EASTWOOD BOURKE LIMITED

Office 1, 89 Chapel Street,
Masterton, New Zealand

Directors: Gerard B. Eastwood CA, BBS
Brian J. Bourke CA

Phone: (06) 377 2300
Fax: (06) 377 2150
Mail: P.O. Box 138
Email: office@eastwoodbourke.co.nz

COUNT ON GROWTH
Web Site: www.eastwoodbourke.co.nz

CHARTERED ACCOUNTANTS

NEWSLETTER

Issue 3
December 2011 – January 2012

INSIDE THIS EDITION

IRD WINS FINAL PENNY AND HOOPER ROUND 1
WORKING FOR FAMILIES CHANGES 2
TAX SYSTEM STATISTICS 3
GST – WHAT IS A SUPPLY? 3
GST – COMPULSORY ZERO RATING 4
CHANGES CONFIDENTIALITY CASE LAW 4
TEST CASE FOR JUSTIFIABLE DISMISSAL 5
SNIPPETS 6
- LIVESTOCK VALUATION ELECTIONS
- EAT DRINK & BE MERRY, TOMORROW WE PAY MORE TAX

Christmas / New Year Wishes

We wish you a Merry Christmas and an enjoyable & successful New Year.

We thank all our clients for the opportunity to provide accounting, taxation, company, business administration and advisory services for you. We do appreciate your business.

OFFICE CLOSE DOWN

Our office will be closed for the Christmas/New Year break, closing Friday 23rd December and **re-opening on Monday 9th January 2012 at 8.30am.**

For any emergencies you can contact:
Gerard Eastwood........ Ph: 027 4481250

OUR TEAM:

Aimee, Brian, Sherree, Vanessa, Gerard

IRD WINS FINAL ROUND AGAINST PENNY AND HOOPER

The recent dispute involving Messrs Penny and Hooper has come to an end with the Supreme Court decision finding in favour of the IRD. The Supreme Court upheld the Court of Appeal's view that the setting of commercially unrealistic salaries constituted tax avoidance.

Penny and Hooper were both orthopaedic surgeons trading in their personal capacity, but restructured their businesses to trade through companies, owned by family trusts. The companies employed the surgeons for substantially less than what they had been earning prior to the restructure. However, their work load and the nature of work did not change. The Supreme Court stated that while the structures used were valid business structures, the yearly setting of a non-commercial salary constituted tax avoidance.

In response to the finding the IRD has provided guidance, in the form of Revenue Alert *RA 11/02,* on circumstances in which it considers tax avoidance would arise.

Based on the Revenue Alert, the IRD will look into all aspects of an arrangement, in order to come to a conclusion on whether or not diversion of personal income through other entities, such as companies and trusts, amounts to tax avoidance. **The Alert identifies the following factors as being relevant:**

- The **commercial reality of the** service provider's **business structure**,
- **How profits have been distributed in substance** and whether the employee and their family benefit from all profit distributions,
- **Whether the remuneration paid to the individual providing the service adequately reflects their contribution to the business' profits**,
- Whether there are other reasons, apart from tax, for justifying departure from the norm.

© 2011

The Alert also identifies situations where a below market salary could be justified, as follows:

- To fund planned capital expenditure,
- To retain profits within the business to provide for future financial difficulties,
- Where profits are down, but most of the profits are still distributed to the service providers, or
- The business relates to a charity and the individual receives less to maximise the charity's return.

The IRD acknowledge other situations may arise where it would not be possible to pay a market salary. However, if a business cannot afford to pay a market salary, IRD would equally expect it could not afford to make significant distributions (such as dividend payments) to associated entities.

Amongst accounting practitioners the heart of the Penny and Hooper case has been the question of whether private companies, which derive income from personal services performed by its employees, need to pay those employees a market salary. However, **the Revenue Alert indicates the IRD may not stop at requiring a fair market salary. The IRD has stated that it is:**

"more likely to examine arrangements where the total remuneration and profit distributions received by the individual service provider is less than 80% of the total distributions received by the controller, his/her family and associated entities."

Paying a commercially realistic salary may not necessarily satisfy the IRD, as the IRD's focus appears to be on the amount of income received by the service provider as a proportion of the total distributed. It is generally understood that disclosures to IRD are being handled centrally to ensure taxpayers are treated consistently.

Working for Families – Changes to Family Scheme Income Definition

The Working for Families (WFF) Tax Credits Scheme provides welfare payments for families with school aged children. To more accurately target families who qualify, the definition of "family scheme income", used to determine family assistance entitlements, was amended from 1 April 2011.

While the previous definition incorporated similar adjustments for calculating the correct level of WFF income, the latest changes go a step further. These seek to eliminate perceived loopholes that exist, such as the sheltering of income through the use of family trusts.

The following amounts now need to be included in calculating income for family assistance purposes:

- **The income of a trust** where the person is a settlor (certain trusts are excluded, but generic family trusts will be caught), **and income of a company** of which that trust (and an associated person) holds 50% or more of the shares. In this situation the attributed income of the company is calculated based on the trust's proportionate shareholding in the company. The amounts attributed are reduced if the trust or company has either distributed its income or paid a dividend, respectively. If there is more than one company, the net income of each company is calculated and attributed separately and if one company has incurred a loss, the loss cannot be offset against the profits of other companies,
- The **taxable value of fringe benefits** attributable to a person who (including associated persons) holds 50% or more of the shares in a company,
- **Total passive income over $500 derived by dependent children** such as interest, dividends, royalties and rent,
- **Portfolio Investment Entity (PIE) income** where the income is not locked in until retirement,
- **50% of certain pensions and annuities** that are treated as exempt income,
- **Foreign sourced income of a person's non-resident spouse**,
- **Tax exempt salary and wages** such as those from specific international agreements e.g. salaries received from employees of the United Nations,
- **Deposits paid to the main 'Income Equalisation Scheme'** (for income from farming, fishing or forestry). Deposits captured include those made by the person and companies and trusts that meet the above requirements for family scheme income. Conversely refunds from the scheme are excluded,
- **A further catch-all provision has been introduced to capture additional payments received** by a person that are used to replace lost or diminished income or meet the living expenses of the person's family if the total of the amounts received exceed $5,000. ***For example, if a person's parents pay his/her family's utilities bills each month and the amounts total more than $5,000 per year, then that total amount is included as income.***

Families who are currently receiving regular WFF payments should review all sources of their income and contact Inland Revenue to ensure they are receiving the correct level of benefit. **Our advice to clients who run their own business is to resist receiving regular WFF payments and leave this to an end of year calculation** and annual payment, to ensure you are not faced with having to repay overpaid WFF as well as facing the tax cost from higher than expected net incomes.

© 2011

Some Statistics Surrounding New Zealand's Tax System

The New Zealand tax regime has been subject to significant political debate and scrutiny in the past few years. We have seen the Tax Working Group weigh in, a GST increase to 15%, a decrease in the company tax rate to 30% and then 28%, and repeated changes to personal marginal tax rates.

The current review of the trust regime by the Law Commission could lead to further changes to the taxation of trusts and their beneficiaries.

In light of this year's Budget (which introduced a number of cost saving and revenue gathering changes), we set out some facts and figures about our tax system:

- **In 2009/2010 the total tax revenue derived from taxpayers was split as follows:**
  - Individuals - $21.9 billion (43%)
  - GST - $11.7 billion (23%)
  - Corporate tax - $7.3 billion (14%)
  - Other tax - $9.8 billion (19%)
- **The split for the 2011/2012 year is forecast to be:**
  - Individuals - $24.3 billion (44%)
  - GST - $15 billion (27%)
  - Corporate tax - $8.1 billion (15%)
  - Other tax - $7.3 billion (13%)
- Before the tax cuts in October 2010, 12% of individual taxpayers contributed 49% of all personal income tax, while the remaining 88% of individual taxpayers contributed 51%.
- Currently, households earning less than $50,000 (43% of households) receive more in income support than they pay in income tax (on a net basis). Income tax paid by households earning between $50,000 – $110,000 effectively pays for this net refund. Households earning over $120,000 pay 97% of net individual income taxes, while **the top 10% of households (those over $150,000) pay 71% of the net individual income tax revenue**.
- Prior to the introduction of the 39% tax rate in 2000 there were about 20,000 trusts in New Zealand. By 2010 that number had increased to about 55,000.

KiwiSaver

- The Budget changes to KiwiSaver are expected to save $2.6 billion over four years.
- By 2015 it is expected that KiwiSaver funds will top $25 billion and in 10 years' time will top $60 billion.

Working For Families

- In the 2005/2006 year the cost of WFF was $1.5 billion. This has now grown to $2.8 billion per year.
- The changes to the WFF package announced in the 2011 Budget are expected to save $448 million over 4 years. As a result of the changes approximately:
  - 280,000 families earning less than $70,000 per year will receive increased WFF entitlements,
  - 110,000 families earning over $60,000 per year will receive slightly less than before the changes,
  - 7,000 families will no longer be eligible for WFF.

Student Loans

- At 30 June 2011 student loan debt was $12 billion.
- Ordinarily, a loan would represent an asset to the lender. However, because no interest is charged and the number of borrowers who default, the Government treats 45.3% of every dollar lent as an expense.
- 15.5% of borrowers are based overseas.
- 8.6% of NZ based borrowers have overdue payments, compared to 37.5% of overseas borrowers.

.

GST – What is a Supply?

To quote the GST Act, GST is a charge "on the supply of goods or services". The definition of "supply" is therefore one of the most important factors to consider when determining whether GST applies to a transaction. A recent trend has emerged in which businesses are re-visiting the GST treatment of transactions and are identifying payments received for supplies that did not take place or are not for "supplies" under the GST Act. Examples of these types of situations include:

- cancellation fees
- break fees or early termination fees (e.g. a customer defaults under a contract or exercises an option to exit from a contract before its term is completed)
- no shows
- enrolment fees
- event cancellations

Businesses (for example gyms, education providers and hotels) should analyse these types of transactions to determine if they receive payments that are not consideration for the supply of a good or service. If these circumstances exist, specific GST advice should be obtained to determine the treatment of any retrospective receipts, and how to treat these receipts going forward. It may be possible to approach the IRD for a refund of over-paid GST.

Adding to the debate, a recent Australian case, *Qantas Airways Ltd v Commissioner of Taxation (2011),* has also considered the question of what constitutes a supply.

The Qantas case involved transactions where customers had paid for a flight and then

© 2011

subsequently cancelled or did not turn up for the booking, and did not receive a refund. Qantas completed GST returns which claimed back the GST previously paid to the Australian Tax Office (ATO) for the flights not used by customers, and not refunded by Qantas.

The full Federal Court of Australia found in favour of Qantas. The Court stated "the actual travel was the relevant supply, and if it did not occur there was no taxable supply", this is "the essence, and sole purpose of the transaction".

In a co-incidental development, new legislation has been introduced that stipulates GST is to apply to late payment fees. The IRD has stated that such fees should have the same treatment as prompt payment discounts, i.e, amounts with or without discount are subject to GST.

Over 25 years after GST was introduced, the question of what transactions are subject to GST is still being debated. This is all the more reason for businesses to spend some time and make sure GST is not unnecessarily being paid to the IRD

Compulsory Zero-Rating

The compulsory zero-rating (CZR) of land transactions has been in force since 1 April 2011. Over the past months, a number of common questions have arisen regarding the application of the new rules.

To summarise, **the new rules require a transaction that wholly or partly consists of land to be zero-rated if:**

- **The vendor and purchaser are both GST registered, and**
- **The purchaser intends to use the land for the purpose of making taxable supplies, and**
- **The purchaser or a person associated with the purchaser does not intend to use the land as a principal place of residence.**

The vendor is to rely on a written statement of intention from the purchaser to determine whether or not a supply of land should be zero-rated. The Auckland District Law Society (ADLS) and the Real Estate Institute have amended the standard form ADLS agreement to include an addendum and additional schedule to accommodate CZR.

There has been some confusion about how parties to an agreement are to complete the addendum, or in some cases not complete it. If a transaction is a basic sale of a residential house between two private parties (not GST registered) the sale is not subject to GST. Consequently, CZR can't apply and the addendum and schedules are 'not applicable'. However, some situations are not so straight forward.

As outlined above, in order for a supply to be zero-rated the vendor must be GST registered. However, a vendor may be registered for a purpose unrelated to the land being sold. For example, a GST registered plumber selling the family home, or a GST registered company that owns residential and commercial land and is selling the residential land. On the face of it the vendor is GST registered. However, the question of whether or not a person is GST registered in the context of the supply needs to be asked. The vendor is not GST registered for the purpose of each of the supplies above, and therefore CZR can't apply and the schedules are 'not applicable'.

Farm sales will generally fall within the CZR regime, however, most farm sales include one or more dwellings situated on the land. Broadly, the GST Act deems the supply of a dwelling to be a separate supply (i.e. two supplies exist, the dwelling and the farmland). The vendor is usually only GST registered in relation to the farmland, and as such CZR could only apply to this portion and it is 'not applicable' to the dwelling.

The treatment applying to the sale of a dwelling within which a home office exists will depend on how that office has been accounted for in the past. If, for example, a partial input tax deduction has been made on acquisition, the sale of the dwelling should be subject to GST and CZR could apply. If however, period by period or annual deductions have been made (under the change of use rules that existed before 1 April 2011) the sale should not be subject to GST.

Given the potential for tax and contractual disputes to occur, if any doubt arises throughout the course of a transaction, consideration should be given to consulting a lawyer or tax advisor.

Change in Confidentiality Case Law

The common law surrounding the level of disclosure required of employers in redundancy situations has been shaken up by the Employment Court decision, *Vice-Chancellor of Massey University v Wrigley and Kelly (2011)*.

Mr Wrigley and Dr Kelly worked in departments that were being downsized and were made redundant whilst their colleagues retained their positions. They sought a considerable amount of information from Massey to

determine whether the decisions made met the test that they were "fair and reasonable in all the circumstances". Massey happily provided the documentation about the process but declined to provide material that was evaluative, about other people, or not in written form. Consequently Wrigley and Kelly raised a claim that Massey had failed to provide all the relevant information. This resulted in a challenge in the Employment Court as to what information should be provided.

The Court weighed up the requirements for good faith under the Employment Relations Act and the confidentiality requirements under the Privacy Act. It also sought submissions from the Privacy Commissioner on the matter.

The Employment Relations Act requires the employer to provide access to information relevant to the continuation of employment where it is considering termination. Information can be withheld for good reason, which is defined as complying with statutory requirements, protecting the privacy of natural persons or protecting the commercial position of the employer.

Wrigley and Kelly sought the following information:

- interview notes and ratings,
- candidate comparison sheets,
- information about successful candidates,
- reasons why they and not others were dismissed,
- facts and opinions relied on in making the decision,
- scores allocated to other candidates,
- any negative opinions formed and relied on in the process,
- the contents of discussions of the selection panel, and
- information in the minds of the selection panel.

The Court concluded that the information sought was confidential but it "did not find that protection of the privacy of those people involved in the selection process was a sufficiently good reason to maintain confidentiality of the information." and that "a fair and reasonable employer will not rely on information adverse to an employee to dismiss him…without making that information available to the employee for comment".

Massey was ordered to provide all the relevant documentation, including information comparing the candidates and the views of the panel members.

This case presents an interesting and for many an uncomfortable precedent that has occasioned considerable debate. However, for now it is the prevailing case law. Employers and those involved in selection processes should consider carefully the documentation used in the employment process in light of the fact that these documents may be required to be disclosed to the employees concerned.

TEST CASE FOR JUSTIFIABLE DISMISSAL

Last year the Government amended the Employment Relations Act ('the Act'), which included significant changes to Section 103A, the test of justification of a dismissal or action of an employer.

The test changed from what "would" a fair and reasonable employer have done in all the circumstances, to what "could" they have done, thus shifting the test from a specific action to a range of possible actions.

In addition, the test was required to take into consideration the resources available to the employer, whether the employer had raised the concerns with the employee and given them an opportunity to respond, and whether they had genuinely considered the response.

The amendment came into effect in April this year and has now been tested in the Employment Relations Authority ('the Authority') in the case of *Sigglekow v Waikato District Health Board*. This is an important case as it sets the benchmark for subsequent cases (that is until one is referred to the Employment Court for a judgement that carries higher legal authority).

Mr Sigglekow was a psychiatric nurse with the DHB working in a secure ward with patients who have histories of criminal and mental health issues. He suffered a heart attack and after some weeks off started returning to work with progressively more shifts.

There were some incidents where Mr Sigglekow was allegedly sleeping during his afternoon shifts (which run to 11pm). He was spoken to about some of these incidents but not formally warned. He was dismissed in April for serious misconduct, of sleeping on the job. Mr Sigglekow took a personal grievance for unjustified dismissal.

The Authority examined the new test for justification and then stepped back to consider the other pertinent sections of the Act, relevant case law, and organisational contracts and policies. This process brought another 35 points into consideration in determining whether or not the action was justified.

In particular the Authority explored the duty of good faith from Section 4 of the Act and the requirement, when considering termination of employment, to give the

© 2011

employee access to, and an opportunity to comment on, information relevant to the decision.

It found that the dismissal was unjustified because the employer had been inconsistent in not dealing with the earlier incidents more severely, had failed to conduct a full and fair inquiry into the incidents and had failed to put before Mr Sigglekow (and therefore seek his response to) all the information that was relevant to the decision.

The first test case to go to the Employment Court about the 90 Day Trial Period (*Smith v Stokes Valley Pharmacy 2009*) was also assessed against the good faith section and was found to be unjustified because the employee had not had all the relevant information put before her nor been given an opportunity to respond. Similarly, the recent judgement in *Massey University v Wrigley and Kelly*, on redundancy processes was based on the good faith provisions and the need to provide all information relevant to the decision to the employee. Clearly, the good faith requirements are still a very important part of the process and cannot be circumvented when termination is being considered, irrespective of the reason.

Snippets

Livestock Valuation Elections

Under the current legislation, it is easy to swap between the Herd Scheme and National Standard Cost (NSC) livestock valuation methods. An officials' issues paper has been released focusing on the Government's concerns about farmers having the ability to switch between the methods to derive tax-free gains when livestock values are increasing, or tax-deductible write-downs when livestock values are decreasing.

Government officials have suggested that the following changes be made:

- Once a farmer has elected to use the Herd Scheme, the election is irrevocable, or
- Livestock election timeframes be altered to reduce advantages that can be acquired by farmers under the existing election framework.

Under the first alternative, any election would survive transfers between associated persons, to remove the ability to work around the changes by using multiple entities.

Lastly, the IRD proposes that the ability to use certain valuations, when trading ceases, should also become more restrictive.

Submissions on this paper closed on 30 September 2011.

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

Eat Drink and be Merry, for Tomorrow we Pay More Tax

As the country looks forward to over-indulging at Christmas and through the summer, it is worth sparing a thought for the Danish who, from 1 October, have been forking out more to buy food with more than 2.3% saturated fat, such as dairy and meat products.

Said to be the first tax of its type in the world, the Danish Government is reported to have introduced the tax in order to reduce cardiovascular disease, obesity, and diabetes.

The tax was approved by 90% of the Danish Parliament, but consumers are not happy with the price increase to items such as butter and cheese.

The tax is charged at 16 DKK (approximately NZ$3.70) per kilogram of saturated fat on foods with more than 2.3% saturated fat. The tax will increase a pack of butter by the equivalent of about 55 cents and a burger by 20 cents. The week leading up to the increase saw consumers stocking up on food that will be subject to the tax.

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.

© 2011