

NEWSLETTER

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Preparing your business for sale: There's no time like the present!

It has been widely publicised that a significant number of businesses may swamp the market in the coming years as baby-boomers look to sell their businesses. This increased supply is likely to make selling your business more difficult than it may have been in the past. Perhaps more than ever before it will be important that businesses are well presented for sale.



The following are four practical suggestions to enable you to start preparing your business for sale in today's environment.

Prepare a formal succession plan - before you can determine what sort of preparation or 'grooming' your business requires it is important to clearly establish your succession plan and exit strategy. If your succession plan involves a progressive sell-down to key employees then an important consideration might be to establish a strong shareholders agreement. By contrast, if your exit plan involves a complete sale then a shareholders agreement may be unnecessary. A formal succession planning document should include:

- your goals and objectives
- intended exit strategy (include a 'Plan B')
- indicative timeframes – this will enable you to tailor and plan your sale preparation initiatives accordingly

Obtain a valuation - a valuation of your business at this stage might seem premature, however, a formal business valuation prepared by a credible

valuer will likely form a key part of your succession plan. Amongst other things, a business valuation will:

- enable you to assess whether your lifestyle goals and objectives will be met by the sale of your business, and
- identify the key drivers of value in your business which will provide an important focus for your business grooming initiatives and identify areas where you can improve value.

Business valuation is a specialist area. It is important to ensure that the valuer you choose has the appropriate expertise and experience.

Document key business processes - any potential purchaser will consider the ongoing assistance they are likely to require from you as vendor to operate the business going forward. Well documented business processes will minimise the required 'handover period' and will also maximise the conversion of 'personal goodwill' to 'business goodwill'. As a bonus, well documented business processes will also aid the induction and training of new employees.

Clean up the financials - one of the most important sets of documents upon which a potential purchaser will base their decision is your business's financial statements. Not only might these determine whether or not a sale takes place at all, but they will also have a significant bearing on the value you are likely to realise. It is essential therefore to ensure that your business's financial statements are as 'clean' as possible, which will include:

- ensuring any personal expenditure is not included within the Company's accounts
- paying 'fair market' salaries to shareholders and family members, and
- paying 'fair market' rents for premises owned by associated persons.

The process of preparing a business for sale is unfortunately something most business owners do not consider until it is far too late. By the time your business is placed for sale there are a limited number options for improving its value. By contrast, good planning and preparation now will ensure you extract maximum value when you decide it is time to exit.

IRD – One step forward, two steps back

Firms re-arranging their business structure to fit within a specific tax provision, to reduce their tax liabilities, has always been an issue for the IRD. For example, when the Labour Government raised the top personal tax rate to 39% on income over \$60,000 from 1 April 2000, it created an incentive for people trading through companies or trusts to set their salaries at \$60,000. This resulted in a spike in the number of people earning salaries of on or around that amount. It also motivated sole traders to sell their businesses into companies or trusts to achieve the same result by effectively capping the tax rate at 33%.

Based on the broad premise that actions of this nature constituted tax avoidance, as detailed in the IRD's Revenue Alert 08/01, the IRD invested resources into attacking what it believed to be tax avoidance arrangements that circumvented the 39% tax rate. Five years ago the IRD gained some traction in this area when the Taxation Review Authority, in Case W33, ruled that a dentist had entered into a tax avoidance arrangement by re-structuring his affairs to trade through a trust.

However, the IRD suffered a considerable setback in March 2009 as a result of a decision of the High Court in *Penny & Hooper v CIR*. This case, involving similar facts to Case W33,

concerned two orthopaedic surgeons who initially traded in their personal names. However, in 1997 Mr Penny, and in 2000 Mr Hooper, sold their respective practices to related companies with the shares held by their family trusts. From 2000 - 2003 the salary of each doctor was \$100,000 to \$120,000. The practice income was about \$450,000 - \$600,000 and the IRD viewed the salary paid as being less than a "commercially realistic salary".



The IRD did not assert that failure to pay a commercially realistic salary was tax avoidance in itself, but that tax avoidance arose by the manner in which the company and trust structures had been used, based on:

- the artificially low salaries paid to the individuals
- the fact the trading entities were controlled by the individuals
- the continued use of the practice income by the individuals and their families to live
- the lack of commercial rationale for the re-structure

- the fact the businesses were sold for inadequate consideration, and
- the tax advantage gained.

To determine whether the arrangement constituted tax avoidance, the High Court relied on recent New Zealand Supreme Court decisions which took a “scheme and purpose” approach and considered legislative policies to determine if a particular tax outcome was acceptable. Past cases indicate that it was not Parliament’s intention for an artificial or contrived arrangement to be used to fit within a specific tax provision.

The High Court considered the individual elements of the arrangements before considering the arrangement as a whole. On this basis it was determined that this case did not constitute tax avoidance. A fundamental element of the judgment was whether the sale of a business to a company was tax avoidance and, although it was recognised that re-structuring the practices to operate through companies altered the amount of tax payable, it was held not to be tax avoidance. In essence, where the choice of corporate form is a commercially orthodox one neither individual nor company taxpayers are required to demonstrate a commercial justification for the choice of one form over another.

The IRD placed strong reliance on the principle that income derived by a person’s exertions must be taxed in the hands of that person. In *Penny & Hooper* no legislative intention for some categories of income to be taxed at personal tax rates, rather than the company rate, could be found and therefore this was not indicative of tax avoidance.

Rather than arguing against the IRD’s assertion that a commercially realistic salary was not paid, the taxpayers basically argued that legislation does not require such a salary to be paid and therefore it cannot provide a basis for identifying a tax avoidance arrangement. The taxpayers were successful. The judge confirmed that the Act determines whether a receipt is or is not income, it does not in these particular circumstances determine the amount of that receipt.

In viewing the arrangement as a whole, the Court found in favour of the taxpayers. The legislation did not intend that professionals should be prohibited from trading through companies and the IRD had taken an “intuitive subjective impression of the morality of income splitting by professionals” – which the Court found to be an unacceptable approach.

The IRD has recently filed a notice of appeal.

GST refunds

The IRD screens GST returns filed by taxpayers to determine if a review or investigation of that return is warranted. This is likely to occur where a taxpayer claims a GST refund that is higher than normal based on that taxpayer’s GST return filing history or where a first GST return is filed claiming a GST refund.

The legislation requires that where the IRD does not investigate a GST refund or request information from the taxpayer, the IRD must release that refund within 15 working days of the IRD receiving that return. If for instance, the refund is higher than normal and no information is sent by the taxpayer to the IRD to support the GST return, an IRD investigation will invariably arise and involve a request for information from the taxpayer.

The High Court in *Contract Pacific v CIR* has recently confirmed that where the IRD commences an investigation and requests information from the taxpayer the refund must be

released if the request for information is not made within 15 working days after the return is received by the IRD.



If a request for information is made within the 15 working day timeframe and the IRD requires further information, requests for that further information must be made within 15 working days from the time the IRD received the last submission of information. If however the IRD were to make a request for further information after the 15 working day period is up, they must then release the refund.

In the event the IRD requests information and the IRD satisfies the 15 working day timeframe requirement, there is no legislated time limit for when a refund must be released. However, administrative law principles require a refund to be processed within a reasonable timeframe.

The value for taxpayers in this decision stems from the requirement that the IRD must progress its investigations in a timely manner. If delays

occur and a request for information is then made after the 15 day timeframe the IRD will have to release the refund. It should be noted that the release of the refund is subject to the taxpayer's

remaining tax obligations being satisfied and the IRD could continue to investigate and dispute the validity of the refund after its release.

Renting out your holiday home

The income tax treatment of a holiday home that is used both privately and rented to third parties can be difficult to determine because of its mixed use. The difficulty arises because expenses of a private nature cannot be claimed, but expenses incurred to derive income can be claimed. The issue then becomes how to apportion expenses between the private and taxable use of the home.



The IRD has recently clarified its position based on general tax principles of how holiday homes should be accounted for, but has stated that each situation will need to be considered on an individual basis. Where a taxpayer can show that a particular expense directly relates to a time when rental income is being derived, then the expense may be deductible. For example, a telephone or power bill that shows actual usage while the home is being rented. However, the deduction may be limited to the lesser of the actual expenditure or rent received, (i.e. deductions cannot exceed rent received).

If the holiday home is treated as a genuine income producing asset and is only partially used for private purposes, deductions may be available for the periods during which it is available but not occupied. Proof of the home being "genuinely made available for rent" requires evidence of "active and regular marketing" of the holiday home for desirable periods at attractive rates. If the holiday home is only sporadically made

available, for undesirable periods at unattractive rates it is more likely to be a personal asset for the intervening periods and deductions therefore would not be available.

Where a part of the property is not made available, the expenses should be apportioned to exclude an amount reflecting that proportion.

The IRD also contends that where the home is made available to friends or family at less than market rates, deductions should be limited to the amounts received, so the net income is nil.

Snippets

Making the most of the changes

The Government's relief package for small to medium sized businesses includes a new provision which provides beneficial treatment for legal expenses. Under the general deductibility provisions of the Income Tax Act, if an expense is of a capital nature it is non-deductible. The process of analysing expenses to determine if they are of a capital nature can be complicated and time consuming. Legal fees are often reviewed for this purpose as legal services are often required for transactions that are of a capital nature, such as the acquisition of a building.

The new legislation provides that in deriving income or running a business, where a taxpayer incurs legal fees of \$10,000 or less in a tax year, the legal fees will be deductible irrespective of whether they are capital in nature. However, it is important to note that if more than \$10,000 of legal fees are incurred the whole amount will be subject to the capital limitation and require analysis to confirm deductibility. The definition of legal services is tied to the definition under the

Lawyers and Conveyancers Act 2006, which is very wide and is likely to cover most types of services. A further requirement is that the services be provided by a person holding a practising certificate issued by the NZ Law Society or an Australian equivalent.



A practical method of applying the provision is to monitor legal expenditure and where possible request that your lawyer defers further services until the following tax year.

Use-of-money interest (UOMI)

From 1 March 2009, the UOMI rate for underpayments of tax to IRD fell from 14.24% to 9.73% and the rate for overpayments of tax fell from 6.66% to 4.23%.

Contractor or Employee?

Businesses or individuals can often make the mistake of assuming they can operate under an independent contractor relationship by simply crafting the contract to reflect that intention.

Clearly there can be advantages for both parties in setting up this type of relationship. For the employer these include not having to withhold tax, provide sick leave or annual leave, and they can typically cancel the service contract within a contractually specified timeframe. For the independent contractor they can claim expenses incurred in deriving income and thereby reducing their tax liability and generally avoid the confines of PAYE.

However, people often do not realise that it is the circumstances of a situation that will determine if a person can in fact operate as an independent contractor. If it goes wrong, there may be severe repercussions. For example, if a person believes he/she is an independent contractor, but based on the facts, the IRD deems the relationship to be that of employment, the IRD can:

- demand unpaid PAYE from the employer based on grossed up payments
- disallow expenses claimed by the employee, and
- charge both parties penalties and interest.

So the question then becomes how do you differentiate between an employee and an independent contractor? Two cases heard by the Taxation Review Authority, and by the same judge, one in 2006 and the other in March of 2009, highlight how difficult this question may be.

The first case related to a self-employed courier driver who used the services of a relief driver. The second case related to drivers used by a nationwide rental car company to relocate their vehicles to its various centres. Some facts from each case are listed below, followed by the verdict of each.

Relief courier driver	Re-location drivers
Oral agreement	Standard independent contractor agreement
\$125 per day	Typically a fixed per kilometre rate
On an as needed basis	On an as needed basis
No invoice provided by relief driver	Invoices provided by re-location drivers
No sick leave or holiday pay	No sick leave or holiday pay
Travel costs are not paid by the driver	Travel costs are not paid by the driver
Vehicle insured by courier driver (not the relief driver)	Vehicle insured by rental company but driver could be liable for excess
Required pick ups and drop offs must be made	Drivers must take the most direct route
Verdict: Casual employee	Verdict: Independent contractor

Looking at the above factors, it would appear that both cases are fairly similar. Emphasis was placed on the fact that irrespective of how efficiently the relief driver performed, and the wear and tear inflicted on the vehicle, he would be paid the same amount and would not incur a loss of profits, which is indicative of an employment relationship. Similarly, the re-location drivers could not control the amount of profit/loss to them. The re-location drivers were paid by the distance travelled, and were required to travel by the shortest possible route. Therefore, even though they could not control the amount of profit/loss to them (as was the case with the relief drivers), they were held to be independent contractors.

It was not held to be determinative that an independent contractor agreement was entered into by the re-location drivers or that invoices were issued. However, that is a clear difference between the two cases.

A further difference between the two cases is evidenced by the Judge's view that the relief driver effectively stepped into the shoes of the courier driver and this degree of integration was indicative of an employment relationship. The re-location drivers on the other hand were not an integrated part of the rental car company.

The two cases highlight the pitfalls and complexity of determining whether a person is an employee or independent contractor. When considering whether a worker is an independent contractor or employee, business owners should assess the relationship as a whole. If in doubt, take the time to clearly define the relationship as the consequences of getting it wrong can be costly.

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