NEWSLETTER

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Inland Revenue activity

After a relatively quiet few years through the Covid pandemic, Inland Revenue's (IR) audit activity has slowly started to increase over the past few years.

In 2021, IR's campaign had a focus on the real estate sector, where the concern was around real estate agents claiming a disproportionately large amount of expenses relative to their income. As a result, a trend of increasing private expenditure claims, reversed.

In 2023, IR launched a 'Tax Toolbox' campaign aimed at engaging and educating construction ('Tradie') taxpayers. The Tax Toolbox resources include a detailed web page with information on items such as claimable expenditure, income tax and GST, access to free online Tradies seminars covering tax tips for Tradies, and the option to request a business advisory visit for one-on-one support. As part of the 2024 budget announcement, IR has confirmed that they will be increasing their enforcement on this sector this year, with unannounced visits to construction sites starting July 2024.

This year's Budget allocated $29 million to Inland Revenue for compliance, to target taxpayers who are not meeting their tax obligations. Specifically, areas that are expected to be closely scrutinised include the following: the hidden economy, organised crime, retail sector, trust compliance, cryptocurrency, corporate restructures, and electronic sales suppression tools.

Overdue student loan debt, for which those in default are mainly based overseas, will be allocated $4 million of the compliance funding. Individuals who own New Zealand property that are based overseas and are not meeting their student loan repayment obligations will likely be contacted by Inland Revenue.

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In terms of the hidden economy work, in June 2024, IR released some insights from their investigation on small liquor stores.

The investigation involved 220 unannounced visits nationwide, where investigators were looking for signs of income suppression, unreported sales and non-registered staff. It was found that over 100 employees had PAYE deducted from their wages which had not been paid to IR. Nine liquor stores have been escalated to the IR audit phase.

An IR campaign that has spanned across a number of years is the Tax Governance campaign. This campaign is aimed at New Zealand significant enterprises (taxpayers with >$30m annual turnover), and using the results of questionnaires issued to these taxpayers, the areas of improvement include the documentation of tax strategy and tax controls framework, regular reporting to the board on key tax matters, and the independent testing of controls.

As IR reviews and investigations increase, there will be the need for both accountants and IR staff to rehone their skills on how to conduct an investigation, given the comparatively lower level of activity that has been seen since the Covid pandemic.

Non-BAU transactions

BAU is a phrase that is used to describe "business as usual". It is a good barometer of whether anything strange or unusual has occurred or whether things have been BAU. Invariably, non BAU transactions will occur: an insurance payout, a large asset purchase, a fine or a penalty. This then leads to the question of what the tax treatment is of that non-BAU transaction.

A non-BAU type transaction was the subject of a recent Technical Decision Summary (TDS 24/12) released by Inland Revenue.

Two companies received lump sum compensation payments from a third party for damage to intellectual property (IP). The IP was held in the form of licenses to commercialise certain products. The settlement amount was based on discounting the future income streams that were otherwise expected if the licenses had not been damaged.

New Zealand's income tax legislation captures specific items as taxable, such as rental income, and then more broadly, amounts that are income under ordinary concepts. In addition, income derived from a business is taxable, unless it is capital in nature.

One principle that has developed through case law is that where an amount is intended to replace lost profits, then the payment takes on the attributes of the amount it was designed to replace and could therefore be taxable. One frustration with this approach is that the value attributable to most capital assets is a function of the income to be derived from them.

In a positive outcome for the taxpayer, the fact that the compensation was calculated based on lost cashflows was not determinative. Instead, the focus was placed on the fact the settlement payment was for the damage to their IP rights which was permanently damaged (but not destroyed) and that damage was significant or substantial. The companies and the third party expressly agreed that the payment was in respect of that damage.

The damage had significantly reduced the companies' ability to participate in the market in which they would otherwise have been able to participate and the companies had effectively lost earning capacity from their asset. The nature of the compensatory payment was one-off rather than regular or recurrent.

This case demonstrates that although it is routine to treat amounts derived by a business as taxable, that may not always be the case. If a non-BAU situation has arisen it is worth pausing and asking the question 'how should this transaction be treated?'. It may also be worth asking your advisor early in the process, particularly if agreements or communications are being put in writing, because those statements may become determinative and therefore crucial that they are correct.

Employee Share Schemes

For businesses that trade through a company, circumstances might arise in which the shareholders consider selling a minority stake in the company to a key employee or group of employees. This could be to ensure that key talent is 'locked in' for the long term, as a means of succession if the existing shareholders are looking to wind-down or simply as a means to link effort to reward. The pros and cons

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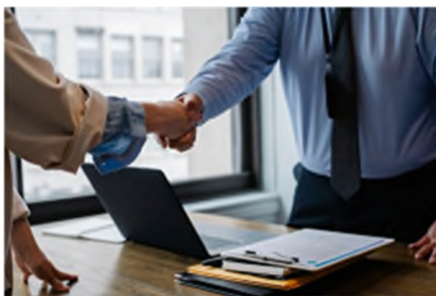
of transferring shares to key employees through an Employee Share Scheme (ESS) need to be carefully weighed because the devil is in the detail.



From a tax perspective, shares are typically held on capital account and therefore any gains in value are non-taxable. However, complex rules exist which try and delineate between an arrangement that resembles a generic shareholding interest, versus one that is received in connection with a person's employment.

If the arrangement is tied to a person's employment, the 'share scheme taxing date' (SSTD), being the date when the value of an employee's shares are taxed, is deferred until:

- there is no significant risk that the ownership of the shares could change for other than market value,
- the employee is not protected from a fall in value of the shares, and
- there is no material risk that the terms of the shares will change in a way that affects their value.

For example, if the rules of an employee share scheme state that an employee who leaves to work for a competitor must sell their shares for the lesser of cost or market value, this would carry a 'material risk' of occurring and therefore will defer the SSTD. Hence, the full value of the shares could be taxed on disposal, being the time at which this condition ceases to operate. On the other hand, if a bad leaver is defined as someone dismissed for serious misconduct (such as fraud or theft), this condition is less likely to occur (immaterial risk) and should not defer the SSTD. It is not uncommon to find income tax applies to shares within an ESS, when the participants have assumed it does not.

Another aspect that can complicate an ESS is the management of minority shareholder rights. When employees are granted shares, they become minority shareholders and are entitled to certain rights (such as voting rights) within the company. Managing these rights can be complex and cumbersome and can detract from the overall appeal of an ESS for some companies. Additionally, setting up such schemes can be costly and time-consuming.

As companies consider their options, the fundamental gating question becomes what the shareholders are trying to achieve and whether there is a better option. An alternative is to implement a phantom equity incentive where an employee is compensated (e.g. with bonuses) based on the value of a business and/or its performance. Phantom equity, can offer similar motivational benefits without the complexities of actual share ownership.

Donating trading stock

What was a temporary tax concession relating to donated trading stock has now become a permanent one thanks to the enactment of the Taxation (Annual Rates for 2023–24, Multinational Tax, and Remedial Matters) Act 2024 on 1 April 2024.

Prior to March 2020, in most cases, if a business donated trading stock it resulted in deemed income equivalent to its market value. This resulted in a business being taxed on a deemed profit margin, even though no cash was received.

The rule was initially introduced to counter tax avoidance, to address situations where sole traders were using trading stock personally. This provision was temporarily amended in March 2020 to allow trading stock to be donated to donee organisations (such as charities) and public authorities without triggering deemed income.

A deduction for the cost of the trading stock was also allowed (i.e. a net tax deduction for the donated trading stock to these specific parties arose). This was to encourage donations of products like hand sanitiser to hospitals, or consumables to food banks during the Covid pandemic.

Where trading stock was donated to non-associates (that were not either a donee organisation or a public authority), the concession deemed income to arise, but it was equal to the cost of the trading stock (i.e. net nil impact on taxable income). The concession was extended at the start of 2023 as a result of the adverse weather events that occurred in January – March 2023, and was due to expire on 31 March 2024.

The recently enacted legislation has permanently amended the deemed market value provision. From

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1 April 2024, deemed income will not arise if the trading stock is donated to a donee organisation. However, if the trading stock is not donated to a donee organisation it becomes more complex. In this context income based on the market value of the trading stock will only be triggered if:

- it is disposed of to an associated person, or
- a person takes it for their own consumption, or
- it has not been disposed of in the course of carrying on a business for the purpose of deriving assessable or excluded income.

The relevance of it 'not' being in the ordinary course of business is important and arguably counter intuitive. To illustrate:

- If as a result of a weather event a large supermarket chain makes a one-off donation of groceries to specific families in need, then deemed income arises.
- If instead a supermarket chain provides groceries to families as part of a marketing or promotional campaign that is part of its ordinary marketing initiatives, income is not deemed to arise.

In the context of donations of trading stock to donee organisations the amendment is positive. However, based on the weather event example above, it falls short.

Snippets

Changes in marginal tax thresholds

For the first time since 2010, personal tax rate thresholds will change from 31 July 2024. The change was announced as part of the 2024 budget.

When personal tax thresholds are not regularly adjusted to take into account inflation or wage growth, individuals end up paying a higher percentage of their income in taxes over time. As such, adjusting these thresholds arguably reverses past tax increases.

The new personal tax rates for individuals are:

Current brackets	New Brackets	Rate
$0 - $14,000	$0 - $15,600	10.5%
$14,001 - $48,000	$15,601 - $53,500	17.5%
$48,001 - $70,000	$53,501 - $78,100	30%
$70,001 - $180,000	$78,101 - $180,000	33%
$180,001 +	No Change	39%

Employers will be responsible for handling these pay adjustments on behalf of employees from 31 July 2024 in pay cycles going forward.

Payroll software users should receive updates from providers (if they haven't already) once the new thresholds are ready. For those managing payroll manually or without software, it's essential to use updated tax tables for precise calculations.

Most NZ individuals have a balance date of 31 March. As the changes are effective part-way through the 31 March 2025 year, if an employer's payroll system hasn't been updated by 31 July 2024, any owed amounts should be included in subsequent payments or settled during an end-of-year reconciliation.

New product lines

It is important to regularly ask whether you are providing the products that your customers want and whether there are any new products that you could provide to ensure you are evolving with changing times as you look for the next income stream.

There are plenty of examples of new products meeting an unexpected demand or creating a whole new market - the first Cronut, streaming service, putting coffee in a martini. But how do you know whether your latest idea is going too far, such as the following examples:

- Similar to DNA kits to confirm ancestry, DNA kits can be purchased for your dog to confirm its genetic makeup.
- Adults in some U.S. states can now buy gun ammunition from vending machines at their local grocery store.
- Fresh Icelandic Mountain Air can be purchased by the can.
- Bacon scented Mustache wax – "the bacon scent will make you the envy of all your friends".
- A remote-controlled crocodile head, to keep people out of the pool.

A brain storming session with the team is a good idea to test whether you are delivering for your customers and to identify gaps you could be filling. But remember to test any ideas with trusted customers before they are implemented.

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

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