November 2011

The Client Link

Asset Sales between Associated Parties

Time and again, taxpayers get caught under the associated party rules even when there is a genuine business transaction between the two. For example, where a company is expanding and restructures to house different business streams in different companies which will entail selling assets to the newly formed company; or more commonly, where farming parents are retiring and sell their farm assets to their son/daughter's new entity. In such situations, the parties will be 'associated persons'.

Issue with GST

Where a transaction is between associated parties, the purchaser can claim GST input tax on the **lesser** of:

- The GST component (if any) on the original cost to the supplier;
- 3/23 of the purchase price; or
- 3/23 of the open market value.

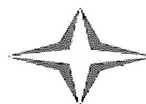
So in our first point, if the market values of the assets sold to a related entity are less than the purchase price, the purchasing company will be able to claim GST input tax on the lesser amount while the selling company will have to return GST output tax on the higher sale price. The net result for a group of companies is that it will be out of pocket while still owning the same assets. The situation could be worse if say in a second situation for instance, the parents inherited the farm assets or purchased them before the introduction of GST legislation in New Zealand. The GST component on the original cost to the vendor will be zero which is the lesser of the three values above and, therefore, the purchasing entity will not be able to claim any GST!

Other Tax issues

The ITA 2007 (section EE 40) limits the depreciation base for the purchaser as well. The purchaser can depreciate the assets on the **lesser** of:

- The purchase price of the assets to the purchaser; or
- The (original) cost of the assets to the vendor.

Taking the farming situation above, if the farm assets are sold at (higher) market values the purchasing entity will not be able to depreciate them at the market values but instead at the original cost of the assets. In addition, the vendor will have depreciation recovery which will be taxable. To illustrate this, let's say the original cost to the parents of a shed was $10,000 which has a depreciated book value of $5,000 but the market value on date of sale to their son's entity is $20,000. The parents will be taxed on depreciation recovery of $5,000 while the son's entity will be able to depreciate the asset only on $10,000 (although $20,000 purchase price is paid). Section EE 40 is an anti-avoidance section designed to stop an associated party from selling at an inflated price to make a huge (tax free) capital gain and to stop the purchaser from using an inflated price to depreciate an asset. Unfortunately, the section also catches unintended genuine transactions, as can be seen from above. This problem can be overcome if the taxpayer makes an application to the IRD requesting it apply its discretion to allow the taxpayer to use the actual purchase cost as the depreciation base. The IRD will look at certain factors on a case-by-case basis before it exercises its discretion. If you believe you are in such a situation, you are better to contact us.



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Trustees Liability

The legal position of a trustee is that they are personally liable for trust transactions.

Often, the trust deed has a limitation of liability clause that is included to effectively provide a trustee (usually an independent trustee) with protection against claims by a beneficiary. The trustee, however, may not be protected when transacting with third parties if a limitation of liability clause is not included in a third party contract.

Just as often, the trustee has a right of indemnification from the trust funds under the terms of the trust deed. Again, the trustee can seek reimbursement only to the extent of the trust assets.

Where a trustee transacts with a third party (even if in good faith), and believes that his liability is limited to the trust assets (which may not be adequate), he leaves himself open to being personally sued in the Courts.

<u>Likewise, trustees are also personally liable for any GST or income tax payable to the IRD by the trust</u>. If the trust funds are exhausted, the trustee may not only be not reimbursed but will also end up with a liability for tax.

In the context of income tax, usually the liability is more likely to arise from accrual income than in the normal course of business. For example, a bank could be owed a debt by the trust that the trust is now unable to repay. The bank may write-off that debt and not be able to seek remedy from the independent trustee due to a limitation of liability clause in the bank documentation. However, the debt written-off may become taxable income resulting in tax to pay. The IRD can recover the tax by suing the trustees personally.

Where that trustee is a family friend, lawyer or accountant, the trustee cannot escape from the tax liability by simply resigning because they are liable for any tax that results from income arising in the year that they were trustees. In the above example, if the trustees had resigned in the year before the bank wrote-off the debt, they may not have been personally liable for tax. The resigning trustees should ensure that the IRD is advised that they are no longer a trustee.

Directors Liability

There are personal risks when a person acts as a company director. It is possible for a director to be held personally liable to the company, the shareholders or to a third party.

A person may become a deemed director if he or she exercises powers as a director or is unwittingly treated as one by being involved with that company or by sitting at the board table (e.g. a shareholder who is not a director). Sometimes a person is only a nominee director but he is still acting as a director and therefore has responsibilities and may be liable for his actions.

It is important for directors (and deemed or nominee directors) to be aware of their obligations. One such obligation is the request to maintain a Directors' Interests Register. Directors must disclose any interest they have in a transaction of the company on the Interest Register.

An interest includes situations where the director is a:

- Party to a transaction in which he or she will derive financial benefit from a transaction with the company;
- Director, officer or trustee of an entity deriving financial benefit from a company transaction; or
- Parent, child or spouse of the party deriving such financial benefit from a transaction of the company.

Regardless of whether or not the interest is disclosed, the company can void the transaction at any time up to three months after the disclosure is made to all the shareholders in the event where the company does not receive fair value for a transaction in which the director had an interest. If a disclosure of the interest is not made, the director could be liable for a fine of up to $10,000. However, the transaction cannot be voided where the company receives fair value.

Where a person is asked to accept a role as a director, it is advisable to require both:

- an indemnity; and
- insurance

from a company before that person accepts a directorship.

An indemnity typically provides that a director will be reimbursed by the company in respect of liability to any person, other than the company or a related company (as defined by the Companies Act 1993), for any act or omission in his or her capacity as company director. However, an indemnity can only be provided by a company if it is permitted by the company's constitution and will not cover all the acts of the director, for example criminal acts or breach of his fiduciary duties as the law does not allow it.

In case of insurance, the company may provide this only if its constitution allows it and the required board resolutions and certificates are signed.

Abolition of Gift Duty

The abolition of gift duty has been legislated and is effective from 1 October 2011. Many people who are owed large debts from their family trusts will be keen on forgiving all outstanding debts as soon as possible. However, it is strongly recommended that they seek their accountant's advice before rushing into forgiving the debt as it may affect their position. Some of the situations to be aware of are as follows:

- You may lose the entitlement to rest home subsidy because the residential care subsidy rules have no time limits to add back gifts made in excess of $27,000.
- If the trust (usually older ones) does not have the donor as the beneficiary, the donor will not have the security of the debt-back if say he wants to continue to live in the trust property.
- Proof of solvency is required at the time of the gifting in case creditors revoke gifting (which can go back up to five years).

Beach Houses

If you are GST registered and rent out your Beach bach (say through "Book a Bach") at Christmas you now have to account for GST on the income etc from 1 April 2011.

If you are in this position if you need clarification please contact us to discuss. If you are in this position you need to consider selling the bach to a non-GST registered Trust or taking similar action.

Donations

With the change in tax rules in allowing taxpayers to claim one third of the amount they donate there are some things to bear in mind:

- must be $5 or more in cash (i.e. not goods).

- If you are making donations in your Will consider making the donation while you are alive so that you receive a rebate from the IRD. Your Estate will not receive a rebate.

KiwiSaver Changes

The three key changes that have been legislated are:

1. The Government's contribution has reduced from $1042 to $521 maximum per annum beginning 1 July 2011 year. However, in order to get the $521 contribution one still has to save $1042.

2. The minimum level of employee and employer compulsory contribution rates has increased from 2% to 3% from 1 April 2013.

3. The employer contributions will be taxable from 1 April 2012. Up until this point the compulsory employer contributions of 2% were tax free, but from 1 April 2012 anybody on the top tax rate of 33 cents in the dollar will actually get only 67% of their employer's contributions paid into KiwiSaver.

Employer contributions

Compulsory employer contributions to KiwiSaver schemes and complying funds are currently exempt from employer superannuation contribution tax (ESCT). A complying fund is a section within a registered superannuation scheme that has incorporated certain KiwiSaver rules – in particular portability and lock-in. Any voluntary employer contributions to KiwiSaver schemes are subject to ESCT. Voluntary employer contributions include contributions you make:

- Over and above the compulsory employer contribution rate;

- To employees aged under 18 or over 65 years (and who have been a member for more than five years)

- To employees on a contribution holiday; or

- To employees who are on leave without pay.

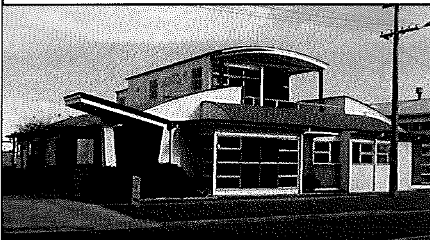
When did you last review your Will ?

Reasons to consider are:

- You may have changed your mind about the Will contents.
- You may have married/divorced or have a new or terminated relationship.
- Changed ownership/business structure or financial position.
- There may be a change in asset/liability composition ownership.
- Family circumstances changed.
- Personal representatives need changing.
- Beneficiaries died or born.
- Laws changed—eg Gift abolition.

Common Will components

- Personal representatives/trustees if continuing estate.
- Burial/cremation & funeral arrangements.
- Clause re - payment of debts, testamentary expenses and taxes.
- Provision for dependents/others.
- Chattels/possessions.
- Organ/tissue donor wishes—leave body for research.
- Guardianship.
- Legacies/Bequests/Gifts to charities.
- Instructions re business continuity/management/governance.
- Residue
- Possible estate & future interests.
- Home occupancy.



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