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A lesson for us all

The "general permission" under the Income Tax Act broadly allows expenditure to be deductible if it is:

- incurred in deriving assessable income, or
- incurred in the course of carrying on a business for the purpose of deriving assessable income.

A recent Taxation Review Authority (TRA) case provides a strong reminder to us of the importance of ensuring there is a connection ('nexus') between the expenditure you deduct for tax purposes and your business or income earning process.



In TRA 008/13, a taxpayer entered into an agreement in 2006 to purchase a block of land for the development and sale of retail units and residential apartments. By June 2007 four deposit payments had been made totalling \$1.9m. Before settlement occurred, a number of conflicts arose between the vendor and the taxpayer.

Following several failed attempts by each party to cancel the agreement, they eventually went through a disputes resolution process where they agreed to split the deposit between them. The taxpayer also agreed to pay the vendor's costs (\$70,047). The taxpayer subsequently entered into an agreement to sell the plans for the project, including resource consent, for \$650,000; however the transaction was not completed.

The IRD sought to disallow \$1.4m of expenditure (including the lost deposit) incurred after 24 July 2008, when the taxpayer ceased negotiations to resurrect the agreement. The taxpayer disagreed with the IRD and the case went to the TRA.

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The taxpayer argued:

- the expenditure related to a business that operated until at least December 2011,
- the agreement was entered into for the purpose of purchasing the land to derive taxable income or alternatively to escape an onerous contract, therefore all expenses are deductible, or
- the business was operating in 2007 (the IRD agreed) and the lost deposit was deductible because it was paid at that time.

The TRA decided in the IRD's favour, concluding that from July 2008 onwards the taxpayer's focus changed from advancing the settlement of the purchase, to pulling out of the Agreement. From this point the taxpayer ceased being in business, and there was no nexus between the taxpayer's business and the expenditure.

The TRA also broadly concluded that in order to deduct expenditure to derive income, income must be derived and here there was none. It was further stated that the taxpayer intended to acquire and sell full legal title to the land. However, the taxpayer only acquired an equitable interest in the land. The implication being that the taxpayer's intention when

the due diligence clause was fulfilled was not to sell an equitable interest, therefore there was no requisite intention of resale in respect of the interest that was acquired.

The TRA took the view that the settlement amount was paid from the deposit monies held by the taxpayers' lawyer as a stakeholder; it was not payment of the deposit.

The IRD not only denied the deductions, but also charged a \$39,194 shortfall penalty for taking an unacceptable tax position.

Decisions like this are unsettling because at face value, it would seem reasonable to claim a deduction for the expenditure. Especially given, if income had been derived, the expenditure is likely to have been deductible.

The lesson here is to think carefully about situations that may be outside 'the norm'. Even if intuitively an expense appears deductible, it may not be. In these situations, a quick phone call to your advisor would be a good idea.

Valuing diversity

There is a convincing argument that diversity within an organisation leads to better decision-making, innovation and business performance. For many entities, diversity has become a business imperative critical to the success of their strategic goals. As New Zealand's demographic continues to change, business leaders must embrace diversity and recognise its benefits by understanding how it affects their relationships and ability to perform in the market.

Diversity refers to the variety of differences between people within an organisation and encompasses race, religion, language, age, personality, cognitive style, education, background and more. Each year our demographic becomes more diverse and more multicultural, which impacts the workforce and our customers. Effectively managing this change is key to an organisation's ability to adapt and thrive.

Benefits of diversity

By bringing a team of diverse people together, an entity can strengthen its ability to respond to changing conditions, and improve its ability to anticipate and meet customer needs and expectations.



Diversity can lead to new and interesting ideas. Employees who feel comfortable communicating their different viewpoints can help add to the pool of ideas contributing to strategic needs.

Workplace diversity can also increase an entity's range of services and customer network. The diverse skills and experiences brought out by different employees (such as languages and cultural understanding) can allow a company to provide services to previously untapped customer segments and markets.

So what can your business do to increase diversity?

Start by creating an attitude of openness in your organisation. Encourage employees to share their ideas and opinions and provide a sense of equal value to all. This awareness will help drive change.

In order to maximise the competitive advantage of becoming more diverse, you must identify what your business needs are. Reflect on how the competitive and customer landscape has changed over the past three to five years and consider what things might look like in the future. For example, has there been a change in the mix of your

employees and your customer base and the communities that you serve? Do your employees reflect the demographic that you serve or want to serve? If not, develop a hiring strategy to increase workforce diversity.

At the same time, provide diversity training in your workplace to ensure that all employees understand hiring decisions are based on finding the best candidate to match the needs of the business and not political correctness. Transparency is important to keep employees minds at ease. Managers also need to understand the benefits of a diverse

workplace as they will be involved in implementing the policies.

Aim to promote and bring diversity into the leadership positions of your organisation. This will create visibility and enable the benefits to be realised.

And finally, to get the best out of your employees they need to feel able to bring the whole of themselves to work. Create a culture that values and respects differences. Encourage staff to be themselves, to be different.

Attribution of personal services income

Many people aren't aware that specific tax rules exist that can deem income derived by a company or trust to be derived by them personally. The rules were first introduced when the 39% tax rate was introduced to stop people getting a tax advantage by trading through a company or trust to access the lower 33% tax rate. Although the top personal marginal tax rate has been reduced to 33%, the company rate is lower at 28%, and hence the rules are still active and need to be kept in mind.

Income is attributed when:

- 80% or more of the entity's income from personal services is derived from services personally performed by an associated person or a relative;
- 80% or more of the entity's income from personal services is derived from the sale of services to a customer or a person associated with the customer;
- the person's net income for the income year exceeds \$70,000, including any amounts available for attribution; and
- substantial business assets (as defined below) are not a necessary part of the business structure used to derive the entity's assessable income.

"Substantial business assets" are depreciable property that cost more than \$75,000 or, make up at least 25% of the associated entity's total assessable income from services for the income year and are not for private use.

When a person first sets up business, it may be that the rules don't apply. But experience has shown that circumstances change over time and those changes can mean someone drops into the ambit

of the rules, without realising it. For example, Jenny and Harry are a brother and sister team that went into business together. Jenny is an interior designer and Harry is an architect. They are employed by a company in which they each own 50% of the shares. The Company receives income from the services they perform.

Jenny decides she wants a change of scenery and sells up and moves to New York to become an actress. Harry buys Jenny's 50% share in the Company.



Harry subsequently wins a large contract with Fletcher Construction that provides more than 80% of the company's income for the following six months and the contract is later extended.

In this scenario, the income derived by the company from personal services performed by Harry is likely to be subject to the 'attribution rules'. Under the attribution rules, the net personal services income derived by the Company will be attributed to Harry. If net income of \$180,000 were attributed directly to Harry and subject to tax at the top marginal tax rate (33% as opposed to the 28% company tax rate), additional tax of \$9,000 would be payable.

The IRD's intention is to ensure that taxpayers like Harry cannot avoid the highest personal tax rate (currently 33%). Increasingly more resources are being put into this area to ensure taxpayers are returning the appropriate amount of tax, so if you think the attribution rules may apply to you, please seek professional advice.

IRD Releases

The IRD appears to have been busy before the holidays, with a number of documents released in the lead up to, and after Christmas. A summary of the documents that have been released is provided below.

PUB0214 - Scholarships and Bursaries

Income tax law exempts certain scholarships and bursaries from income tax. The IRD has released a draft interpretation statement that sets out how this law should be interpreted and applied. In particular, the statement sets out the requirements that must be met in order for the payments to be exempt from tax.

Of relevance in a business context, the IRD sets out its view as to whether payments provided to staff to study, qualify as true bursary payments or as taxable employment remuneration. In determining the tax treatment of a payment its true character must be established by looking at the agreement that gives rise to the payment and the surrounding circumstances, including the relationship between the payer and payee, the basis for the payment and what the payee is required to provide in return for the payment.

Disposal of land that is part of an undertaking or scheme involving development or division

The IRD has released a draft 'Questions We've Been Asked' document (QWB0040) regarding whether or not land retained after a taxable subdivision is completed, is also taxable when it is later sold. This topic is somewhat of an 'old chestnut', the issue being whether the area retained is taxable when it is later sold under the same provision as the land sold as part of the subdivision. The IRD conclude that it may be possible for the later sale of the retained land to be non-taxable.

Snippets

International measures to prevent tax evasion

When some individuals move overseas they stop fulfilling their NZ tax obligations (e.g. student loans and child support).

In 2012 NZ signed up to The Convention on Mutual Administrative Assistance in Tax Matters, however it only came into effect for NZ from 1 January 2015. As a result of the agreement, the IRD's ability to find and pursue tax evasion and tax debts internationally has been strengthened.

0110	Frankfurt	QF 5	C24	
2320	London-Heathw	BA 16	C18	Gate Closed
2325	Tokyo-Narita	NH 902	D35	Gate Closed
2325	London-Heathw	QF 9	C13	Gate Closing
2330	Paris-CDG	DL 8377	C22	Gate Closed
2330	Tokyo-Narita	AA 5832	D44	Gate Closed
2355	Osaka/Kansai	JL 722	D40	Gate Closing
0130	London-Heathw	QF 31	C26	
0015	Beijing	CA 970	D30	Boarding
0050	Moscow-Domod	UN 516	C23	Gate Open

Gates close 10 mins before departure No boarding calls will be made 01 Mar 2016, 23:04

The draft QWBA is an update to an earlier version, the ultimate outcome has not changed. However, the IRD has amended its view to provide that taxpayers need to be able to "provide satisfactory evidence" that the subdivision was not completed with a view to disposing of the retained land. Given land sales are a focus of the IRD's Investigations Unit, this requirement needs to be taken into account when completing a subdivision that is partly taxable.

Changing to a different depreciation rate

After the change in depreciation rate for buildings to 0% from the 2011-2012 income year, many taxpayers asked whether they could review their fixed asset registers to split the value of a building into its component parts and depreciate those parts at their respective rates.

Due to the uncertainty around whether changes could be made to depreciation rates, the IRD has released a draft QWBA (QWB0131) document. The QWBA sets out the limited circumstances when the depreciation rate for an item of depreciable property can be changed. Generally, such changes may be permitted where:

- there is a change in legislation that affects the applicable depreciation rate;
- the Commissioner sets a new depreciation rate for an item;
- the taxpayer changes from using a special rate to using the economic or provisional rate that applies to their item;
- the taxpayer has been using an incorrect depreciation rate; or
- the depreciation rate is no longer applicable due to a change in circumstances.

The Agreement provides for administrative assistance in the assessment and collection of taxes between tax authorities who have signed up to the Convention (currently 84 countries). The IRD can now seek assistance from other tax authorities also signed up to the convention.

This reinforces the need for people to be aware of and meet their tax obligations irrespective of where they happen to move to.

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