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Provisional Tax and GST Due Reminder

The first provisional tax payment for the year ended 31 March 2012 for those taxpayers who pay GST on a six-monthly basis is due 28 October 2011, ie at the end of next week.

This applies to those companies and sole traders who are registered for GST six-monthly. Those taxpayers will also have to pay GST at 28 October.

Those taxpayers who pay provisional tax individually, or sole traders or companies that pay GST two-monthly, will not have to pay provisional tax on 28 October. They may still have to pay GST but the next provisional tax payment date for individuals, sole traders and companies registered for GST on a two-monthly basis, is 15 January 2012.

If you are registered for GST on a six-monthly basis and you don't know how much provisional tax to pay please call us.

Update on Penny and Hooper

At the end of August the Supreme Court, the highest court in our judicial system, issued its decision in *Commissioner of Inland Revenue v Penny and Hooper*.

In that case two orthopaedic surgeons from Christchurch had set up family trusts and companies and paid themselves very low salaries through their companies. The balance of company surpluses were then paid to the trust but the surgeons continued to receive the benefit of those original earnings through the trust. The Court found that this arrangement amounted to tax avoidance.

They found that it was acceptable to operate through company and trust structures but that this particular arrangement had no economic substance and was not commercially realistic. This was because after the surgeons started operating (no pun intended) through the companies their personal incomes dropped significantly and subsequently the taxes they paid reduced. While the companies and trusts still paid tax, the overall amount of tax paid reduced significantly with the company / trust structure. The amount of tax saved was even more evident when the trust was paying tax at 33% while they would personally have been paying tax on the income at 39% or, latterly, 38%.

During the case, much hinged on whether payment of a market salary to each surgeon would have meant the arrangement was commercially realistic. This was never specifically answered as it was held that the surgeons retained the benefits of their high earnings but without having to pay as much tax as they had previously. This led to the decision that the arrangement was tax avoidance.

Much in this case seems to have hinged on the fact that both were paid significantly less than a market salary, less than they had earned previously, and less than they would have accepted from an independent company. However the concept of a market salary is never mentioned in the legislation. The Court decision has raised many more questions than it has answered for both accountants and lawyers as well as taxpayers who have been following the cases through the courts.

Inland Revenue's response to the Penny and Hooper decision

Accountants, lawyers and taxpayers have sought clarification from Inland Revenue as to how they will be interpreting this Supreme Court decision since this was the last appeal available.

How Inland Revenue interprets this decision is important. Although their interpretation holds no legal weight it is expensive to argue with their assessment because it relies on going through courts, a time consuming and expensive procedure as Penny and Hooper will have discovered.

To help provide some certainty to advisers Inland Revenue produced Revenue Alert 11/02 in September. This can be read at http://www.ird.govt.nz/technical-tax/revenue-alerts/revenue-alert-ra1102.html.

This sets out Inland Revenue's approach which in summary expects a company to allocate 80% of the income earned by an individual to that individual, leaving 20% to be taxed in the company before being allocated out to shareholders, whether these shareholders are individuals, a family trust etc.

The reduction in the top personal tax rate from 38% to 33%, the same tax rate as for trusts, has now reduced the tax benefits of allocating income through a trust.

Inland Revenue accepts that there may be valid commercial reasons for not allocating 80% of the income as a salary. For example, the company may be experiencing a loss overall or setting funds aside for capital purchases or business growth.

The cases Inland Revenue is most interested in investigating are those cases where individuals have earned large incomes through a company structure, paid themselves an unrealistically low salary and then allocated the surplus via dividend to lower taxed shareholders or a family trust over which those individuals exert significant control.

Our interpretation of the Supreme Court decision and Inland Revenue's subsequent Revenue Alert then is that taxpayers who earn company income through their own personal efforts need to ensure they are receiving remuneration for their efforts totaling around 80% of the income received, after associated expenses. Payment of a lesser amount may be justified but Inland Revenue has made it quite clear that it will be looking at situations where 80% of the net income is not being paid out to those that earned it.

The Attribution Rules and Penny and Hooper

We're often asked where the Penny and Hooper decision fits in with the Personal Services Attribution rules.

The Personal Services Attribution rules apply to service companies such as consulting companies.

In summary if the company's gross income for the year is more than $60,000, more than 80% of the income is earned by the personal efforts of an individual, more than 80% of the income is earned from one client or customer and the business uses assets costing less than $75,000, then all the income after direct expenses only, must be attributed to the principal earner. All four of the criteria need to be met for this rule to apply.

The Personal Services Attribution rules do not apply if there are multiple clients, staff working in the business and generating more than 20% of the revenue, or if there are substantial assets in the business. However business activities cannot be joined to get around the rules. For example putting the assets of a rental property company into a services company will not get around the personal services attribution rules as the assets

are not being directly used in the services business.

However if the company has multiple clients, even if the work is performed by one principal, then there may still be opportunities to allocate a market salary to that principal and carry forward any remaining surplus to the next year (for example to cover a slower year) or to pay any surplus to the shareholders as a dividend.

But if an individual is earning most of the company income and the company has one major client then generally all the income after direct expense, needs to be allocated to that individual.

The Penny and Hooper decision extends that principle to those who may have multiple clients and staff to say that the individuals should be allocated 80% of the surplus after paying staff and direct costs if the income has been earned principally from their efforts.

We see the Penny and Hooper decision being applied to professionals such as doctors, architects, consultants, plumbers and others who earn mainly based on their skills.

Changes to Financial Reporting

In August Commerce Minister Simon Power announced that companies would no longer be required under the Companies Act to prepare general purpose financial reports.

We understand the objective was to reduce compliance costs for small to medium sized businesses.

This sounds a great idea and we are also keen to reduce compliance costs. As accountants we'd much prefer to spend our time talking to business owners about ways of improving their businesses rather than filling out forms.

However this announcement just removed the requirement to prepare annual financial statements for companies under the Companies Act. This does not affect sole traders or those operating through partnerships or trusts and doesn't affect any taxpayer who has to prepare an income tax return.

All businesses need to maintain records to complete their income tax returns at year end and the Income Tax Act merely requires that financial records be maintained. However these financial records need to be to a standard that allows year end income tax returns to be completed so most accounting systems are set up to provide reports that meet both the Companies Act and Income Tax Act requirements from the one set of data input. Removing the legislative requirement then to prepare accounts under the Companies Act doesn't have much impact on "business as usual".

We're not aware of the Companies Office checking that small companies have prepared their accounts according to generally accepted accounting practice? But Inland Revenue will still continue with audits to ensure both GST and income tax have been correctly calculated.

Practically then this change to the legislation will unfortunately have very little impact on small to medium sized businesses. We'd recommend that these businesses still use an accountant to make sure they are claiming all the expenses they can and correctly calculating GST. While a good accounting system is a great start, it is only as good as the information input.

For example we often see cases where taxpayers have claimed GST on drawings, claimed principal repayments on loans as interest etc., etc, Accumulated over a year the impact after an Inland Revenue audit can be penalties up to 100% of the tax underpaid as well as interest calculated on a daily basis. You will all have heard about cases where a $4,000 tax underpayment

escalated to $20,000. So we'd recommend that you don't immediately dispense with your accountant.

We see this announcment as an opportunity to have more freedom in the final reporting provided. The new reporting standard will be special purpose financial reports and the NZ Institute of Chartered Accountants (NZICA) has been charged with designing these special purpose financial reports. Baubre is a member of the NZICA working group establishing these reports.

There are also changes to the reporting for charities and these are being designed by the XRB. We'll provide more information as it becomes available on these reporting changes.

Deductible expenses

We are often asked about whether certain expenses are deductible.

Usually these conversations are prefaced with comments such as "my friend's accountant says it's OK to claim these" or "I need them for my business".

As you'll be aware from the Budget in May this year (and last year) the government has allocated significant funding to Inland Revenue for audit activity. This may be because for every dollar spent Inland Revenue expects to receive around $7 in return – a good return on investment. Therefore it targets audit activity. Percentage wise this means that you will be audited – it's just a matter of when.

We recommend you take a reasonableness approach to claiming expenses.

For example we were recently asked about guard dogs because someone had read that the costs of maintaining guard dogs (food, housing, vet's bills etc) were all tax deductible. This would usually be to cover the costs of security firms using dogs to assist security guards with their activities. But a woman working from home was assured by her friend that her dog was a guard dog and all the costs related to her dog were deductible expenses against her income. Her argument was that her dog (which she'd had for more than 5 years) barked every time a stranger arrived at the door and that the dog was essential so that she could continue working safely from home.

Having been in interview rooms with Inland Revenue investigators the next question would be something along the lines of "wouldn't it be cheaper to get a door bell and/ or peephole in your front door?" And if you decided to stop running the business from home and took a salaried job in the city, would you sell the dog as it was no longer required?

We'd recommend that you were honest with yourself and took a reasonable approach. In the same way, expensive haircuts, clothes and meals out are not costs necessarily incurred in deriving taxable income.

In talking to other accountants we have found that they usually re-allocate those costs to drawings or personal costs instead of claiming them even though the client has included them as deductible in their records. There are plenty of deductible costs available so use common sense and you shouldn't fear an Inland Revenue audit.

Tech Corner

For online streaming music have a look at www.grooveshark.com. There is a good selection of music, it runs beautifully in the browser and it is free.

Essential software for Macs living in a Windows world – Office 2011 for the Mac, Cord for remote access to PCs, Paragon for write access to NTFS drives, and DavMail to connect Mac Mail, Calendar and Address Book to Exchange 2003 (because Lion only talks nicely to Exchange 2010).