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Client Newsletter

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IRD Compliance Focus Report for 2011-2012

Although most individuals and businesses voluntarily comply with their tax obligations, there are those who don't comply. One of the objectives of the compliance focus is to ensure that people pay and receive the right amount of tax and the IRD has shifted its compliance strategy plans to address this. Previously, they have looked at patterns of non-compliant behaviour by customer groups, eg individuals, families, small and medium enterprises (SMEs) and employers. This has now shifted to four key themes:

- *To provide certainty to their customers* – in case errors have been made, then the process to fix it is laid out thereby giving certainty;
- *To receive the right information at the right time* – so any entitlements to claim are made at the right time;
- *Everyone files and pays on time* – so they meet their tax obligations to register, file, report and pay on time; and
- *Everyone receives and pays the right amount* – this takes into account various areas of activities as stated below.

To ensure that people pay the right amount of tax, the IRD will look at:

- Aggressive tax planning eg adopting a particular structure or arranging tax affairs to gain a tax benefit;
- Under-reporting eg having overseas bank accounts where income earned from it is not reported;
- Diversion of income to claim Working for Families Tax Credits or other such benefits;
- Operations outside the system eg businesses trading online or cash operations and not declaring that income; and
- Continuing to target those businesses:
  - taking part in the hidden economy;
  - in the hospitality and tourism trade;
  - property developers, speculators and dealers earning income from property transactions;
  - that need improved compliance such as agricultural or horticultural industries.

If you think you may be a target due to the IRD's Compliance Focus strategy then you may want to contact your advisor.

Abolition of Gift Duty

The abolition of gift duty has been legislated and is effective from 1 October 2011. Many people who are owed large debts from their family trusts will be keen on forgiving all outstanding debts as soon as possible. However, it is strongly recommended that they seek their accountant's advice before rushing into forgiving the debt as it may affect their position. Some of the situations to be aware of are as follows:

- You may lose the entitlement to rest home subsidy because the residential care subsidy rules have no time limits to add back gifts made in excess of $27,000.
- If the trust (usually older ones) does not have the donor as the beneficiary, the donor will not have the security of the debt-back if say he wants to continue to live in the trust property.
- If the donor is a shareholder of a look through company (LTC) then forgiveness of debt can affect the shareholder's 'equity' and limit the loss availability.
- Proof of solvency is required at the time of the gifting in case creditors revoke gifting (which can go back up to five years).
- Depending on the type of beneficiaries in the trust deed, sometimes the gifted amount may become trustee income.

KiwiSaver Changes

The three key changes that have been legislated are:

1. The Government's contribution has reduced from $1042 to $521 maximum per annum beginning 1 July 2011 year. However, in order to get the $521 contribution one still has to save $1042.
2. The minimum level of employee and employer compulsory contribution rates has increased from 2% to 3% from 1 April 2013.
3. The employer contributions will be taxable from 1 April 2012. Up until this point the compulsory employer contributions of 2% were tax free, but from 1 April 2012 anybody on the top tax rate of 33 cents in the dollar will actually get only 67% of their employer's contributions paid into KiwiSaver.

Employer contributions

Compulsory employer contributions to KiwiSaver schemes and complying funds are currently exempt from employer superannuation contribution tax (ESCT). A complying fund is a section within a registered superannuation scheme that has incorporated certain KiwiSaver rules – in particular portability and lock-in. Any voluntary employer contributions to KiwiSaver schemes are subject to ESCT. Voluntary employer contributions include contributions you make:

- Over and above the compulsory employer contribution rate;
- To employees aged under 18 or over 65 years (and who have been a member for more than five years);
- To employees on a contribution holiday; or
- To employees who are on leave without pay.

Asset Sales between Associated Parties

Time again, taxpayers get caught under the associated party rules even when there is a genuine business transaction between the two. For example, where a company is expanding and restructures to house different business streams in different companies which will entail selling assets to the newly formed company; or more commonly, where farming parents are retiring and sell their farm assets to their son/daughter's new entity. In such situations, the parties will be 'associated persons'.

Issue with GST

Where a transaction is between associated parties, the purchaser can claim GST input tax on the **lesser** of:

- The GST component (if any) on the original cost to the supplier;
- 3/23 of the purchase price; or
- 3/23 of the open market value.

So in our first example, if the market values of the assets sold to a related entity are less than the purchase price, the purchasing company will be able to claim GST input tax on the lesser amount while the selling company will have to return GST output tax on the higher sale price. The net result for this group of companies is that it will be out of pocket while still owning the same assets. The situation could be worse if say in the second example for instance, the parents inherited the farm assets or purchased them before the introduction of GST legislation in New Zealand. The GST component on the original cost to the vendor will be zero which is the lesser of the three values above and, therefore, the purchasing entity will not be able to claim any GST!

Other Tax issues

The ITA 2007 (section EE 40) limits the depreciation base for the purchaser as well. The purchaser can depreciate the assets on the **lesser** of:

- The purchase price of the assets to the purchaser; or
- The (original) cost of the assets to the vendor.

Taking the farming situation above, if the farm assets are sold at (higher) market values the purchasing entity will not be able to depreciate them at the market values but instead at the original cost of the assets. In addition, the vendor will have depreciation recovery which will be taxable. To illustrate this, let's say the original cost to the parents of a shed was $10,000 which has a depreciated book value of $5,000 but the market value on date of sale to their son's entity is $20,000. The parents will be taxed on depreciation recovery of $5,000 while the son's entity will be able to depreciate the asset only on $10,000 (although $20,000 purchase price is paid). Section EE 40 is an anti-avoidance section designed to stop an associated party from selling at an inflated price to make a huge (tax free) capital gain and to stop the purchaser from using an inflated price to depreciate an asset. Unfortunately, the section also catches unintended genuine transactions, as can be seen from above. This problem can be overcome if the taxpayer makes an application to the IRD requesting it apply its discretion to allow the taxpayer to use the actual purchase cost as the depreciation base. The IRD will look at certain factors on a case-by-case basis before it exercises its discretion. If you believe you are in such a situation, you are better to contact your advisor.

Important: This is not advice. Clients should not act solely on the basis of the material contained in the Client Newsletter. Items herein are general comments only and do not constitute or convey advice per se. Changes in legislation may occur quickly. We therefore recommend that our formal advice be sought before acting in any of the areas. The Client Newsletter is issued as a helpful guide to clients and for their private information. Therefore it should be regarded as confidential and should not be made available to any person without our prior approval. 188/2011.