NEWSLETTER

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INSIDE THIS EDITION

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Staff News

Following Helen's retirement in May, we are pleased to advise that **Rebecca O'Brien** and **Kristina Kulvis** have joined the firm.

On the debit side, we are losing **Cassandra** who is moving to Brisbane with her fiancé, Harvey, who takes on a Veterinary surgical contract for a year. We are pleased for Cassandra as she will benefit from the experience overseas in a different business and living environment. She, and we, are hoping she can return to the firm in a year's time. We have been fortunate to have had Cassandra with us as she was a Massey University Excellence Scholar and has been a valued staff member these last four years. We do wish her all the best.

On the credit side, **Rebecca** is an experienced Accountant returning to a permanent role in public practice accounting now that her two boys are getting older. She has a BCA and Graduate Diploma in Professional Accounting from Victoria University and hails originally from Upper Hutt. Rebecca is married to David and they are owners in See Hear, a Levin based vision and hearing business. Rebecca works with us Monday to Thursday.

Kristina has joined us as a Graduate Accountant having recently completed a Bachelor of Applied Management. She has worked at PKF Rutherfords in Palmerston North and has family ties in Levin having attended Horowhenua College. Kristina is Lithuanian by birth and is bilingual having emigrated to New Zealand as a child.

Both Rebecca and Kristina are certified Xero Advisors and are available to assist with any accounting software queries with Xero, MYOB or other platforms that you may be using or wish to know more about. They will be taking on client responsibilities of both Helen and Cassandra, and we hope to introduce them to you throughout the year.

Other important news is that **Aleashia** is expecting her second baby and she will be going on maternity leave at the end of August. We are lucky that **Sara Bryers** is able to work for us to cover Aleashia whilst juggling family and study at Massey University. Sara has covered for us before and you may know her well already. She will be in contact with a number of you for payroll in particular.

We wish Aleashia and her husband Matt well for the safe arrival of their new baby.

Ring-fencing rental losses

Labour's pre-election manifesto proposed to increase the fairness of the tax system and improve housing affordability. In the six months since the Labour-led coalition entered Parliament, we have started to see some changes filtering through. As part of the proposals aimed at house prices, Inland Revenue has recently released an Issues Paper proposing to ring-fence rental losses, with draft legislation likely to follow once Inland Revenue has considered public responses. So how would the rules work?

People derive income from multiple sources, such as salary / wages, business income, interest, dividends and rental income. It is a fundamental feature of NZ's tax system that a person is taxed on their total income from all sources, whether a profit or loss.

This aggregation allows losses incurred from rental properties to be offset against other income, reducing a taxpayer's total income and corresponding tax liability. The Government's concern is that this mechanism allows property investors to take on high levels of debt to finance their property investments, giving rise to tax losses, effectively subsidising the rental portfolio through a reduced tax liability. The high-gearing offers an advantage compared to owner-occupiers because their interest cost is not tax deductible.

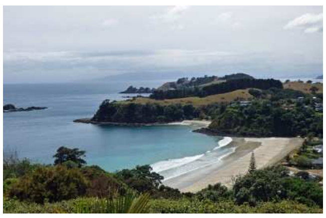
The proposed ring-fencing rules contained within the Issues Paper will eliminate this advantage by preventing rental losses from being offset against other income. Instead, rental losses will be 'ring-fenced' and offset against future rental income, or any tax incurred on the future sale of the property.

Labour originally indicated losses might be ring-fenced by individual property. Thankfully, the proposed 'portfolio approach' is more logical, enabling investors to pool their profits and losses from all residential properties, including overseas properties. If enacted, the rules will apply to all rental properties irrespective of how they are held, i.e. the rules will apply to individuals, companies and trusts. The proposed rules also use the existing definition of 'residential land'. Thus, the rules will not apply to commercial property or property subject to the mixed-use asset rules.

There is complexity in the new rules because they can impact people that don't hold rental properties. For example, if a person has borrowed to purchase shares in a company and that company uses the funds to purchase a rental property, the interest incurred by the shareholder is normally tax deductible. In this situation, if 50% or more of the company's asset value is derived from residential properties the company will be classified as "residential property land-rich". Amounts paid to the shareholder (e.g. dividends) will be classified as "rental property income" and their interest expense will be classified as "rental property loan interest". The rental interest can only be deducted against "rental property income" derived from the company, or the individual's other rental properties, with any excess loss ring-fenced to the person.

The application of the proposed 50% asset test is currently unclear – the issues paper does not indicate whether it will be based on market value or historical cost. This will undoubtedly be addressed during the consultation period. If enacted, the proposed rules may be phased in from the start of the 2019 – 2020 income year. This will allow investors time to adjust to the new rules and provide the opportunity for taxpayers to rearrange their affairs before the rules are adopted in full.

Bright-line breach warning



The bright-line test came into force from October 2015, introducing rules that a profit derived on the sale of a residential property is subject to tax if sold within two years of purchase, albeit subject to some exceptions such as the family home. These rules have recently been revised to extend the bright-line period from two years to five.

Whilst the bright-line provisions appear relatively straightforward, there are some intricacies to the rules, so it is advisable to seek professional advice before selling a residential property. A recent High Court decision highlighted the potential consequences of failing to seek sufficient advice.

The case involved a woman, who personally owned a property on Waiheke Island for a number of years, before selling it to her family trust for $2.85m on 31 March 2016, 6 months after the introduction of the bright-line test. The following year, the Trust sold the property to a third party for just over $5m.

Although the woman had owned the property for several years, the trust is a separate taxpayer for the purpose of the bright-line provision, hence the profit derived on sale of the property was taxable. However, the Trustees did not return the sale in their tax return and IRD later assessed them for income tax, resulting in a tax liability of approximately $775,000.

Displeased with this outcome, the Trustees applied for a summary judgement against their accountants, seeking $785,696.09, claiming that if they had known a tax liability would be incurred, they would not have entered into an agreement to sell the property. Since 2013, the Trust had received regular accounting services and tax advice from their accountant. However, the Trust had engaged a lawyer specifically in relation to the sale of the Waiheke property. The lawyer raised the concern with the Trustees that any gain on sale would be subject to income tax under the bright-line test. Hence, the Trustees should have been aware of the tax position.

However, the Trustees alleged that they also sought their accountant's "thoughts" on the proposed sale, and the accountant did not raise any concern that a tax liability would be incurred. In the absence of any concern, the Trust went ahead with the sale.

In court, the accounting firm argued that the Trust had not sought specific tax advice regarding the sale of the property. It was also asserted that the Trust had already received advice from their lawyer advising them that the sale would be captured under the bright-line test. The judge ultimately dismissed the Trustees summary judgement application on the grounds that the Trust was unable to establish beyond reasonable argument that there was a formal request for advice.

The case acts as a timely reminder that when seeking advice, the scope of services should be clearly agreed between you and your lawyer or accountant, so there is no doubt on either side.

Reimbursing allowances

On 3 April, Inland Revenue issued a draft 'Questions we've been asked' (QWBA) covering the tax treatment of allowances and benefits paid or provided to farm workers. A key principle covering such payments centres on the tax treatment of 'reimbursing allowances' – this is relevant not just to farm workers but all employees.

Reimbursing allowances are paid to employees for expenses incurred, or likely to be incurred, in connection with their employment, e.g., vehicle mileage and tools. Section CW 17 of the Income Tax Act contains the requirements that must be met for such payments to be received tax-free and one of the key tests is that the expense incurred must be a 'necessary expense' incurred in performing the employment duties.

Furthermore, if employees were allowed to deduct expenses incurred to derive salary or wages, the expense would need to qualify as tax deductible. For example, if an employee was instead self-employed and the expense was tax deductible because it was incurred to derive their self-employed income, the test would be met.

A self-employed person can't deduct the cost of a motor vehicle used to derive income because the expense would be capital in nature. Therefore, an employee cannot be paid a tax free reimbursement for the cost of their vehicle. However, vehicle running costs would be tax deductible to a self-employed person, and therefore an employee can be paid a tax-free amount to cover such costs.

The draft QWBA also includes an example of depreciable farm machinery used both in the farm business and privately. In this scenario, an apportionment of the reimbursement would be required, with the business portion of the reimbursement being tax-free, whilst the private portion would be taxable to the employee and subject to PAYE.

In addition to reimbursing specific expenses, allowances can be paid tax free based on a reasonable estimate of the expenditure. The estimation should have some reasonable basis, such as historical data, industry standard, or employee survey information. The employer must also keep sufficient information about the calculation method, and review the amount periodically to ensure the estimate remains reasonable.

Reimbursing allowances can sometimes be paid tax-free to independent contractors, for example where they receive scheduler payments. This is based on the assumption that the contractor would generally be able to deduct the expenses to which the allowance relates.

However, this raises the issue of whether the contractor is entitled to deduct the expenses as well as receive a tax-free reimbursement, effectively creating a 'double deduction'. The draft QWBA clarifies that this is not the case; if the allowance is treated as exempt income, the contractor is denied a deduction for the attributable expense.

The tax treatment of reimbursing allowances is a 'standard' area of focus by Inland Revenue when reviewing a taxpayer's affairs, hence it is worthwhile checking to make sure they are being treated correctly.

AML/CFT Compliance – Coming Our Way 1 October 2018

You have possibly faced increasing identity verification questions from Banks and other financial institutions in recent years. This is the result of the Anti-Money Laundering and Counter Financing of Terrorism (AML/CFT) Act which has now been extended to accounting practices and other professional groups that provide services captured under the Act.

The intent of the law which New Zealand signed up to internationally several years ago (affecting our Banks initially) is to identify people that may be laundering proceeds of crime and/or financing terrorism.

From 1 October 2018, we are required to comply with this new law which will affect us in a number of different ways, including performing customer due diligence on a number of our clients and being required to report certain suspicious activity should it arise. Our compliance obligations include needing to submit annual reports to the Department of Internal Affairs and be audited as a firm on our documented procedures by an independent auditor.

We stress that this new law will not affect most of you, but inevitably there will be some impact to some of you. Do not be concerned as there is nothing you have to do especially, but please bear with us at times when we need to ask for certain identity information or query you on transactions that may need consideration.

For some clients where we manage your funds and/or operate your bank accounts on your instructions e.g. payroll disbursements to your staff, there likely will need to be some change in our current procedures and management relationship. Essentially it will become much more onerous because of the AML/CFT law for us to operate in the way that we have.

We will be in touch directly with any clients affected, but kindly ask in advance for your cooperation in any changes necessary that stem from the new legal requirements that have been put on us.

This new legislation will affect us going forward and will add additional time and cost to our daily work but we will aim to manage our legal requirements as efficiently as possible.

Snippets

Cryptocurrency and tax

Over the last decade, the use of digital or virtual currencies, known as "cryptocurrencies", has

grown dramatically in popularity. A single piece of Bitcoin is currently valued at over $9,000 NZD. Some New Zealand retailers have already begun accepting Bitcoin as a form of payment, which has led to the Inland Revenue releasing a 'Questions & answers' considering the tax treatment of cryptocurrency.

For tax purposes, cryptocurrency is treated as property, which means that foreign currency gain or loss provisions do not apply. However, if a New Zealand business accepts cryptocurrency as a form of payment, the amount is treated as taxable business income based on the value of the cryptocurrency at the time it is received.

Any gain on sale of cryptocurrency is assessed by considering the original purpose for acquiring the currency. If the currency was acquired with the purpose of disposal, any proceeds made from selling the currency are taxable. IRD consider the nature of cryptocurrency means it is unlikely that a person would acquire it without the intention to sell or exchange it, meaning the majority of gains made on disposals would give rise to a tax liability.

If you invest or trade in cryptocurrencies, be sure to keep an eye out for further developments from Inland Revenue, as they intend to refine its tax treatment as more information becomes available.

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