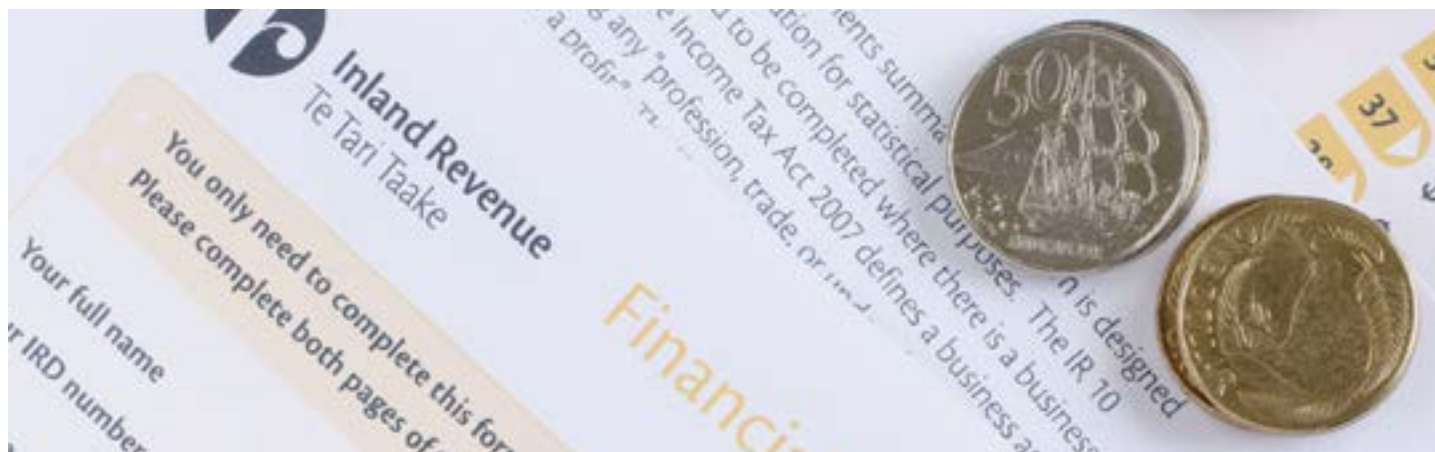


TAX TODAY



TAX DEPRECIATION – MAKE SURE YOU CLAIM THE CORRECT AMOUNT

Recently the IRD issued an exposure draft which discusses the circumstances under which a taxpayer may change the depreciation rate adopted for an item of depreciable property.

The IRD has confirmed that the depreciation rate can change under limited circumstances. Specifically, a rate change is permitted where:

- ▶ There is a change in legislation that means a different rate applies to the item;
- ▶ The taxpayer changes from using a special rate to using the economic or provisional rate that applies to the item;
- ▶ A new rate is set by the IRD;
- ▶ The taxpayer has been using an incorrect rate;
- ▶ The rate is no longer applicable due to a change in circumstances.

The obvious circumstance to note is the change to depreciation rates for buildings from the 2011/12 income year. From 1 April 2011 (for taxpayers with standard balance dates), broadly, the rate of depreciation for buildings with an estimated useful life in excess of 50 years fell to 0%.

While effectively this meant no depreciation on most buildings from that date, the buildings retain their status as depreciable property. This is no mistake, as the IRD will still have an eye on potential depreciation recovery income (i.e. a claw back of historical depreciation previously claimed) on a subsequent sale of the building.

In our experience, when it comes to buildings, we are still encountering situations where the taxpayer has incorrectly identified the item of depreciable property and is using the wrong rate. In particular:

- ▶ The building continues to be depreciated at the old rate (generally being 2% per annum); or
- ▶ The taxpayer has failed to classify the building as one which is deemed to have a useful life of less than 50 years and can therefore continue to be depreciated at the relevant prescribed rate.

There are mechanisms available for the taxpayer to voluntarily disclose and for the IRD to amend previous positions that are incorrect.

IN THIS ISSUE

- ▶ Tax depreciation - make sure you claim the correct amount
- ▶ Tax avoidance scenarios
- ▶ Year-end tax reminders 2015
- ▶ When is a trust beneficiary a settlor of the trust
- ▶ IRD's compliance focus in 2015 - what to watch for
- ▶ Liquidations - are we there yet?

While the rate adopted is of importance (and is the focus of the exposure draft), other areas of concern for the IRD include:

- ▶ Use of the 20% loading rate (which was removed for assets acquired after 20 May 2010);
- ▶ Assets that no longer exist (i.e. the asset has been sold, scrapped, stolen or lost);
- ▶ Incorrect classification (while it is often said that depreciation is only a timing difference, claiming at a higher rate and accelerating deductions can result in penalties and interest being payable);
- ▶ Either not claiming or incorrectly applying the \$500 concessionary treatment for low value assets.

Please contact your usual BDO tax adviser if you would like any assistance checking your tax fixed asset register to identify whether you are maximising the available deductions and minimising the risk of over claiming deductions (which could give rise to penalties and interest).



TAX AVOIDANCE SCENARIOS

The IRD recently finalised an important document: Questions We've Been Asked on avoidance: QB 14/11: Income Tax - Scenarios on Tax Avoidance. We have previously outlined the key aspects of the draft QWBA issued on 23 May 2014 in our July 2014 edition of Tax Today.

As previously mentioned, the draft QWBA considered whether a tax avoidance arrangement would arise in four situations:

- ▶ Scenario 1: Interest deductions where shareholder loans are replaced with external debt
- ▶ Scenario 2: Look-through company elections
- ▶ Scenario 3: Substituting debentures, and
- ▶ Scenario 4: Debt capitalisation

The most obvious change from the draft QWBA is that the fourth scenario in respect of the debt capitalisation of an insolvent company has been omitted from the final QWBA. This scenario was widely debated (evidenced by the number of submissions made) when the draft QWBA was issued. The IRD has stated that it will further consider the submissions in respect of this particular scenario. A legislative change has also been signalled that would address this issue (at least in respect of two resident group companies). We are expecting a discussion document to address this issue sometime this year. Taxpayers should use caution when considering any debt capitalisation until further guidance is released.

The IRD's position in respect of the substituting debenture example and whether that constitutes tax avoidance has been changed. The IRD's original view was that the tax avoidance provision would potentially apply if a company issues convertible debt

to shareholders. The IRD's draft conclusion provided that in order for the use of substituting debentures to not constitute tax avoidance, Parliament would expect to see either:

- ▶ debentures that as a matter of commercial and economic reality have not been issued to shareholders in proportion to their shareholdings; or
- ▶ convertible debentures that have some prospect of changing the effective ownership of the company on a conversion.

The first expectation has not changed from the draft QWBA but the second has been amended. The second expectation in the final QWBA is that Parliament would expect to see debentures that are genuinely convertible notes.

There is no longer a requirement for the convertible debt to change the effective ownership of the company upon conversion. An arrangement will not be tax avoidance provided the debentures issued are genuine convertible debt with a realistic prospect of being converted to some practical effect. The effects on conversion that the IRD identified include solvency and cash flow benefits achieved without having recourse to shareholders as well as the likely impact on shareholders' priority on liquidation as against third-party creditors.

The changes between the draft QWBA and the final version illustrate the complexities associated with identifying tax avoidance. However, it is positive that the IRD has provided some insight into the types of arrangements that it would be concerned with.

We also note that at the recent CAANZ Tax Conference (held in Auckland in October 2014) three different tax avoidance scenarios were discussed. These covered the following common arrangements:

- ▶ discretionary distributions from a complying trust;
- ▶ the use of a limited partnership to allow one partner to utilise losses; and
- ▶ borrowing to invest in a PIE.

The IRD is open to the possibility of releasing another QWBA to address these scenarios in 2015. In our view this would be a further positive step in assisting taxpayers to navigate the "murky waters of tax avoidance".



YEAR-END TAX REMINDERS 2015

With the tax year end fast approaching for most taxpayers, there are a number of steps that you can take prior to balance date that can assist in maximizing tax efficiency. [Click here to identify some of these steps together with important tax reminders.](#)



WHEN IS A TRUST BENEFICIARY A SETTLOR OF THE TRUST

Tax law as it applies to trusts is complex and readily misunderstood. The taxation of a trust is driven by the tax residence of the "settlor". It is therefore important to be able to establish who the settlor (or settlors) is.

The settlor is not necessarily the name of the person on the trust deed. For tax purposes a settlor is widely defined and includes anyone who transfers value to the trust or provides certain financial assistance to the trust.

One common scenario that raises the 'financial assistance' question is where a trust makes a distribution to a beneficiary, and instead of being paid out in cash the distribution is simply credited to the beneficiary's current account. The question here is whether the beneficiary has provided financial assistance to the trust

and, if so, does this result in the beneficiary being considered a settlor of the trust for tax purposes?

The IRD has released an exposure draft which seeks to clarify this point. The IRD's view is that a beneficiary will be classed as a settlor of a trust where:

- ▶ The trust pays or vests an amount to the beneficiary;
- ▶ The amount is not physically transferred to the beneficiary; and
- ▶ The beneficiary loans the amount to the trust either for: no interest; at an interest rate below market; interest is payable on demand and no demand is ever made; or demand is deferred for so long that the loan is uncommercial.

The crux of the matter is that identifying the settlor(s) of a trust is crucial for New Zealand tax purposes. For example, as mentioned above, the tax residence of a settlor can drive the New Zealand tax classification and treatment of the trust. It is also important to note that identifying the settlor(s) of a trust can be very important when considering other areas such as the Working For Families tax credit provisions and specific land taxing provisions.

Please contact your local BDO tax adviser should you require any assistance.



IRD'S COMPLIANCE FOCUS IN 2015 - WHAT TO WATCH FOR

The IRD's 2014/2015 Compliance Focus provides an insight into its thinking and signals the particular industries and types of transactions that the IRD is concerned about. Some of the focus points are detailed below.

FOCUS AREA	OUR COMMENTS
INTERNATIONAL TAX (TRANSFER PRICING)	We have seen an increasing number of clients being asked questions by the IRD in respect of their approach to transfer pricing. We recommend that all taxpayers who transact with associates in foreign jurisdictions ensure that they have appropriate documentation in place to support the charges for goods and services provided to and received from their overseas associates.
AGGRESSIVE TAX PLANNING	<p>This remains high on the IRD's list of priorities. Tax driven transactions will continue to be under scrutiny. It is important when considering transactions that you first establish the commercial rationale and document this.</p> <p>The IRD's recently finalised QWBA on tax avoidance further indicates that this area is of high importance.</p>
INDIVIDUALS USING BUSINESS / INCOME EARNING ASSETS PRIVATELY	With the recent changes to the mixed use asset rules, this area will become a major focus to ensure that taxpayers are claiming the correct amount of deductions.
PROPERTY BUSINESSES	<p>We often hear in the market place the following comments in respect of land transactions:</p> <ol style="list-style-type: none"> 1. There is no capital gains tax in New Zealand; 2. You can sell a couple of properties a year without being subject to income tax; 3. Residential houses are not subject to the land taxing provisions. <p>New Zealand does not have a capital gains tax. However, this does not mean that all gains arising from property sales will not be subject to tax. The income tax legislation contains a number of provisions that apply to property transactions.</p> <p>If you're a property owner and you or an associated person (e.g. a company) carry on a property related business, gains may be treated as income for income tax purposes (depending on the length of time the property is held).</p> <p>In addition, if a property is acquired with a purpose or intention of disposal then any gain may also be taxable.</p> <p>With regards to the second point, there is no de minimis exception in terms of the number of transactions that would not constitute a business. It is important to note that when the IRD challenges that a taxpayer is carrying on a business activity or has acquired a property with a purpose or intention of disposal, it will have the benefit of hindsight (i.e. evidence of how long the property was held for prior to sale, what other properties have been acquired etc).</p> <p>In respect of the third point, there is an exclusion for properties occupied as a place of residence by the taxpayer. However, if the taxpayer has a pattern of buying and selling their personal residence the exclusion cannot be relied upon.</p>

Continued on next page

FOCUS AREA	OUR COMMENTS
TRUSTS	<p>The IRD has stated it is concerned when trusts are used in a way that does not make commercial sense. The IRD is also interested in arrangements involving trusts that deliver unusually favourable tax advantages.</p> <p>We suspect that this is in part a reference to the IRD's Revenue Alert following the Penny & Hooper decision.</p>
THE CHARITIES SECTOR	<p>The IRD continues to monitor the potential misuse of charities whereby taxpayers pay less tax than what they should. The focus is also on taxpayers who claim tax credits for payments that are in fact not donations. For example, the IRD recently issued an alert on payments to private education centres or for child care – refer: http://www.ird.govt.nz/technical-tax/revenue-alerts/revenue-alert-ra1401.html</p> <p>We note that a donation tax credit is available in respect of monetary donations only.</p>
TIMELY PAYMENTS	<p>The IRD has recently changed its position in terms of when payment must be received in order to avoid penalties and interest.</p> <p>From 1 October 2014, cheques sent by post must be received by the IRD on or before the due date (i.e., the postal rule no longer applies). If you are hand-delivering a cheque, this must be delivered to an IRD office on or before the due date.</p> <p>Electronic payments need to be paid into the IRD's bank account on or before the due date. Online payments need to be made prior to the end of a particular bank's online business hours in order to be processed and recorded as received on that specific day. Check with your bank if you are unsure about its online business hours.</p> <p>Payments by cash or by Eftpos can be made at most branches of Westpac. Payments can only be made over the counter and the payment is received in time if it is made by the close of business on the due date. (NOTE: While payment of tax may be made at Westpac branches, Westpac is not authorised to accept returns. Returns may be filed electronically, posted to the IRD or delivered to the IRD office)</p>

The IRD has also highlighted the areas where taxpayers continue to make errors. For businesses, this includes incorrect PAYE returns, FBT returns, late GST registration and deregistration and the failure to account for GST on the private use of business assets.

The IRD has also stated that seeking out fraud and tax avoidance continues to be a high priority in order to protect the integrity of our tax system. This is to be achieved through improved information sharing with other tax authorities and government departments. The IRD

has also reiterated that if the taxpayer has an obligation that has not been met or is unlikely to be met, their preference is for the taxpayer to contact the IRD upfront so that an appropriate way forward can be determined.

Please contact your usual BDO tax adviser if you have any questions about these areas that the IRD will be focusing on for the 2014/15 year.



LIQUIDATIONS – ARE WE THERE YET?



Solvent liquidations are often used to access capital gains from companies (providing all relevant criteria are met), as most capital gains distributed on the liquidation of a company are not treated as a dividend. We are therefore often asked the question, "When does a liquidation commence and therefore when can we get our tax-free capital gain out?"

The position has recently been confirmed in an updated Public Ruling (which really just maintains the status quo). The IRD determines that a liquidation of a company is a process that starts with the occurrence of a first step.

The first step can be:

- ▶ The appointment of a liquidator;
- ▶ Resolution by the shareholders or board of directors to liquidate the company; or
- ▶ Any other overt decision-making act provided for in a company's constitution to adopt a course of action that will end in the company's removal from the register.

In our experience, companies will often adopt a 'short-form' liquidation rather than performing the full legal process of appointing a liquidator. The position as illustrated by the IRD provides comfort that the passing of a resolution would be sufficient to commence the liquidation process. With reference to "any other overt decision-making act" we recommend evidence be held to establish the first step that was carried out with the aim of achieving liquidation.

It is worth reiterating at this point that associated person capital gains cannot be extracted tax-free on liquidation. This is a long-standing quirk in the dividend rules that can trip up an otherwise simple transaction – usually a group restructure between related parties. It is prudent to seek advice before embarking on any internal restructure to ensure that you do not crystallise a capital gain that cannot be extracted from a company without triggering a tax liability.

In terms of the process of extracting non-associated person capital gains, it's critical to get the steps performed in the right sequence, or otherwise a tax-free capital gain could become a taxable dividend in the hands of a shareholder. Talk to your BDO tax adviser if you are considering liquidating a company to extract a tax-free capital gain.

This publication has been carefully prepared, but it has been written in general terms and should be seen as broad guidance only. The publication cannot be relied upon to cover specific situations and you should not act, or refrain from acting, upon the information contained therein without obtaining specific professional advice. Please contact your local BDO member firm to discuss these matters in the context of your particular circumstances. BDO New Zealand Ltd, its partners, employees and agents do not accept or assume any liability or duty of care for any loss arising from any action taken or not taken by anyone in reliance on the information in this publication or for any decision based on it.

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