Larsen, Patterson & Willson Limited
t/as LPW Accounting
M Northcote Office Park, Unit 11, 80 Grey Street, P O Box 28,
PALMERSTON NORTH 4440
P 06 357 5793, E office@lpw.co.nz, W www.lpw.co.nz

CHARTERED ACCOUNTANTS AUSTRALIA • NEW ZEALAND

lpw ACCOUNTING

NEWSLETTER

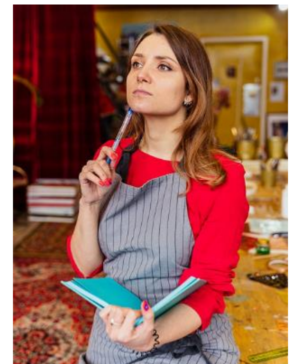
Issue 1
February – April 2024

INSIDE THIS EDITION

Assessing your business's viability 1
Beware of deemed dividends 2
De facto relationship or not? 3
Trust Disclosure regime – Insights from the first year 3
Snippets 4
End of year write-offs 4
UK's HMRC hit workers with big tax bills.....4

All information in this newsletter is to the best of the authors' knowledge true and accurate. No liability is assumed by the authors, or publishers, for any losses suffered by any person relying directly or indirectly upon this newsletter. It is recommended that clients should consult a senior representative of the firm before acting upon this information.

Assessing your business's viability



Sitting back at your desk after a month of busy family time or relaxing beach days, business owners and executive teams should start to think about not only the year ahead, but the long-term viability of their businesses.

With rapid changes and multiple existential threats impacting different businesses in different ways, it might be an opportunistic time to ask yourself: do you expect your market and/or customers to be subject to fundamental change? Will your business be viable in ten years' time if it continues on its current trajectory? Do you have the option of carrying on as you are and hoping for the best, or do you need to make some proactive (and potentially risky) changes to give your business the best chance of continuing into the future?

With pressure from consumers for reinvention intensifying, it's no surprise that we are seeing businesses adopting new technology. Air New Zealand, aware of its reliance on fossil fuels, is looking at new ways to power their aircraft fleet. They have just purchased their first all-electric aircraft which will operate cargo routes starting in 2026. They also plan to begin replacing their regional domestic fleet with more sustainable aircraft, with goals to use either green hydrogen or battery hybrid systems from 2030.

Other companies are pivoting into new areas to meet changing consumer demands. For example, consider the amount of 'plant-based alternatives' available today, with fast food restaurants like Burger King offering an entire range of plant-based meat.

It's no secret that climate change and sustainability are hot topics at the moment, and while much of the

© 2024

change is driven by Government, the reality is that consumers are forcing these changes with their wallet.

It is becoming more and more common for a business to accept a lower return on climate-friendly investments, showing a willingness to accept a trade-off of financial return for sustainability outcomes.

Electric vehicle sales are rising across the country, and while it might not have been a consideration 20 years ago, consumers now consider whether the products they purchase have been ethically and sustainably produced.

Companies even need to be mindful of sustainability if they want access to capital, with banks, investors and equity funds refusing to invest or adopting a sinking lid approach depending on the industry a company operates in.

The changes happening now are not just something that the big companies need to worry about. Small companies are more likely than their larger company counterparts to feel their company's viability threatened, and for good reason. The shifts over the coming decades will have flow on effects to all facets of business. Think electric cars – what is a mechanic doing 20 years from now, or a petrol station operator, or the person that leases the land to the petrol station?

By taking the time to reflect, you place yourself in a much better position to not only survive the next few decades but also capitalise.

Beware of deemed dividends

The concept of what is a "dividend" is very broad and starts with the default proposition that any transfer of value from a company to a shareholder is a dividend. That concept includes the simple scenario of an interest free loan to a shareholder or a person associated to a shareholder; which can also include loans between companies.

This matters because a dividend is taxable to the recipient, but not deductible to the payer, i.e. it gives rise to a net tax cost. The standard solution to eliminate the dividend is to charge interest on the loan at either a market rate or the prescribed FBT rate (depending on the parties to the loan).

But not all interest free loans made by a company will give rise to a deemed dividend, some do, some don't and this is an area where mistakes are often made resulting in either no interest being charged when required, or interest being charged when it is not required.

When determining whether loans between related companies can be interest-free or not, two key sections of the Act should be considered – sections CD 27 and CW 10.

If section CD 27 applies, a transfer of value is specifically excluded from being a dividend and then can be ignored for this purpose. The section applies to 'downstream' dividends, e.g. a loan from a parent company to a subsidiary. The provision itself is complex and needs to be worked through on a case by case basis, but it is helpful.

If the exemptions in section CD 27 do not apply and a dividend has arisen, then section CW 10 may help. The section is a broader provision that deems a dividend between wholly owned companies (i.e. companies that have identical shareholders) to be exempt income of the recipient.

This is an area Inland Revenue has and will continue to scrutinize, as seen in a recent Technical Decision Summary (TDS), TDS 24/01.

The TDS concerned an interest-free loan made from a parent company (Company C) to a subsidiary (Company A) and whether the interest-free loan gave rise to a dividend to Company C (yes, the lender).

Importantly, the Tax Counsel Office (TCO) initially points out that Company A is the recipient of the value (being the interest-free loan), hence no dividend has arisen to Company C. The TCO then concluded that the exclusion under section CD 27 applied such that the interest-free loan did not give rise to a dividend.

The TDS also commented on whether the arrangement comprised 'tax avoidance' and stated that it did not raise any tax avoidance concerns because the legislation was working as intended because the Act contemplated capital could be provided by way of interest free loan.

Reading between the lines, it appears an over eager person at Inland Revenue was trying to find something that wasn't there.

As an aside, trusts legally do not pay dividends, hence the deemed dividend risk and therefore the need to charge interest (from a tax perspective) should not apply to a trust.

© 2024

De facto relationship or not?

The Working for Families Tax Credit (WFFTC) is a notoriously complex scheme when it comes to determining eligibility and quantifying entitlement. This leads you to wonder how well the scheme is policed by Inland Revenue, and whether fraud is able to 'fly under the radar'.

Accordingly, it was heartening to see a case brought before the Taxation Review Authority in October of last year regarding a taxpayer making false claims about their de facto relationship.

The taxpayer claimed $39,740 of WFFTC's for the years 2015 to 2018 on the basis that they were a single parent. However, at the time they were living with a Mr X, with whom the Commissioner considered the taxpayer to be in a de facto relationship.

Support was given by the taxpayer, their sister, and Mr X claiming that no de facto relationship existed. However, the evidence to the contrary was extensive. They lived together, went on holidays together, had social media profiles that indicated they were a couple, attended work functions as a 'couple' and were financially interdependent. As a result, the income of Mr X was deemed to be included in the WFFTC calculation and the taxpayer's actual entitlement for the four years was reduced to nil.

If the taxpayer was not satisfied with this, the Commissioner went further to say that regardless of whether a de facto relationship existed or not, their entitlement would have been reduced anyway due to the taxpayer stealing from her place of employment. Because they had stolen money, it would count as income towards the calculation of their WFFTC and their entitlements should have been reduced in 2016 and 2018, and no entitlement would have existed in 2017.

The taxpayer claimed that the Commissioner should exercise their discretion to not collect tax given that the stolen money was used to fund their gambling addiction. Unsurprisingly, the Commissioner held that the taxpayer's circumstances were 'far from justifying the exercise of such a discretion'.

Although this case demonstrates some absurd circumstances, it provides comfort that Inland Revenue does apply resources to ensure schemes such as WFFTC are policed and that their exploitation is met with appropriate action. It also demonstrates the variety of investigation skills within Inland Revenue and provides a warning for those who are considering stretching the truth when it comes to their WFFTC claims.

Trust Disclosure regime – Insights from the first year

After the introduction of the Trust Disclosure rules in March 2022, in November 2023 Inland Revenue released a high-level summary (in the form of a 40-page report) of insights from the first year of reporting.

While tax advisors and clients alike may have begrudgingly completed the disclosures initially, the statistics may prove to be interesting.

The stated purpose of the trust disclosure rules was to provide insights into the way trusts are used, and to ensure compliance with the 39% individual tax rate. The information gathered included reporting on details of settlors, individuals with powers of appointment, beneficiaries, and various financial information.

A recurring theme throughout the report was the level of errors, but not surprising given the complexity of the disclosure rules and it being the first year. Of the 226,000 IR6s received, the errors included:

- 26,000 trusts that provided no financial information but had indicated that they were required to comply.
- An additional 16,000 trusts that only completed the IR10 but did not complete the financial information section of the IR6.
- 49,000 trusts that provided no settlor details.
- 450 instances of beneficiary distributions to minors that exceeded $1,000.
- 300 trust beneficiaries who owe student loans that failed to disclose their trust distributions.
- 1,400 Working for Families recipients that failed to disclose their trust distributions.
- 500 instances where income had been allocated to tax-exempt beneficiaries even though the distribution had not been paid.
- 3,500 trusts that retained trustee income despite having ceased in the same year.
- 250 instances of beneficiary income being allocated to offshore beneficiaries that had not been included in a NZ non-resident tax return.

© 2024

Conversely, there were also numerous trusts that complied with the rules despite not being required to – including 35,000 trusts filing nil tax returns, of which 11,500 provided financial information.

Other key insights into trust income and assets included:

- Total trust assets amounting to $470 billion, which was up from $240 billion reported on the IR10 in 2016.
- $91 billion of trust assets comprising shares and $191 billion comprising land and buildings.
- 16,000 trusts reported untaxed realised gains of $14 billion. This compared to 5,000 trusts which reported $4 billion in untaxed realised gains in 2016.
- The amount of beneficiary income allocated to individuals earning over $180,000 dropping from $900 million in 2020 to $450 million in 2022.

As a result of the information gathered, the Government may consider policy reform to address some of the issues identified – such as implementing a two-month payment notification requirement for beneficiary distributions to charities, in line with Australia's regime. Greater scrutiny of Trust tax affairs is expected, especially as the Government has provided additional funding to complete audits and investigations.

Snippets

End of year write-offs

As increasing interest rates have bitten and with industry sectors such as retail and construction not performing as strongly, some businesses are struggling. As the end of the financial year approaches, now is a good time to assess whether any of your accounts receivable need to be written off as 'bad'. This is because, in order to claim a tax deduction, a bad debt needs to be physically written off as bad within the income year.

Whether an amount is "bad" was discussed by Inland Revenue in Public Ruling BR Pub 18/07. The factors to be considered include:

- the time period the debt has been outstanding;
- steps taken by the lender to recover/collect the debt;
- knowledge of the debtor's financial position;
- status of the debtor, e.g. deceased, unreachable, or in receivership or liquidation; and
- when the debt will become statute barred.

Inland Revenue noted that it is not necessary for a debtor to be insolvent or that legal proceedings be commenced to recover a debt, in order for it to be 'bad'.

Evidence of what recovery action has been taken and why the debt is considered bad should be held in the event of review by Inland Revenue.

If GST has been paid on a sale that has subsequently been written off as bad, the GST paid on the sale should also be recoverable from Inland Revenue.

Paying tax on a sale for which you will not be paid is like pouring salt into a wound, and to be avoided where possible.

UK's HMRC hit workers with big tax bills

The UK's tax collection department (HMRC) has been sending letters to tens of thousands of taxpayers, demanding they pay large outstanding tax obligations. The letters have come as a surprise to many and have allegedly been linked to 10 suicides.

The issue has arisen out of the use of umbrella companies. Workers would have their salaries paid into the umbrella company, which would then lend the money to the worker, but it was not repaid. Such a structure was common in fields such as nursing and teaching, with there often being no choice but to get paid in this way. However, the scheme was not compliant with UK tax legislation, resulting in large underpayments of tax and national insurance over the years.

Rather than go after the employers that set these schemes up, the HMRC is contacting individuals directly and placing the tax burden on them.

Is this something that could happen in New Zealand? Technically, the legislation does allow for it. The Income Tax Act 2007 provides that where PAYE is not withheld from an income payment, the employee is then liable to pay that tax. In reality, this is unlikely to happen because Inland Revenue would more likely pursue the employer.

However, if someone is being paid 'gross' it is better to ask the question and not consider it a 'windfall gain'.

© 2024

Extracting cash tax free from a company

For 99.9% of the time, New Zealand companies are incorporated to operate a business and derive income. On establishment, the focus tends to be on items such as:

- whether a company is the appropriate vehicle, e.g. does limited liability protection warrant it;
- who should own the shares, e.g. in personal names or in a Trust; and
- who should be appointed director.

Understandably, the initial focus is not necessarily on how business income will be extracted, or how the business will eventually be sold. However, with the difference between the company tax rate (28%) and the top personal and trust tax rates (39% from the 2024/25 year) increasing to 11%, a material barrier will exist to extracting taxable value from a company. This makes it important to ensure value is able to be extracted tax-free where possible.

In a simple sense, a company's assets minus liabilities equals the 'value' or equity of a company. Equity is made up of available subscribed capital (ASC), accumulated taxable income, and/or capital gains (whether realised or unrealised).

ASC represents the cash put into a company by its shareholders. For example, if the shareholders paid $100,000 for 100,000 shares at $1 each, ASC of $100,000 exists.

ASC represents a pool of funds that is able to be paid to shareholders tax-free, subject to meeting specific criteria. For example, in the event of a pro-rata share repurchase and cancellation, the amount paid might be tax-free if it is at least 15% of the market value of all participating shares in the company (or 10% if approved by Inland Revenue). Another requirement is that the share purchase amount cannot be in lieu of a dividend.

Capital gains can only be extracted tax-free on liquidation. This often results in capital gains becoming trapped if a company can't be struck off because it owns other assets. For this reason, land is sometimes held in separate, special purpose companies to enable easy extraction (by way of winding up the company) in the event the land is sold.

Finally, another option comes into play when it's time to sell the business to a third party. If a company is 'pregnant' with taxable value, the company's shares could be sold to another company. Assuming the shares are held on capital account, the exiting shareholder should derive a non-taxable capital gain. Future extraction of that value is not necessarily taxable to the purchaser.

A landscape will exist where the difference between the 28% rate and 39% rate is material and will inevitably lead to actions to mitigate the higher rate where possible, but it is also a complicated area that Inland Revenue will likely focus. Hence, with any tax mitigation strategy, risk versus reward will come into play.

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

© 2024