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CHARTERED ACCOUNTANTS

DEBORAH NOBILO, M.Com., CA (PP)
JOHN NOBILO, B.Com., CA (PP)

Members of the Institute of Chartered Accountants of New Zealand

NEWSLETTER

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Can't See the Carbon for the Trees

It has been well reported through the news media that New Zealand looks set to adopt an Emissions Trading Scheme to aid in the global effort to combat climate change.

Broadly speaking, it is intended that the scheme will alter the cost structure of goods and services supplied in New Zealand through the operation of a "cap and trade" model. Under the model the Government will place a cap on the greenhouse gases certain industries can produce.

The Government will allocate free carbon units, New Zealand Units (NZUs), in some limited circumstances. Those entities not receiving free NZUs (or receiving insufficient NZUs to cover their obligations) will need to purchase NZUs. As carbon is emitted, NZUs that an entity possesses will need to be surrendered to the Government, effectively "paying" for the greenhouse gases produced.

An emissions trading scheme will be established to allow participants to buy or sell NZUs. This arrangement places either a further cost, or saving, at specific points in a supply chain depending on the quantity of greenhouse gases associated with the good or service. Goods and services with high emissions will cost more to produce and/or to purchase.

Theoretically, this will influence production and consumption decisions in a way that will be of benefit to the environment. For example, if a clothing manufacturer were to produce lower emissions compared to a competitor, its emissions cost under the scheme would be relatively lower, most likely resulting in higher profits. The hope is that its competitor is more likely to attempt to lower its own emissions through

changes to its production methods in order to gain similar profit levels and to stay competitive.

Discussion is currently underway about how to treat the various types of transactions that can occur under the scheme for tax purposes. The Government has released its initial view, and has sought feedback, on the tax treatment of the various transactions in the form of an officials' issues paper.

The proposed treatment of possible transactions under the scheme (excluding the forestry industry) is as follows:

- Expenses relating to meeting emissions obligations, such as the purchase of units, will be deductible as a cost of doing business.
- If a business faces emissions costs (directly or indirectly), but its competitor does not, that business will be at a disadvantage. To even the playing field, free units may be allocated to effectively reimburse the emissions cost. The value of these free units would represent taxable income in the period the expenditures are incurred or when they are relinquished to the Government.
- The issues paper suggests that NZUs will be treated as a service and subject to GST. However, we understand that the IRD may be giving consideration to a change in this position.

Complexities around timing are likely to arise as emissions will be measured on a calendar year basis. Because few businesses have a December balance date it is expected that businesses will measure their emissions through the year to either accrue income or expenditure.

The forestry industry faces unique tax issues, as units will be earned as trees grow and capture carbon, but surrendered when the trees are harvested. The forestry industry will be the first to face implementation of the scheme from January 2008.

Trial/Probation Periods – Performance Management First Time Around

A personal grievance report recently released by the Department of Labour provided interesting reading regarding personal grievance mediations. An interesting statistic was that 38.7% of mediations involved employees that had been employed less than 12 months, which suggests that employers need to be increasingly careful when recruiting new employees, by evaluating whether or not they are able to perform the role employed for and that they fit with the company values and culture.

Trial periods provide a mechanism by which employers can 'test the waters' with new employees. However, employers need to be careful. Recent Employment Relations Authority cases have highlighted that if employers wish to utilise trial periods they cannot simply be a 'critical observer', they must be ready to review and advise on necessary improvements, give sufficient time for these to occur and warn of the likely consequences should expectations not be met.

What does a trial (probation period) involve?

A trial period provides time for the employee to show that he or she is suitable for the position that they have been hired to perform. If an employer wishes to have a trial period, this must be agreed with the employee at the start of the employment and robust performance management procedures must be put in place to ensure that the trial period is handled appropriately.

How should trial periods be managed?

A fair and reasonable employer (which is the objective standard in employment law) would follow these guidelines:

1. Establish the appropriate length of the trial period: It should only be long enough for the employee to demonstrate their suitability for the position and the period can be extended if both parties agree.
2. Hiring: To be legal and effective, the trial period must be agreed by both parties at the beginning of the employment period.
3. Managing the trial period: In managing the employee the employer should:
   - supervise and review the employee's progress in line with the performance expectations on a regular basis;
   - provide the employee with appropriate training, tell them about concerns and give them an opportunity to improve;
   - tell the employee about the purpose and content of any meeting needed to discuss performance.
4. Managing concerns: The employer must give the employee clear descriptions of the inadequate performance and the employee must know what they need to do to improve.

It is also important to remember that during a trial period the employee must still be paid the agreed salary and that the employee can be dismissed at any stage for serious misconduct.

Trial periods can be an effective way of integrating new employees into your business and providing an employer with a useful tool for managing and encouraging appropriate performance standards. If trial periods are not managed correctly they can

result in an organisation retaining unsuitable employees or inappropriately dismissing unsatisfactory employees, which could result in costly unjustifiable dismissal claims.

Trusts – First the Dentist Now the Driver

A recent decision by the Taxation Review Authority (TRA) considered if a tax avoidance arrangement had been entered into for the purpose of deriving tax credits in the form of family assistance.

In May 1995 a bakery company shifted from having its products distributed by employee drivers to self-employed distributors responsible for their own depots, vehicles, deliveries and handling of customer cash sales. One of the previously employed drivers, a husband and father of four, settled a trust with a corporate trustee with the aim of becoming a self-employed driver. The husband, together with his wife and accountant, were the directors of the corporate trustee.

The bakery company entered into a distribution agreement with the trustee company to provide distribution services. The trustee entered into a management contract for services with the husband and wife (in partnership) to carry out the work.

In the husband's final year of employment with the bakery company he had received a total wage of $33,525 including overtime. His base pay was $20,000 per annum.

Initially the management agreement between the trust and partnership prescribed an amount payable to the partnership of $18,750 plus GST. After the first year this was increased to $20,000 plus GST.

For each of the years in question the husband and wife, as partners, returned taxable income of about $10,000 each. The net profit of the trust from the distribution agreement was distributed to the four children, with the total distributions being $36,572 in 1998, $42,248 in 1999 and $64,432 in 2000. These amounts were not physically paid to the children; they were only credited to their current accounts. The parents drew advances from the trust for household expenses including food, Visa, insurance and mortgage repayments. In the trust's accounts, the advances owed by the parents to the trust were reduced by transfers from the childrens' current accounts. Family assistance of approximately $10,000 per year was received over a three year period as a result of the parents' income levels. In addition, low marginal tax rates applied to the income distributed to the children.

The husband and wife argued that the management fee had been set based on the husband's previous base salary and that it is "absolute nonsense" that they set the management fee at a level in order to gain more family assistance payments.

The TRA considered that the taxpayers were entitled to structure their affairs as they wished and appropriate commercial or family purposes existed in respect of the arrangement. However, the amount of income paid to the partnership "clearly involved tax avoidance" and the "fixing of the management fee was carefully contrived specifically for the purposes of the Family Support credits for the wife". This tax benefit could not be regarded as merely incidental to the arrangement and the arrangement was void for tax purposes. The Judge held the tax credits (family assistance) must be reduced to remove the advantage gained under the arrangement.

A further decision relating to this case was subsequently heard to determine the appropriateness of the management fee to be paid to the partnership. No family assistance entitlement would arise if family income was greater than approximately $57,000 for the years in question. The Court suggested a management fee of $48,000, being a combination of a fair management fee and enough to reduce the family assistance to a reasonable level.

Trusts have come under the IRD's radar in recent years due to their ability to distribute income at trustees' discretion, specifically in the high profile TRA decision W33, in which a dentist was employed by a related trust for what was found to be a below-market salary. This case not only covers similar issues, but also family assistance, and it is therefore understandable why the IRD brought the case to the TRA. A reasonable person should question their family assistance entitlement if it is based on an income level that is less than the income on which they are living.

New Zealand Pie

The rules around investing in shares have recently been shaken up to resolve some long standing issues. The changes are intended to remove disincentives to save and also go hand in hand with the introduction of KiwiSaver.

Under the old rules, if a person invested in a managed fund comprising multiple investors, in most cases any gain derived on the sale of the shares would be taxable, but the same gain would not be taxable if the person had purchased the shares

directly (unless the person was either in the business of trading in shares or acquired the shares for the purpose of resale). This distinction arose because a fund actively buys and sells shares and therefore the shares become akin to trading stock in the fund. In comparison, most shares held personally are held on capital account. Disadvantages could also arise using managed funds as they were taxed on income at 33%, compared with income being taxed at personal marginal tax rates (as low as 19.5%) if the investments were held personally.

If a managed fund elects to be governed by the new rules the issues outlined above can be eliminated, since the tax treatment of the fund is broadly meant to be the same as if the shares were held personally. Under the new rules, profits derived by the fund from the sale of New Zealand and some Australian listed shares will not be taxable. In addition, investors can elect for the fund to pay tax on their behalf at either 33% (30% from the start of the 2009 income year) or 19.5% (whichever is applicable) on income attributed to them by the managed fund. Since the fund has paid the tax on the individual's behalf, the investor will not have to include the income in their tax return. Since the income is taxed under the fund, and does not need to be included in a person's tax return, it is not taken into account for family assistance, student loan or child support purposes. An investor may request to have no tax deducted, with the gross amount received. This would be applicable to tax exempt investors such as charities.

Potential investors should carefully consider their own circumstances before choosing to invest under the new rules to make sure there are no unintended results. For example, if a family trust were to invest in a complying managed fund or "portfolio investment entity" (PIE) as they are known, choosing how the investment should be taxed will have implications. If the trust elects for its income to be taxed in the fund, the rate of 33% (or 30% from the 2009 income year) must be used. However, because the income is not treated as trust income for tax purposes, the income cannot be included in the beneficiaries' tax returns and the ability to take advantage of a beneficiary's lower marginal rate will not be available. However, if the trust elected a rate of 0%, effectively choosing for the income to be taxed in the trust, the income will have to be included in either the trust's or its beneficiaries' tax returns. This could result in either the beneficiaries or the trust itself being subject to the provisional tax regime, which could result in interest and penalties, if no provisional tax has been paid.

The new legislation was amended once prior to enactment to iron out some kinks and it would not be surprising if further "tweaks" are made as practical issues are encountered on implementation. However, the new PIE rules are generally taxpayer friendly.

Snippets

Employee Relocation Expenses - Update

In October 2006 the IRD released a draft "Question we've been asked" outlining its view of the required tax treatment of amounts paid to reimburse either existing or new employees for costs incurred to relocate for the purpose of employment. The draft was not well received as it concluded reimbursement payments to new employees would not be tax free to the employee.

A draft interpretation guideline has now been released reflecting this view. Reimbursement payments paid to existing employees for costs such as real estate agents' and solicitors' fees are also considered taxable. In response to the IRD's view, the government has announced that it will introduce legislation ensuring that employee relocation expenses and overtime meal allowances will be tax free. The changes are to apply to payments made over the past four years, as well as to future payments. The exact form of the legislation will become available in due course.

KiwiSaver Enrolments

Almost 213,000 people joined KiwiSaver in its first 3 months of operation, twice the number Treasury expected. Nearly 102,000 people enrolled directly with providers, with 67,000 choosing to enrol via their employers. In addition 44,000 people were enrolled automatically on commencing employment, and 21,000 who were automatically enrolled opted out of the scheme.

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