

NEWSLETTER

February/ March 2003

REVOLVING CREDIT – HIDDEN COSTS

There has been a big rise in the use of flexiloans or revolving credit. Major lenders now offer the ability to bundle business and private debt. Surplus cash can be used to reduce your interest costs, and if you can pay more than the minimum repayment in one period, the buffer built up can be drawn down later.

These products are promoted as minimising interest costs and the term of the loan. But the ability to redraw, if exercised, will negate some of the savings. And, if the facility combines business and private borrowings, the apportionment of interest can create a tax headache and in extreme cases a complete haemorrhage.

For example, a farmer has a flexiloan which permits deposits and redraws up to a set limit at any time. Deposits are made to reduce the loan balance by \$60,000. Later on the farmer draws down \$40,000 for a new boat.

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Here's the rub. The interest on the boat is not tax deductible – ouch! Tax deductibility requires a link between the money borrowed and earning taxable income. No link - no deduction.

Our farmer example was straightforward. Imagine what happens when the flexiloan goes: up for a boat, down for a dairy cheque, up for a trip to Aussie, up to buy more cows and pay provisional tax, down for a stock sale deposit. Technically each draw down must be tested for a link to the farming business. Analysing the interest is a beanie's nightmare.

To avoid the work involved in analysing the loan interest, we recommend:

- Private and business transactions are kept separate.
- Planning before paying extra off your business loan. It may be more efficient to hold surplus cash in a savings account rather than repay the business loan and have to draw again for private spending.
- Setting up two flexiloans: one for the business and the other for private transactions.

Loan interest is often a "big ticket" item for businesses. Losing part or all of the tax deduction for interest can be a big cost, and you will get pretty upset if we have to tell you some of your interest bill is not deductible.

Plan and seek advice before you start.

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RECENT TAX CASES

Get your Tax Position Right!

The High Court recently considered the relationship between losses from a loss attributing qualifying company (LAQC) and individual taxpayers. The particular LAQC had lodged a tax return showing losses attributed out to shareholders. The IRD disallowed some deductions claimed by the company. This reduced the loss in the company and therefore the loss attributable to the shareholders. The IRD considered the claiming of the deductions amounted to tax avoidance which carries a 100% penalty. The IRD imposed the penalties on both the company and the individual shareholders.

This does seem like double dipping on the IRD's part. However, the High Court upheld the decision, concluding that all taxpayers involved, i.e. the company and the shareholders, were obliged to determine the correct amount of tax payable by them. The case is a timely reminder of the importance of getting your tax position right. If you are involved in LAQC you could be facing double penalties for getting your tax position it wrong.

How Late is Too Late?

In December 2002 the Court of Appeal decided in favour of a taxpayer, Lawton. Interestingly, the case looks at the issue of stale tax assessments.

Tax law states that the IRD cannot go back and revise tax assessments upwards when the tax assessment is stale or "out of time". Generally the IRD can only increase an assessment within 4 years of the end of the income year in which the taxpayer provided the tax return (unless the IRD suspect fraud or omission).

The Lawton case considered the "out of time" question when it is the taxpayer, rather than the IRD, who wants the position reviewed. Currently a taxpayer must request an

alteration within two months of an assessment being issued.

After reading about the Inglis case, where a taxpayer succeeded in getting a deduction for 1987 share trading losses, Lawton decided to ask for some old tax assessments to be reviewed. Lawton had borrowed to trade in shares during the late 80s and early 90s and wanted a tax deduction for share trading losses and the interest cost on his borrowings.

Initially the IRD refused to reopen the tax assessments. But the court concluded that the IRD was required to exercise discretion and consider the merits of Lawton's position even though the request was "out of time". The judge reminded those involved that our tax system relies on voluntary compliance. The IRD cannot use delays in requesting reassessments to deny opportunities for review.

You may have "out of time" issues that you want reconsidered. The Lawton case could provide you with a window of opportunity to request a reassessment.

YEAR END TAX REMINDERS

For most clients the tax year end is 31 March making February/March a good time to consider your final tax position for 2003.



Bad Debts

The rules for Bad Debts are precise. You need to be in a position to prove that any bad debts were written off before balance date. We recommend that you review your debtors during the February and March statement runs and physically write off any bad debts immediately. You must have made "reasonable" steps to collect the debts before writing them off and established that the debts were really bad. The write off does not stop you from continuing to chase payment.

Stock or Work in Progress

Most businesses carry some form of Stock or Work in Progress. The tax rules usually require an adjustment for the value of stock or work in progress in your annual accounts. To support this adjustment a stocktake should be completed. Where services are involved, a summary of time records of work in progress should be provided. Please note that some industries have special rules, for example the calculations for manufacturing operations can be particularly complicated.

Taxpayers with turnover of less than \$1.3 m. in a year can use the value of their opening stock as the value of closing stock providing that their closing stock, based on a reasonable estimate, is worth less than \$5,000.

Holiday Pay/Bonuses

Holiday Pay/Bonuses paid within 63 days of 31 March 2003, i.e. by 2 June 2003, will be deductible in the 2003 income year. The holiday pay entitlement or the decision to pay the bonus must have arisen before balance date.

Fixed Assets

Review your Fixed Asset Schedule. Are there assets listed which are no longer used in your business? Until recently, unless the asset was sold or taken to the dump, taxpayers had to make a written application to the IRD to write off assets which were no longer in use. A law change now permits a write off without reference to the IRD providing you can satisfy three conditions:

- The assets are no longer in use in your business;
- You do not intend to use them in the future; and
- The cost of disposing of the property is more than its disposal value.

Tax to Pay

Many taxpayers will have Provisional Tax due in the last month of the financial year (March)

and Terminal Tax in the following month (April). If you are unable to meet either payment please contact us before the due date. We may be able to alter the level of provisional tax payable or arrange an instalment plan with the IRD. This will help to limit any penalty exposure.

Subvention Payments

Subvention payments to allow the offset of profits and losses between companies with common ownership must be made by 31 March 2003 for the preceding (2002) year.

Shareholders Salaries

Company minutes must be in place before the year end to authorise payment of remuneration to shareholders and directors. The actual dollars can be quantified after the year end, but the entry in the minute book gives the basis for the company claiming a tax deduction for the salary or directors' fee.

Qualifying Companies

Elections to enter the qualifying company or loss attributing qualifying company regime for the 2004 year need to be in place by 31 March 2003. Likewise the paperwork to go with any decision to exit these regimes for the 2003 year must be with the IRD before the end of March.

Annual Accounting Questionnaire

Review and complete your Annual Accounting Questionnaire. These questionnaires are designed to help us limit the questions we have to ask you at a later date. Once your records are gathered together, make an appointment to review them with us.

SMEs: HAVE YOUR SAY

The IRD has announced a programme of interactive consultation with small to medium sized businesses (SMEs). The aim is to better understand business needs and look at ways of simplifying the tax process and

compliance costs. The process will involve:

- Group discussions with 6 to 8 taxpayers in 15 larger centres around the country
- One-on-one visits to taxpayers in provincial and rural areas
- Telephone surveys of 2100 SME taxpayers and agents
- A website survey in which any SME taxpayer can take part

The information gathered will be used by the IRD to improve the IRD's advisory services, promote electronic communication and simplify calculating and paying tax. If you have the opportunity, please get involved and have your say.

MORE TELE TECH DEDUCTIBILITY

Mobile phones – Texting – the Internet – Jetstream – Teletext – PalmTops - Faxes. Feel like technology is taking over your world? It probably is! The challenge for us is to work out how much of the amounts you pay for these services are deductible.



Traditionally businesses operating from private homes are allowed to claim 50% of the telephone line rental and all of the business related tolls. Phone accounts need to be analysed to determine the business and private portions of the rental.

More and more services are available to home users, (e.g. Call Waiting, Call Minder, Fax Ability, and Internet Access). The question is: What proportion of the charges are deductible? And, when the charges are bundled into the telephone rental cost, how do we isolate the cost of add on services?

The IRD has not issued any updated guidelines on apportionment in the technological age. But we do know they regularly audit these expense areas. For home based businesses our recommendations are:

- Continue to claim the 50% phone line rental and business related tolls.
- Consider the facts of your situation relating to the additional services.

Did you purchase Call Waiting, Call Minder, Call Diversion, or Fax Ability solely for use in your business? If so, the additional rental and service costs should be fully deductible on the basis that there is no private use.

If you purchased these services for your private use and you are also getting a business benefit, you may be entitled to an apportionment. The apportionment basis must be fair, reasonable, and justifiable when the IRD comes to call.

- Where you have an Internet connection at home and home is also your business base, it is almost certain there will be both private and business use of the service. Again, apportionment is required. Do not arbitrarily claim all Internet costs as a business expense. Think about the extent of business and private use and decide on a reasonable apportionment.
- Mobile phones are another problem area. As with Internet usage, you will need to consider the extent to which you have made private calls. Some mobile phone package deals allow you free calls at certain times of day. If you can make all of your private calls in the free call hours, only a proportion of the package cost representing the phone rental will be non-deductible.

A substantial home office that manages a number of staff and has dedicated business lines and a part-time admin person will have grounds for a bigger deduction.

Messy! We think so. Necessary? Yes. Put together a summary setting out how you will treat each item. Work out the basis of apportionment on estimated hours of access or

actual use. Make sure you are confident you can support your decision when the IRD asks: How did you allocate these costs?

LEGISLATION CHANGES

Individual taxpayers

Individual taxpayers will not be required to file IR3 returns for the 2002-03 and subsequent years if they earn small amounts of income (less than \$200 in total) from which no tax has been withheld. Individual taxpayers may still need to obtain personal tax summaries for other reasons, e.g. interest income not correctly taxed, part year earnings.

Tax Payments over the Internet

Many banks now allow taxpayers to pay tax over the Net. Each bank has a specific cut-off time for actioning your payment instructions. If you instruct a payment to occur after the cut-off on a particular day, the transaction may be delayed. Please check your bank's cut-off time and make sure you action any Internet tax payments in time to meet the IRD's deadlines.

FBT Prescribed Interest Rate

In our last newsletter we advised that the FBT rate for low-interest, employment related loans had increased to 7.98% with effect from 1 October 2002. The IRD had a rethink after that announcement and in mid-November announced that the FBT rate would be 7.83% from 1 October 2002. Set out below are FBT rates for the 2002-03 year:

1 April 2002	6.70%
1 July 2002	7.50%
1 Oct 2002	7.83%

Holiday Pay

As a general rule, a business can only claim a tax deduction for wage-related provisions when payment is actually made to the employees. This occurs when the provision, e.g.

holiday pay, sick pay, or annual leave, is used up.

When businesses change hands the parties involved will agree the basis on which employees transfer. Frequently the new business owner will agree to meet the cost of any leave provisions transferred across. And, the sale price will reflect the liability which the new owner is picking up.

In 2000 the Privy Council considered the NZ Forest Research Institute case. The question was: Who had the right to a tax deduction for transferred employee provisions? The Privy Council decision caused an anomaly - sometimes neither side got a tax deduction.

A recent legislation change will fix the uncertainty surrounding the tax treatment of wage-related provisions. For arm's-length sales, where the purchaser takes over the responsibility for the provisions, the vendor will be allowed a deduction. The purchaser cannot also take a deduction, i.e. no double dipping. If the purchaser finds that the actual leave costs are more than the provision transferred under the agreement, a tax adjustment can be made for the increased cost.

Special rules apply to the sale of businesses between associated persons. Generally the deduction for the leave provisions is available when the purchaser pays out the leave. There is no deduction for the vendor.

If you are involved in pricing the purchase or sale of a business, make sure that you have considered the tax effect of these provisions when doing your sums. And, if you are the new employer you will need to carefully track the draw down of leave and ensure that a tax deduction is only claimed for leave entitlements earned post-acquisition.

Please call us if we can help with your decision to buy or sell a business and the tax treatment.

ASB ECONOMIC UPDATE

A Mean Reversion

Last year the worry was the global economy and terrorism. This year the worry is the global economy and terrorism. And now war. Things have changed but not necessarily for the better.

The global economic issue is that, in spite of efforts by central banks to re-invigorate economies, the global growth pattern is faltering. Growth rates were low in the last quarter of 2002. There is little sign yet – albeit early days – that things have improved since. It is possible that global central banks will have to ease interest rates again to stimulate growth.

New Zealand has – so far – weathered the global storm quite well, aided by a low NZ dollar and high immigration, but it is getting harder to maintain this immunity to world events. The sharply higher dollar has caused export incomes to decline, dampening the recent strong domestic spending spree. A slight decline to the migrant inflow will also remove the impetus this has provided to the housing market. Housing activity may not fall away but achieving higher levels with slower population growth is a big ask.

For some time we have known that these two stimuli would wane, but it was hoped that global demand would take up the slack. This may still happen but seems less likely. More local investment would be an ideal way to pick up the slack, especially with capacity reportedly tight. However, investment requires confidence and that is one factor that is lacking at present in our local economy.

In sum, it is getting less likely that the New Zealand economy can repeat the 4% growth rate of 2002. A much more mundane 2½%-3% looks likely.