the employees of the company,
- liquidate the assets of the business, or

- sell the shares to the public.

A lot of small business owners hope to have a family member take over on their retirement. In practice we find that children increasingly have no interest in taking over the family business.

The key to planning for succession is to grow the business so that it is less dependent on the owner and more attractive for sale.



For buyers there are a number of considerations.

It is important to have a good understanding of what you are buying. This can only be determined by adhering to a properly structured due diligence process. Due diligence is a term for a number of concepts involving either the performance of an investigation of a business or person, or the performance of an act with a certain standard of care.

External advisors can help to make sure that the process is not

hijacked by a desire to complete the purchase.

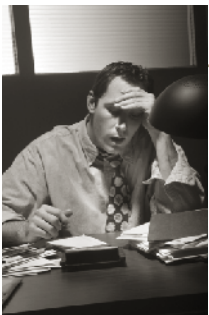
Small businesses often depend on the owner's commitment, contacts and history. The challenge the purchaser faces is to make sure the goodwill they have paid for sticks to the business in the future.

Businesses looking for new acquisition opportunities should look for potential acquisitions closely aligned to their core competencies and to which they can add value following the purchase. Follow the old maxim – "stick to your knitting". Once they

have selected the target they should follow the right process. That means putting the right team together to work through the due diligence process.

Trends of market convergence, the age of many business owners and difficult market conditions mean that many businesses will be on the market over the next five years.

For prospective business owners, who follow the right process, there will be some nuggets out there.



Tax Changes – Small to Medium Sized Businesses

The Government recently sought submissions on a range of options that were put forward to reduce compliance costs for small to medium sized entities. The options were outlined in a Discussion Document (published in December 2007) and are intended to benefit small to medium sized entities (SMEs) because these entities tend to disproportionately bear the brunt of high tax compliance costs.

Amendments that will effect the changes will apply from either 1 April 2009 or 1 April 2010, depending on the complexity of the specific change.

The proposed options will be considered and chosen based on a number of different factors, including the level of compliance cost saving, fiscal cost and unintended or undesirable effects.

Threshold Changes

Some of these options only raise monetary thresholds, to reduce the numbers of SMEs having

to comply. Threshold changes include:

- where the PAYE paid in the previous year is \$100,000 or less, an employer can file their PAYE returns monthly and FBT returns annually; this threshold may be raised to \$250,000
- raising the residual income tax threshold from \$35,000 to \$50,000 for individuals to avoid interest charges on provisional tax underpayments
- increasing the compulsory GST registration threshold from \$40,000 to \$50,000
- increasing the turnover threshold for 6 monthly GST filing from \$250,000 to \$500,000
- increasing the low value trading stock threshold from \$5,000 to \$10,000.

Introduction of new thresholds are also being considered:

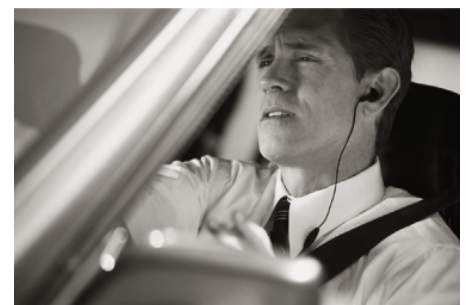
- legal fees up to \$10,000 per year to automatically be deductible

- non-deductible entertainment expenses would not have to be recognised where total entertainment expenses are less than a particular amount (e.g. \$2,500 – \$10,000).

These threshold changes should provide some relief for SMEs.

Fringe Benefit Tax (FBT) Changes

The FBT rules are often an area where the compliance cost is relatively high compared to the



tax paid, particularly in the case of motor vehicles. Currently, types of vehicles that qualify as "work-related vehicles" are not subject to FBT if the private use of the vehicle is restricted to "home-to-work" travel and "incidental" private use. It has been proposed that the "work-related vehicle" concession be phased out and a "restricted private use" category be introduced. Basically, this category would apply to all types

"I know you think you understand what I said, but what you heard was not what I meant"

of vehicles; however if the private use of a vehicle is within limits yet to be specified, the FBT value would be 10% of the vehicle's cost or 18% of the vehicle's book value (depending on the method used), as opposed to the current 20% or 36%, respectively. This change could be a double edged sword for "work-related vehicles". On the one hand this will eliminate the need to determine if a vehicle qualifies as a "work-related vehicle". But on the other hand as "work-related vehicles" that are still under the current rules are replaced, new "work-related vehicles" could be subject to FBT, although at a reduced rate.

"You cannot discover new oceans unless you have the courage to lose sight of the shore."

This change may lead to the Government deriving more FBT from vehicles overall.

Miscellaneous Changes

As is the norm in Discussion Documents of this nature the opportunity is generally taken to tweak or fine-tune existing rules.

Further miscellaneous proposals include:

- relaxing various provisions relating to GST invoices to reduce their prescriptive nature, e.g. removing the need to state the quantity or volume of the goods supplied
- the option to correct errors in a subsequent return, where the error involves less than \$500 of tax
- tweaking of the rules relating to the GST ratio method for paying provisional tax

- a reduction in the period of time tax records must be retained
- allowing businesses to assume in certain circumstances, that contractors subject to the withholding payments regulations hold certificates of exemption.

The Government has also used the Discussion Document process as an opportunity to request feedback on the low use of the PAYE intermediaries' subsidy as well as information sharing between Government departments to reduce instances where businesses provide the same information more than once.

It will be interesting to see what changes come out of the process; it is expected that some of the proposals will be introduced in the May 2008 Budget.

Snippets

Student Loan Repayment Threshold

From 1 April 2008 the student loan repayment threshold will rise from \$17,784 to \$18,148.

Tax Legislation Enacted

The second major piece of tax legislation introduced in the 2007 Budget finally received Royal Assent in December 2007. The passing of the legislation introduces various changes, some of which received considerable attention by the media at the time of the Budget.

Key amendments include:

- the introduction of employer and employee KiwiSaver tax credits and the requirement for employers to contribute to an employee's KiwiSaver scheme
- the introduction of tax credits for research and development

- measures to enable a smooth transition to a 30% company tax rate.

Inland Revenue Alerts

The Inland Revenue (IRD) has launched what it has called an early warning system for tax professionals. The service is intended to highlight significant or emerging areas of concern that have been identified by the IRD. This could involve a scheme, arrangement or particular transaction. By fully informing tax professionals of these issues, the IRD hopes that voluntary compliance will improve as taxpayers become aware of what the IRD considers risky.

Most recently the Revenue Alert



Service has been used to express the IRD's concern over "the family home" being sold to a Loss Attributing Qualifying Company (LAQC), which then rents it back to the family, thus "allowing" what were non-deductible personal expenses to be claimed for tax purposes. Depending on the specific facts, the IRD may consider this tax avoidance.

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

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