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# Office Update

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## Paying Income Tax from Trading

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It is well known that the IRD have comprehensive powers to request information for the purposes of enforcing the collection of tax. A recent project by the IRD saw those powers directed at identification of on-line traders (using auction websites such as TradeMe) who collectively had not paid over \$1.2 Million of tax over the past three years.

The IRD website advises that as a "general guide", business income from trading online should be declared (and taxed) if:

- the goods were acquired for the purpose of on-selling,
- the purpose of the activity is to make a profit, or
- the business involves dealing in these goods.



It is important to note that, despite the fact that the IRD's message is specifically in the context of on-line trading, the same principles can be applied to all types of trading activities.

Irrespective of what a person is doing, whether it is on-line or otherwise, the IRD is likely to apply one of two criteria, namely:

- have goods been purchased with a purpose of resale, or
- does the level of activity indicate that a business exists.

If either criterion applies all profits from the trading are taxable.

In order to determine "purpose", the IRD is likely to rely on documentary evidence. Without evidence it becomes an argument over a person's intention, which is difficult to establish at the best of times. If a person does not have a purpose of resale the IRD could instead argue that a business exists, which case law has shown can be proven on the facts of a particular case. As stated in the Court of Appeal decision of *Grieve v Commissioner of Inland Revenue* in 1984, "whether a business existed turned on the intention of the taxpayer as evidenced by his conduct".

In the *Grieve* case the taxpayers had to prove that their farming activities were a business in the 1976 and 1977 income years, even though it had been operating at a loss. The result was a thorough analysis of what, in the context of the Income Tax Act, is meant by the term "business". The tests arrived at by the Court are:

- statements by the taxpayer as to intention
- the nature of the activity
- the period over which the activity is engaged
- the scale of operations and the volume of transactions
- the commitment of time, money and effort
- the pattern of activity
- the financial results
- whether the activity is run in the same way as other businesses in that particular trade

It is better to consider the tests above, reach your own conclusion and gather evidence that a business exists, before the IRD come knocking on your door.

## 2010 Budget Personal Income Tax Cuts vs GST Increase

Income \$	% Now	% from 1//10/10
\$0 - \$14,000	12½%	10½%
\$14,001 - \$48,000	21%	17½%
\$48,001 - \$70,000	33%	30%
\$70,001 plus	38%	33%

When we analyse the Income Tax Cuts of 1 October 2010 they appear generous, however, if you factor in the GST increase, the IRD will claim back a large percentage of the tax you saved.

### For example:

Assume you earn \$80,000 Gross per annum and have mortgage payments of \$15,050 per annum.

	Was	New	Difference	
			Per Annum	Per Week
Your Nett Earnings	60,050	62,680	2,630	50
Less Mortgage/Savings	15,050	15,050		
Available for Spending	45,000	47,630		
GST Portion of Spending	5,000	6,213	(1,213)	(23)
Spare Money from Tax Cut			\$1,417	\$27

## GST Increase – Be Prepared

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As a business owner/operator it is worth taking the time to consider what effect a GST increase will have and what planning can be done to minimise any disruption.

The change in the GST rate should be considered from various angles. There is the mechanical aspect, i.e. the methodology of preparing and filing a GST return through the “change” period. Also, the behavioural aspect, such as, will the rate increase affect patterns of supplier and customer behaviour? Finally, there are other points, including cash flow issues, that will be helpful to keep in mind. The following looks into these various aspects.

If a GST rate increase comes into effect part way through a business's GST period, two GST returns have to be completed. For example, with the rate increase expected to be effective from 1 October 2010, a GST return that ordinarily covers the two month period ending 31 October 2010, will need one GST return for the month to 30 September and another for the month to 31 October.

The process of transitioning to the new rate varies depending on whether a person is on the payments or invoice basis.

**Payments basis** - debtors and creditors existing at the time of the change are subject to a notional 2.5% conversion and then all payments or receipts are subject to 15%. The notional conversion has the effect of deeming payments or receipts relating to transactions prior to the rate increase to be at a net 12.5%.

**Invoice basis** – the transition process for those working on an invoice basis may be more complicated. Most accounting packages are set up with a default GST rate of 12.5%. However, in various circumstances an accounting package will need to simultaneously cater for GST at 15% and 12.5%. For example:

- Purchases subject to GST at 12.5% may be claimed after the rate increase, along with other purchases that are subject to GST at 15%, or
- Credit and debit notes need to be issued or are received at the old rate because of when the original supply took place.

As this transition process is potentially complex, it is advisable to seek guidance from an accountant so that it is navigated correctly.

Systems set up to automatically code repeat transactions will need to be reviewed or switched to manual coding during the transitional period. If an accountant is completing the GST return(s), the client will need to specify which rate applies to every transaction, especially in the periods immediately after the change.

It is likely that businesses will experience an increase in sales to consumers prior to the increase coming into effect. This increase in activity could be in the form of purchases, purchase arrangements where the old rate is "locked-in" or the pre-payment of recurring expenses. Where possible steps should be taken to meet, or take advantage of this demand.

Other points to keep in mind include:

- Reviewing contracts with suppliers and customers to confirm that the effects of the rate change will be neutral. Generally, the GST Act deems a contract to be altered to align with a GST rate change, unless the contract specifies otherwise, or the contract is entered into more than three months after the rate increase.
- Increasing the amount of a deposit when selling large value assets to avoid having to fund the GST output liability to the IRD prior to full payment being received.
- The increase from 12.5% to 15% represents a 20% impact on cash flow when waiting for a GST refund to be released by the IRD.

As it is widely anticipated that the change to the GST rate will take place later this year, planning should be undertaken now to determine if your business and your GST return process are properly geared up for the transition and new GST rate. It may be helpful to consult an accountant to enable a smooth transition.

## Cash Flow Forecasts and Budgets

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It is often said that "failing to plan is like planning to fail". In today's economic climate the need to plan is critical to the ongoing success, and in some instances survival, of your business. Two effective tools for planning are budgets and cash flow forecasts.

A budget encourages you to look forward and forecast what your income and expenses will be for the upcoming year. Once the budget is set, regular comparisons against actual performance will enable you to investigate any variances and take action where necessary. This pro-active approach will help you to make informed decisions.

The budget can be used to help you start planning for your cash commitments. However profitable your business may appear to be, cash is still the lifeblood of any organisation. Common questions asked by business owners are, "if the business made a profit for the year why does the bank balance not reflect this?" and "where has the money gone?" Unfortunately sales do not always equal cash and this can make it difficult when it comes time to pay the bills. Collection of cash from customers can at times prove challenging. Likewise, business owners need to be able to live, and often drawings are overlooked when it comes to cash management.



A cash flow forecast enables you to anticipate any shortfalls that may occur and to make plans accordingly. For example, if it looks like cash is going to be tight when a taxation payment is due, there are various options available to you to minimise underpayment penalties and interest – whether it be organising a payment plan with Inland Revenue or purchasing tax from a tax intermediary. The cash flow forecast can also indicate whether you may need to review your current banking arrangements. Perhaps you may need to re-negotiate payment terms with your suppliers or introduce measures to encourage debtors to part with their cash earlier, such as early payment discounts or penalty interest for late payments.

Regularly reviewing your liquidity and where your business is at financially will also mean that when the bank manager requests this information you have it on hand. As banks are becoming more cautious with their lending, there has been an increase in the request for up-to-date financial information. If you are able to produce budgets and cash flow forecasts for your bank manager in a timely manner it demonstrates you have a good grasp on the financial state of your business. Of course the quality of this financial information is crucial. It would be a wise move to engage an accountant to assist you with this process.

There are numerous tools that can be used to prepare budgets and cash flow forecasts, whether they are part of your current accounting system, an excel spreadsheet or a more sophisticated specialist piece of software. What is important is that they do become an integral part of your business planning.

## Company Salaries - Cause for Alarm

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Whether a trust or company is required to pay a fair market salary to an associated employee has received considerable attention in recent years. Another case involving the issue was recently heard by the Taxation Review Authority ('TRA'), but the decision included a statement that may start alarm bells ringing.

The case involved a husband and wife who re-structured their activities to operate through a company. The wife was an anaesthetist working part-time in the public sector and also part-time on a private basis through her family trust. The husband operated a quality assurance business. The pair ceased to be self employed in 2002 and were instead employed by the company. The family trust acquired two orchards in 2002 – one from the husband and wife and the other from a third party. The company operated the orchards by leasing both the orchards and equipment from the family trust.

Prior to the restructure, the wife's public sector income as an anaesthetist was approximately \$120,000 per annum. After the re-structure, the company barely made a profit due to losses incurred by the orchard business. Due to the low profit, salaries attributed to the taxpayer were either very low or non-existent during the years in dispute.

The IRD argued that the rent from the leasing of the orchards and equipment that was paid to the family trust was too high, and that the salary paid to the taxpayer was commercially unrealistic, i.e. too low.

In relation to the rent paid to the family trust, the Judge found that though it seemed a little high, the accountant had taken a fairly sensible approach to fixing the orchard rental, and the Judge could not find evidence that there was anything artificial or contrived about the fixing of the rent.

When looking at the salaries paid to the taxpayer however, the Judge found this case to be straightforward. He was of the opinion that the taxpayer had entered into an artificial, contrived and uncommercial arrangement. The Judge agreed with the IRD that the structure was used to significantly reduce the taxpayers income tax liability from personal exertions, while retaining full control and benefiting from the income. This arrangement therefore amounted to tax avoidance.

In the Judge's view, the only reason someone would agree to take such a significant reduction in income was that the income was controlled by a related entity and was still available to them or their family in some other way.

The Judge acknowledged that the same result could have been achieved by paying a fair market salary and electing for the company to be an LAQC or through the use of a partnership. The Judge also commented that a fair market salary could have been payable by the company if it had borrowed against future profits, in effect, causing the company to incur tax losses to be carried forward for future years.

Surprisingly, the High Court decision in the *Penny & Hooper* case was not discussed, which found in favour of the taxpayer on the market salary issue. The High Court decision was appealed and the Court of Appeal's decision is currently due to be released. If the Court of Appeal rules in favour of the IRD the TRA decision above is worrying because it is the first time the Authority has taken the view that a company should incur a loss in order to pay a fair market salary and it could be seen as a further movement of the tax avoidance boundary.



## ACC and You

ACC provides 24/7 personal injury cover for everyone in New Zealand. So whether you have an accident in the workplace, home or on the road, you have the peace of mind to know that you are covered.

If you're self employed, your personal injury cover is one of the most important business asset you will have, as it gives you peace of mind should the worst happen and you end up having to take time off work.

If you're injured and unable to work, under your default injury cover ACC CoverPlus, you will be able to receive up to 80% of your previous year's income. So if your income stays the same year-in, year-out or if last year's income was good, ACC CoverPlus should be sufficient.

But what happens if:

- Your income fluctuates and last year's earnings were poor?
- You're just starting out in your own business and have no income history?
- Your personal income is not a true indication of your true earnings capacity because you're splitting income with a partner or spouse?

### **ACC CoverPlus Extra**

ACC CoverPlus Extra works differently. If you are injured and have to take time off work, you are guaranteed a pre-agreed level of income regardless of how much you earned in the previous year.

As this amount is pre-agreed, there is less paperwork required at claim time, which means faster payments. And unlike ACC CoverPlus, your payments remain fixed at the pre-agreed level, regardless of whether you have returned to work on a partial basis.

Here are some examples of how ACC CoverPlus Extra has worked for these self-employed people.

Jeff is an owner/driver earning \$55,000 a year; Kelly does the bookwork and answers the phone. Their income is split 50/50 so with standard CoverPlus Jeff will only receive \$22,000 in lost earnings cover if he is injured. And Kelly's lost earnings cover is too high at \$22,000 also. Using CoverPlus Extra they can adjust the sum, so if Jeff has an accident their weekly payments will cover their living costs – say \$33,000 for Jeff and \$18,720 for Kelly (the minimum).

Mike started his own business six months ago and filed an IR3 showing a loss in his first part year. He then suffered an injury, which meant he needed four weeks off work. But as he made a loss in his first year, he's only eligible for the minimum weekly compensation. If Mike had taken up ACC CoverPlus Extra before his injury, he would have received a pre-agreed amount of weekly compensation that more accurately reflects his outgoings and allows him to keep his business running.

### **For further information:**

Visit ACC's website	<a href="http://www.acc.co.nz">www.acc.co.nz</a>
Agents and advisors	0800 222 991
Self-employed	0508 426 837
Employers	0800 222 776
Claims	0800 101 996



**If the money you earn each year fluctuates,  
you need ACC CoverPlus Extra**

## **ACC Workplace Safety Discounts.**

Workplace Safety Discounts is a great new way to save 10% off the work levy for some small businesses and self employed people who can show sound health and safety practices. Using good health and safety management practices not only helps you and your employees to avoid injury, it can also help you avoid the cost and hassles that usually come with it, such as staff absence, reduced productivity and official investigations. The average lost time injury costs a business is \$4000.

Currently the programme is available in agriculture, construction, fishing, forestry, motor trades and road transport and waste industry.

### **How much is the discount?**

The discount is 10% of the work-related component of your levies. The total amount of the discount will depend on the levies you pay. The discount applies for three tax years from the date your application is accepted, although you'll be required to complete an annual declaration during that time to confirm your details. You'll also be playing a valuable role in keeping injuries out of your workplace.

### **How do I qualify?**

To be eligible you need to be self employed or a small employer with an annual payroll of \$450,000 or less and 10 or fewer full time employee equivalents. You will need to show you have capability in health and safety management. This generally means completing a FREE industry specific training course and a self assessment booklet and returning to ACC.

### **How to apply**

To check out training providers or download a self assessment booklet simply go to [www.acc.co.nz/wsd](http://www.acc.co.nz/wsd). Once your application is received ACC will review it and notify you.

## **Ensuring Financial Security when Injury Strikes**



Some small business owners and self-employed people may not appreciate the financial impact an injury can have on their business, especially if they have to take time off work to recover. But, if the worst happens, a range of assistance is available.

ACC provides comprehensive, 24/7 personal injury cover on a no-fault basis for everyone in New Zealand. This means that if you are injured at home, on the road or at work, you are eligible for ACC cover.

All business owners are legally required to provide ACC cover for work related injuries. For businesses with employees they are covered by ACC Workplace Cover. This provides personal injury cover for business owners and their employees, so if the business owner or a staff member is injured at work and needs time off, they are eligible to receive medical treatment, rehabilitation and weekly compensation of up to 80% of their regular income.

### **But what about self-employed people?**

All self-employed people are automatically covered by a product called ACC CoverPlus. Under CoverPlus, weekly compensation is based on a person's declared earnings during the previous year and they can be eligible for weekly compensation of up to 80% of those declared earnings. This however could be reduced if the business continues to generate income.

But what if a person's income varies from year to year? Or if they haven't been self-employed for very long?

For these people, there is another option – CoverPlus Extra. This product gives self-employed people the ability to negotiate an amount of personal injury lost earnings\* cover to the level they and their family require.

So, if someone with CoverPlus Extra is injured, they already know how much they are entitled to without having to prove their last year's earnings. The individual will receive 100 per cent of the agreed weekly compensation, right up to the point when they are deemed fully fit, and this stays the same should the business continue to generate income.

Here's an example of how CoverPlus Extra might work for a self-employed person:



Sally is a mother of two small children, and runs a small accounting business from home. This year Sally expects to earn about \$55,000 from her accounting work, income that is crucial to supporting her family and contributing to mortgage payments on the family home. However, because Sally started her business last year when the needs of her children were greater, she only earned about \$40,000.

Because Sally's income was lower last year, if she sustained an injury that prevented her from working she would be entitled to a maximum of about \$615 a week (before tax) under CoverPlus. This would be significantly lower than the \$850 a week she would have expected to earn. But if Sally had CoverPlus Extra, she could negotiate the level of compensation required to support her family and continue to contribute to the mortgage.

On the flip side, CoverPlus Extra also allows self-employed people to reduce the 'premiums' or levies they pay by negotiating a weekly compensation rate lower than their anticipated income. An example might be a dairy farmer who currently has very high earnings (over \$100k) and wishes to negotiate cover at a more suitable level of \$45,000.

### **Isn't this the same as income protection insurance?**



No – it's more than that. ACC provides financial assistance in the event of an injury, but also assists with medical treatment and rehabilitation, helping get people back to work, and earning regular income as quickly as possible.

Income protection insurance will cover a person in the event of illness and is something ACC encourages businesses to invest in, as it provides the person with the peace of mind to know that financially they will be covered should they become ill; however it may not assist them with their medical treatment or rehabilitation.

ACC cover, combined with income protection insurance, ensures the person is provided for financially if an injury or illness prevents them from working, and ACC's cover helps ensure the person receives the right medical treatment and rehabilitation to get back to normal life. Depending on the individual's income protection insurance policy, the insurer may top up their ACC compensation to a pre-arranged percentage of their income.

### **How are ACC levies calculated?**

For the self employed, all ACC levies are calculated using the individual's "liable" income – which is basically their total declared income minus expenses – and the type of business activity they are engaged in. ACC levies vary according to the type of business activity or industry the business operates in due to the different risks associated with various types of work.



Additionally, CoverPlus Extra levies also take into account the amount of compensation agreed with the individual, the difference between the person's normal entitlement rate and their chosen weekly compensation payment, as well as the agreed business classification of the person's business activity.

For more information about ACC CoverPlus and CoverPlus Extra, contact ACC on 0508 4COVER (0508 426 837), or visit [www.acc.co.nz/cpx](http://www.acc.co.nz/cpx) to apply online. Or you can contact Business Relationship Manager Andrea Coles on :email [Colesa@acc.co.nz](mailto:Colesa@acc.co.nz), phone 07 957 6190 or mobile 027 233 5032.



\*Terms and conditions apply

## Snippets

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### **IRD Recording Interviews**

The IRD is increasingly conducting interviews using audio recording technology, and has recently sought feedback on its Standard Practice Statement (SPS) for recording interviews with taxpayers.

It is important to note that most interviews are voluntary. The only exception is a compulsory interview under section 19 of the Tax Administration Act (provision for the IRD to require a person to give evidence). These are always electronically recorded, using video recording technology in appropriate cases, and the interviewee's consent is not required. However, attendance by the taxpayer at initial investigation meetings and follow up meetings is generally voluntary in nature.

Excluding section 19 interviews, a taxpayer will be asked before the interview if they consent to the interview being recorded. The taxpayer has the right under the Privacy Act 1993 to not consent to the interview being recorded. The reasons behind the refusal are not important and the taxpayer is not required to justify their decision to refuse. The draft SPS advises that the IRD will respect the taxpayer's decisions.

### **KiwiSaver and Business Transfers**

On the sale of a business from one company to another, or when companies amalgamate, existing employees are often employed by either the purchasing or amalgamated company. Typically, automatic enrolment into KiwiSaver occurs on commencement of new employment. However, this type of situation is excluded from being treated as "new employment" for KiwiSaver purposes.



Specifically, "new employment" does not include situations where the employee remains on the same payroll or where an employer carries on the "same business", as long as the employee was previously employed on that payroll or in that business. The "same business" is defined as a business that in substance carries on the same or a similar role and includes an amalgamated company or a business taken over as a going concern.

## EFTPOS Facilities

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Due to increased demand and to improve our services further, we are proud to announce that we now provide EFTPOS facilities to our customers. So if you wish to pay your fees using your cards then we will be happy to assist you with this new facility.



## WE HAVE A FANTASTIC HUGHSON & ASSOCIATES WEBSITE

Check it out on [www.hughson.co.nz](http://www.hughson.co.nz)

If you have any questions about the newsletter items,  
please contact us, we are here to help.  
(06) 278 4169 or [services@hughson.co.nz](mailto:services@hughson.co.nz)



### **An Accountant Dies and Goes to Heaven**

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He reaches the pearly gates and is amazed to see a happy crowd all waving banners and chanting his name.

After a few minutes St. Peter comes running across and says, "I'm sorry I wasn't here to greet you personally. God is looking forward to meeting such a remarkable man as yourself."

The accountant is perplexed. "I've tried to lead a good life, but I am overwhelmed by your welcome," he tells St. Peter.

"It's the least we can do for someone as special as you are. Imagine, living to the age of 123 and still looking so young," says St. Peter.

The man looks even more dumbfounded and replies, "123 years old? I don't know what you mean. I'm only 40."

St. Peter replies, "But that can't be right - we've seen your time sheets!"