

IN TOUCH WITH TAX

Penny & Hooper – IRD wins Court of Appeal Tax Avoidance case.

In an earlier edition of *InTouch*, we reported that the IRD had lost its High Court case in which they challenged the legitimacy of two orthopaedic surgeons operating their respective practices via a company/family trust structure.

Basically, the IRD considered this structure, combined with the 'artificially' low salaries paid to the surgeons, to be tax avoidance.

The IRD have now won this case in the Court of Appeal. The result is that the surgeons will be personally taxable on much of the practice income at the higher personal tax rates.

This decision certainly sends a signal that the commerciality of every aspect of an operating structure must be considered and overall the structure must not be artificial or contrived. Particularly at issue is the amount of salary paid to the primary service provider in any SME (not just medical practitioners) and whether that same income is ultimately channelled back to that person, via an operating company and trust shareholder, rather than, for example, being retained in a trust for investment purposes.

The IRD have indicated that they will not be auditing all and sundry as a result of this decision, which reflects the point that 'tax avoidance' is not a straight forward matter and tends to require a combination of factors to be present.



Messrs Penny and Hooper have appealed this case to the Supreme Court, which will hopefully provide some clarification about where the IRD will draw the line between commerciality and tax avoidance.

In the meantime, the alignment of the trust tax rate and top personal tax rate will no doubt take the heat out of this issue in the future.

GIFT DUTY TO BE REPEALED?

The Government has announced that it intends to repeal gift duty if its concerns around creditor protection and social assistance targeting can be addressed.

Tax legislation is not expected until November 2010, but if it proceeds, it will be welcomed by many clients.

PAYE – Not working capital.

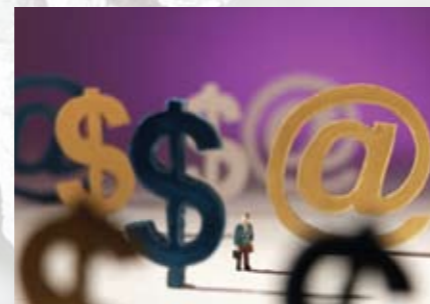
With the economic downturn, more and more businesses are looking at ways to cut costs, prioritise creditors and maximise working capital. But you cannot afford to treat PAYE as working capital, rather than paying it on time to the IRD.

PAYE may not appear to be any different from other taxes. But a noteworthy difference is that PAYE deducted by an employer from salaries paid to employees is deemed to be held in trust by the employer for the IRD. An employer who fails to pay the PAYE to the IRD by the due date is deemed to have misapplied it.

How serious the IRD take unpaid PAYE is reflected by the toughness of the IRD debt collection team, significantly higher potential penalties and the approach sometimes taken by IRD liquidators. Specifically, in some cases, IRD liquidators are insisting directors of any company they have put into liquidation are personally liable for unpaid PAYE on the basis that unpaid PAYE is evidence of trading while insolvent.

If your business has liquidity problems, don't consider your PAYE liability to be working capital.

If paying your taxes is a problem, it is always best to contact us as early as possible. We can then guide you through the IRD debt collection process and seek reduction or waiver of IRD penalties on your behalf.



Mike Ruffell
Tax Manager

INTOUCH

with PKF Martin Jarvie

INTRODUCTION

This issue marks the passing of the middle of another year, the shortest day has been and winter is well upon us.

From a business and financial perspective interest has been created with the ground breaking changes announced in the May Budget. The key changes are discussed in this issue of *InTouch*. The key theme associated with the changes is "Planning" and whilst the various changes seem simple, there is quite a significant effect on business philosophy and administration.

Whilst tax matters dominate, it is important not to lose focus on general business matters. We have taken the opportunity in this issue to review the key components of the Business Life Cycle. This is an important tool to assist you in your strategic planning.

KEY BUDGET CHANGES – GST

On 1 October 2010 the GST rate will increase to 15.0%. While a seemingly simple change there are a number of business implications.

Perhaps, the major implication that needs to be considered is the effect on pricing your products. Whilst the legislation, generally, provides for the increase to be passed on to your customers, can you from a practical point of view recover the increase. Remember, if the product currently has a GST inclusive price of \$8 the change would give a price of \$8.18 including GST – is this practical, what are your competitors likely to do and how will this affect your business?

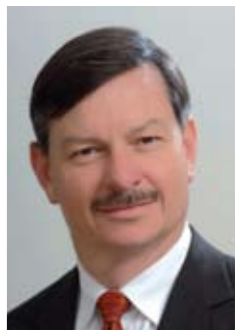
From a practical administrative point of view, there are a number of implications for GST registered taxpayers, which should be reviewed as soon as possible, including:

- Checking that your accounting system copes with the rate change or does it need to be replaced?
- Updating the GST rate in your billing and accounting systems
- Checking contracts to see whether they are GST exclusive or inclusive. For the latter there are legal considerations as to whether the price can be increased
- Issuing new perpetual invoices e.g. as a landlord of a commercial property
- Having customers amend any automatic payments to you, where necessary
- Be ready to amend relevant automatic payments that you make i.e. rent
- Ensuring that any credit notes are issued using the GST rate on the original invoice
- Consider the effects of the increase on cash flows and update forecasts if necessary
- Making sure that your accounting "team" is able to cope with the changes or do they need training or assistance?

Additional GST returns will be required where:

- Your GST period straddles 1 October 2010, then two returns will be required.
- You are on a Payments or Hybrid basis then a GST adjustment form relating to any unpaid supplies, both made and received as at 30 September 2010 will be required.

Remember, we are here to assist you, if you have any queries or concerns please contact us.



Robert Elms
Partner

KEY BUDGET CHANGES – INCOME TAX

Reduction in Personal Tax Rates

Personal tax rates reduce from 1 October 2010, resulting in a composite tax rate for the current tax year. The new tax rates and composite rate for this financial year are:

Composite Rate	Income level	Current Rate	2010/11 New Rate
\$0 – \$14,000	12.5%	10.5%	11.5%
\$14,001 – \$48,000	21.0%	17.5%	19.25%
\$48,001 – \$70,000	33.8%	30.0%	31.5%
\$70,000 +	38.0%	33.0%	35.5%

From 1 October 2010, the reduced tax rates will be reflected in PAYE deductions, RWT rates on interest and PIE investor tax rates.

Provisional tax payments for the 2010/11 tax year will be adjusted for the new rates after 1 October 2010. Payments due before 1 October 2010 will be calculated using the old rates and uplift calculation, with the payments due after that date adjusted to take into account the new rates.

The reduction in tax rates will be of significant benefit to those on higher incomes.

Reduction in the Company Tax Rate

The company income tax rate will reduce from 30% to 28% from the start of the 2011/12 income year. For companies with a 31 March balance date this will be 1 April 2011.

The new company tax rate will change the ratio at which imputation credits can be attached to dividends. However, for a

two year transition period, credits relating to tax years up to and including 2010/11 can still be attached at an effective rate of 30%. Once these credits have been used, or the transition period expires, the effective rate will reduce to 28%. With the current requirement for most companies to deduct RWT to top up the tax credits to 33%, the current 3% top up will eventually increase to 5%.

Depreciation Rates for Buildings

From the 2011/12 year, tax payers will no longer be able to claim depreciation on buildings, unless the building has a useful life of less than 50 years. With the 50 year test applying from the date it was built, rather than when it was purchased, we expect that most buildings won't meet this exemption.

From a practical perspective, the change will result in a building depreciation rate of 0% (currently generally 2% to 4%). This change effectively freezes the depreciation claimed to date. The existing depreciation recovered rules will continue to apply on the depreciation claimed to the 2010/11 year.

The impact on taxpayers currently claiming depreciation on buildings will be an increase in their taxable income, or a reduction in the tax loss incurred. Care will need to be taken to manage any increase in tax liability. We recommend that you contact us to assist you to manage the impact of these changes.

The IRD has also advised that they are reviewing the treatment of commercial building fit-out components which can be depreciated separately from buildings. These separate assets are currently allowed a higher depreciation rate which would be reduced to the building depreciation rate should they be reclassified as part of the building, under the changes this rate would be 0%.

Depreciation Loading

For a number of years the depreciation rates for plant and equipment, purchased new, have included a 20 percent loading. This loading has now been removed and will affect fixed assets purchased on or after 20 May 2010. For most taxpayers we expect this change to have minimal impact.

LAQC and QC changes

Proposed changes were announced that would see LAQCs and QCs treated for tax purposes in a similar way to limited liability partnerships. This would allow losses to be passed to shareholders, however there would be some situations where these losses are limited. Conversely, any profits would also need to be attributed to the shareholders and taxed at their marginal tax rates.

The IRD have produced an issues paper and requested submissions, which may result in significant changes to the current proposal. The proposed changes are intended to take effect for the income year commencing on or after 1 April 2011. The legislation is expected to be passed by the end of this year.

We will keep you informed of the final situation, once it is known.



THE BUSINESS LIFE CYCLE

The business life cycle that generally most businesses go through has four distinct stages:

Start Up.....Growth....Maturity.... & Exit

It is important to recognise the stage of the life cycle that your business is currently in, as it can help identify any potential issues that the business should be aware of and may need to address. The diagram shows the impact of the various stages of the life cycle.

Start Up Stage

This stage, the owner works on building up a business based upon two key factors: the initial business idea and a clear opportunity to enter the market. The objective during this stage is to establish the business with a customer base and market presence whilst conserving cash flow.

This stage is typified by high time input by the owners, low capital base often obtained by borrowing on the house and high failure rates. The difficulties of gaining market acceptance makes this stage hard to survive. Motivation and skill are required to get a business off the ground. A key to success in these early stages is identifying the advice you need and actually obtaining it.

Advice is typically required for such things as market research, creation of a business plan, legal structures and accounting & tax.

Growth Stage

The Growth stage reflects the time where the business has become somewhat established in the market.

This stage is typified as having a core base of customers, continuing high time demands on the owners and the need for more capital.

Success during this time can often be attributed to effective management and careful consideration of the demands of increasing capital requirements to fund more staff, larger premises, and plant & equipment, the diversification of products and services, determining future strategies and ensuring up to date business plans.

Maturity Stage

A thriving business has developed, characterised by stable profits, market share and loyal customers. The business will be able to ride out most unforeseen events, such as market instability.

This stage is typified by stability of the business and its profitability, often this stage can lead to complacency. As the business environment changes constantly, there is a constant need to review your markets, business environment, technology and financial matters, in order not to fall into the complacency trap.

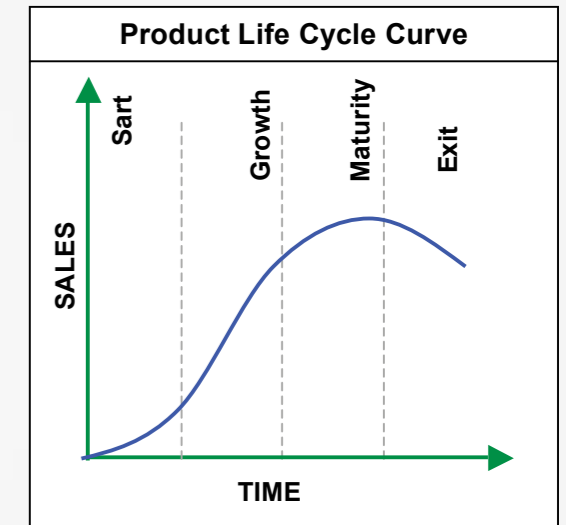
Consideration at this stage needs to be given to evaluating your options - do you maintain current operations as is, expand into a new growth phase with potential for higher profits or start planning your exit?

Exit Stage

The Exit stage is generally seen as the sale of the business, it is an opportunity for the business owner to reap the benefit of all their efforts. Some types of businesses do not lend themselves to sale, but to an orderly wind down – in these cases it is essential for the owners reward to come from the annual profits of the business.

The challenge is to get the best overall return for yourself as the owner. Therefore the business needs to be in a 'saleable state' at all times. Planning ahead for your exit is very important in order to maximise the potential overall return from the business.

Each of these stages presents many challenges to a business and the business owner, these challenges are best tackled by early identification and obtaining advice from specialist advisors as soon as possible. We are well placed to assist with all aspects of your business planning.



David Hulston
Partner



Chris Morrison
Associate