NEWSLETTER

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Trust reforms

Trusts are a popular way of protecting property and managing assets in New Zealand. The number of trusts we have in New Zealand is unknown, but estimates put the figure between 300,000 and 500,000.

The legislation governing NZ trusts has remained unchanged for decades as it has been predominantly governed by the Trustee Act 1956. The Act has been criticised for allowing the mismanagement of trusts with no easy legal redress for beneficiaries, however this is set to change. The legal framework has been subject to an in-depth review by the Law Commission, with the Trusts Act 2017 released in draft late last year, followed by ongoing consultation.

The draft bill seeks to clarify core trust concepts, resulting in a more useful piece of legislation that can be applied to fix practical problems and reduce the costs associated with trust administration. This will effectively impose 'minimum standards' for the governance of trusts so that trustees and beneficiaries are clear on their precise obligations, duties and rights.

The draft Bill features seven key proposed reforms that vary in nature from clarifying the key features of a trust, to detailing the duties and powers of trustees.

Under the new Act, trustees will be required to know the terms of the trust and act in accordance with them, act honestly and in good faith, to act for the benefit of the beneficiaries and to exercise their powers for a proper purpose. There are a further eleven default duties that apply, unless they are modified or excluded by the terms of an individual trust deed. The default duties cover areas such as the requirement to invest prudently, avoid conflicts of interest and to act for no reward. The formalisation of Trustee duties will provide protection to beneficiaries that assets will be dealt with in their best interests, and provide legal remedies if

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trustees fail to meet these standards. The Act also requires trustees to disclose certain information to beneficiaries who are reasonably likely to receive property under a trust.

It will be important for all trustees to understand the new law and their individual trust deeds, to ensure they discharge their duties with the appropriate standard of skill and care.

No changes to the tax treatment of trusts are proposed. However, there is additional focus on trusts from a tax perspective following the recent "Panama Papers" scandal and the alleged misuse of NZ foreign trusts, which has resulted in a Government led investigation into whether existing disclosure rules are adequate. In response, the Government is beefing up the requirements for foreign trusts in three key areas; registration, disclosure, and annual filing. The proposed changes will require all foreign trusts to formally register with the IRD and be subject to an increased number of disclosure requirements, with sanctions for non-compliance with the new rules.

To some degree, the new Act serves to codify existing case law and current best practice, bringing a degree of consistency to New Zealand's trust regime. Ideally, this will reduce the frequency with which disputes end up before the courts and benefit all beneficiaries, which is ultimately what a trust is designed for.

Importance of good record keeping

A recent case Taxation Review Authority (TRA) decision has highlighted the importance of good record keeping.

The taxpayer, an accountant, was accused by Inland Revenue (IRD) of using a company as a vehicle to create a tax advantage. He claimed to have sold his sole trade accountancy practice to his own company for $2m in 2002. The company did not have the 'cash' to purchase the business, and hence a loan was recognised to the company. Later, in 2007, his family trust purchased a family beach house for $1.3m. To fund the purchase of the beach house, the company borrowed from the bank to repay the debt it owed to him and he lent the funds to the trust.

The IRD did not dispute that the 2002 sale took place, however they argued that the sale price was just $425,000, creating a much smaller loan. On this approach, recognition of the $2m loan to the accountant triggered a taxable dividend for the difference.

Given the facts of the case, it is not surprising IRD were suspicious of the transaction.

Originally, the accountant was unable to produce a sale and purchase agreement evidencing the transaction. When eventually he did, IRD referred the agreement to a document examiner who found a number of irregularities, based on which the IRD concluded the document was a fabrication. The accountant's explanation for the irregularities were that he had used a client's sale and purchase agreement, that he had 'twinked' out the details and hand written in his own changes.

At the time of the transaction, the company's 2002 financial statements only recorded a goodwill value for the purchase of the business of $425k. According to the accountant, the original value of $425k was recorded in the financial statements so that his wife did not know the true value of the business (the marriage later broke down). Then In 2003 the goodwill was written off. Over the course of the 2006 and 2007 years, the goodwill and loans were recorded back up to $2m.

The accountant advised the reason for the increase was to improve the standing of the company before a review by the accountant's professional body. The taxpayer prepared three different sets of financial statements for the 2007 year before arriving at the final version.

The accountant claimed a reversing journal in his accounting software showed an original figure of $2m. IRD contended that this entry had not been made until 2008, after the purchase of the beach house. However, an accounting software expert called by the IRD, confirmed journals cannot be entered into prior years because they are effectively "frozen".

IRDs final argument was that $2m was a vast overstatement of the value of the accountancy practice in 2002, for which they had the support of an independent valuer. Again, the taxpayer was able to explain in detail how he arrived at his calculation. He accepted the valuation may have been 'over-enthusiastic'.

Notwithstanding the poor record keeping, unhelpful facts and the arguments put forward by the IRD, the TRA found in favour of the accountant. Accepting the sale was genuine, the price was what was paid by the company and therefore the repayment of the debt was not a taxable dividend. If the accountant had clear and accurate documentation from the outset, the court case and associated costs might have been avoided.

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When is income from professional services derived?

The Inland Revenue Department (IRD) recently released a new interpretation statement discussing when income from professional services is considered to be derived, and hence becomes taxable. The statement replaces several older IRD Information Bulletin's and consolidates their view, giving greater detail and more examples.

There are two main methods of recognising income, the accruals basis, which taxes income when earned and the cash basis, which taxes income when physically received.

Most businesses use the accruals basis, however professional services providers may be able to apply the cash basis. Historically, both doctors and barristers could use the cash basis because doctors could not create a lien over patients' property, whilst barristers were unable to sue their clients for unpaid fees.

The IRD's interpretation statement provides that the cash basis is not exclusively for these professions and can be applied in other circumstances. Similarly, there may be occasions where the accruals basis may be more appropriate for doctors and barristers. The statement draws on a vast body of case law and lists the following factors to help determine the most appropriate method:

The type of activity: the cash basis might be appropriate where the level of expenditure does not have a material effect on the income derived or there is a high risk of non-collectable income.

The characteristics of the type of income: the cash basis might be appropriate where there is a low expectation of payment inherent in the type of income, or where the timing of receipts are governed by legislation.

Legal and regulatory environment: standard contractual obligations may require payment at specific times, and hence it might be more appropriate to return the income on a cash basis.

Scale of the business or income earning activity: the larger the number of employees, the turnover and general size of a business will indicate the accruals basis should be adopted.

The level of sophistication or complexity of an activity: if a professional services activity requires fixed or circulating capital and accounts for trade receivables on a balance sheet, the accruals basis may be more appropriate.

The IRD provide the example of where the Court held that a pathology practice with five partners, 66 nursing staff across 21 collection centres, approximately 92,000 patients annually and gross fees of $2m per annum should apply the accruals basis. The Court held that the scale of the operation and the fact that a substantial amount of the work to derive the income was performed by nurses and not solely the taxpayer made the accruals basis more appropriate.

Conversely, the Courts determined that a solicitor who worked alone with only the assistance of a secretary should account for income on a cash basis. The size of the practice and the majority of the work being undertaken solely by the taxpayer influenced the outcome.

Use of the cash basis is relatively rare in today's modern environment, it dates back to paper based accounting records, before modern software simplified the accounting process. However, the IRD's statement does acknowledge that there are still situations where it is appropriate to recognise income on a cash basis.

Tax planning before 1 April 2017

For most taxpayers, 31 March represents the end of the financial year. In the lead up to 'year-end' there are a number of actions that business owners may want to take to avoid missing the boat on simple tax planning opportunities.

Trading stock: stock can be valued at the lower of cost and market selling value ("MSV"), and generally it will be beneficial to use a lower MSV where possible. But to use MSV you must have evidence that this represents the market value of the specific stock items at or about balance date. The IRD have indicated that suitable evidence includes independent or internal valuations by suitably qualified persons of the price of goods and actual sales for a reasonable period before and/or after balance date.

Accruals and provisions: a tax deduction should be available if you are definitively committed to an expense at year end and can reliably estimate the amount. Ensure all expenditure is captured and accrued to minimise the amount of taxable income. One exception is employee related accruals that are tax deductible if they are incurred and are paid within 63 days after balance date (so by 6 June);

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consider paying any staff bonuses by then to gain a current year tax deduction.

Bad debts: to be tax deductible bad debts must be actually written off before year end – it's no good booking the journals after balance date as part of your year-end accounts preparation. There also needs to be evidence that the debt was considered "bad" (e.g. review of accounts receivable, debt-enforcement notices and other actions taken).

Assets: if you are planning on buying any depreciable assets (e.g. plant and equipment), a full month's depreciation can be claimed in the month of purchase, so it may be worth buying replacement assets just before 31 March.

Relevant to companies only:

Charitable donations: in order to claim a donation deduction, it needs to be paid in cash before 31 March. The amount of the donation is limited to the amount of a company's net income in the absence of the donation. Hence, if a company has made a loss it might be beneficial to push the payment into the next year.

Shareholder current accounts: if a company is owed money by shareholders, consider paying commercially justifiable shareholder-employee salaries or paying a dividend to settle the debts. If not done, there may be fringe benefit tax or deemed dividend issues.

Imputation Credit Account (ICA) balance: ensure the imputation credit account does not have a debit balance at 31 March, otherwise penalties will be incurred. If the ICA may be in debit, consider a making a voluntary provisional tax payment before 31 March.

Snippets

FBT changes on the horizon

Currently, companies that provide a motor vehicle for the private use of their employees must register for and pay FBT. Draft legislation has been introduced which will enable some small businesses to avoid having to pay FBT.

The proposed amendment will allow close companies (where 5 or fewer natural persons own 50% or more of the shares) that only provide one or two vehicles to shareholder employees (and no other benefits) to apply the rules currently available to sole traders and partnerships. Using these rules, the company will claim a deduction for the use of a vehicle to the extent it is used in the business and not pay FBT in respect of the private use.

In order to apply the treatment to a particular vehicle, it needs to be adopted from the time a vehicle is acquired, or first used in the business. Hence, the method won't be available for company vehicles currently held. Once a particular vehicle is subject to the new treatment, it must continue to be applied until the vehicle is either sold or is no longer used in the business.

The Bill introducing the change is currently going through its second reading in Parliament and will apply from the 2017- 2018 year. With the new rules coming into play soon, it may be the right time to think about your current business vehicle usage and whether or not it is a good excuse to splash out on a new vehicle.

Unusual tax balance date

Tax balance dates around the world are often quite straight forward. Most incorporate a full calendar month, like the standard New Zealand balance date of 31 March. However the standard balance date in the UK is the 5th of April – and there's quite a story behind this.

The British Empire followed the Julian type calendar until 1752 when they changed to the new standard Gregorian. The Julian calendar was slightly different than the Gregorian; longer by about 11.5 minutes each year. The Gregorian calendar was introduced to Europe by Pope Gregory XIII in 1582, and had taken over as the standard throughout most of Europe. The 11.5 minute difference slowly added up resulting in the British Empire being 11 days behind the rest of Europe.

To make sure the British Treasury didn't lose out on any revenue, they added this 11 day difference onto their existing tax balance date of 25th March (New Year's Day in the 18th century). These additional days gave a new balance date of April 4th.

Later in the year 1800, the old Julian calendar was due for a leap year day but the current Gregorian calendar was not. The British Treasury made sure to account for this by moving the balance date to April 5th, which remains the date used today.

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

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