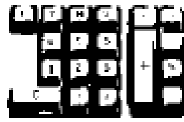

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NEWSLETTER

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Remuneration Reviews

Over recent months a growing number of organisations have stated that they are not going to give pay increases because of the current economic uncertainty. Many of these statements have been made by organisations paid for by our taxes and local government rates, and it is appropriate that they should be circumspect with pay increases when such a large number of people are struggling financially. In contrast, we have seen the US Congress legislate to prevent bonuses being paid to managers of companies that were being bailed out by the US Government. This begs the question of what sort of pay increases are appropriate and what review process should be undertaken in the current economic climate.

Most individual employment agreements have a requirement for remuneration to be reviewed at least annually. A review normally takes into account the movement in the Consumer Price Index ('CPI'), wage movements either generally or for the specific field of work, changes in duties, and performance in the job.

Some employment agreements state that an employee will be paid based on market rates. To assess market rates properly, the employer would need to undertake a formal evaluation process, which may not be simple. If a formal evaluation is required, it would be common to seek advice from human resource professionals, who use structured evaluation tools to compare the "job" in question with other jobs of a similar size in the same (or similar) field.

Some employers may contact a human resource professional and ask for 'ball park' figures on market rates for remuneration. These employers need to keep in mind that if they do not want to invest in a proper evaluation process, and only want a 'ball park' figure for comparable remuneration, they will only get a 'best guess'. No actual comparisons with similar jobs or fields will have been carried out to get the 'ball park' figure. The value of the 'ball park' estimate would be, at best, questionable in a remuneration review process. In some instances, employment agreements will state that the annual pay review will reflect the movement in the CPI, or tie it to market rates. With this type of agreement, the employer is

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obliged to provide a pay increase that reflects the CPI or market rates, as the case may be. But remuneration cannot be reduced if the CPI is negative! The only acceptable reasons to withhold an increase in these circumstances would be where the employment agreement specifies that the company's financial situation must be taken into account or because of poor performance from the individual. If it is the latter, the poor performance would need to be well documented if a pay increase is to be withheld.

Therefore, it would be advisable, especially in present times, to ensure that a robust remuneration review process is undertaken and documented, in order to minimise any likelihood of disputes if the pay increases (or lack thereof) do not meet employee expectations.

IRD Lays its Cards on the Table

The IRD has released a report that sets out the areas of its compliance focus for the 2009-10 year. The report reflects the IRD's intention to be open and transparent about the compliance matters that are of concern to the Department. The IRD believes this will enable people and businesses to better understand areas that will be targeted and hence result in better overall compliance by taxpayers.

Small and Medium Enterprises (SMEs)

There are 665,000 businesses in New Zealand with an individual turnover of less than $100 Million. It is not surprising that given the current economic times the IRD intends to focus on helping businesses avoid getting into debt with the IRD, and if they do, intervene earlier with direct contact. The IRD also intends to enter into agreements with tax authorities in other jurisdictions to recover unpaid tax from New Zealanders living overseas.

New Zealand's "hidden economy" will also be pursued with attention focused on the following specific areas:

- GST fraud involving the use of fictitious identities and false documents
- Agricultural and horticultural contractors - they will continue to be targeted as has been the case for a number of years
- Illegal activity in the form of organised crime and complex fraud, which is expected to increase
- E-commerce involving on-line sales transactions
- Income from property transactions focusing on property traders
- Income from offshore investments, and
- Artificial losses that may be exaggerated or artificially generated.

The IRD appears to be broadly adopting a two pronged approach, through increased information being provided to the public and through specific targeted actions, such as research and intelligence gathering. For example, with respect to property transactions the IRD has identified that many taxpayers are unaware of the obligation to pay tax on certain transactions, rather than deliberate non-compliance. The IRD intends to increase awareness through its "IRD Guides", on-line property related tools, advertising, revenue alerts and working with intermediaries and interest groups such as real estate agents, so that these groups can pass information on to the taxpayer. The report does not go into detail on how it will target property traders; this is probably so that it can protect its methods.

The report also advises that an investigations project has been launched focusing on the hospitality industry. Many businesses in this industry deal mainly in cash, and therefore have greater incentive and opportunity to understate income or overstate expenses. It has been identified that businesses that are non-compliant for tax are more likely to be non-compliant in other areas, so a cross-check will be done with data from local authorities about compliance with local government regulations, to identify prospective audit targets.

Employers

The IRD intends to focus on employers who are not registered for PAYE that should be and ensure that employers file their PAYE returns electronically if required, and that their returns are filed on time.

Individuals & Families

The IRD administers a number of different programmes, two of which are Working for Families and Child Support. Problem areas that will be targeted include families that receive too much family support, whether accidentally or deliberately, and people who try to avoid paying Child Support.

With respect to Working for Families, the IRD intends to contact new recipients and those who are at risk of receiving an over-payment (i.e. seasonal workers or self employed), to clarify their family and income details. Online services will be improved, so that recipients can view and update their information as needed. Where fraud is detected shortfall penalties or prosecution may occur.

Administrative reviews will be undertaken around Child Support payments, so that individual circumstances are taken into account as far as the law allows. Agreements are being looked at with other countries to make it easier to collect Child Support payments for parents who reside overseas. The possibility of paying by credit card over the phone is also being looked into.

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It is expected that with the removal of the donations rebate threshold, fraudulent donations claims are likely to increase. The IRD intends to provide information to individuals and charitable entities about how much may be claimed and continue to identify fraudulent donation rebate claims.

Other topics covered in the report but not discussed above include high wealth individuals, large enterprises, non-profit groups, and tax agents.

Employees of Companies in Liquidations, Receiverships and Voluntary Administrations

Given the current number of employers facing financial difficulties at present, it is timely to consider employees' rights when their employer faces formal insolvency procedures.

Upon the commencement of a liquidation, employment is automatically terminated. A receivership differs in that employment does not cease automatically upon appointment of receivers. Receivers have 14 days within which to terminate employment. If employment is not terminated during this period the receiver will become personally liable for any salary or wages accrued from the date of their appointment. An administrator also has 14 days to terminate employment agreements, much like a receivership.

Employees' claims ranking

Generally, employees' unpaid wages, holiday pay and redundancy payments rank as preferential creditors in a liquidation or receivership, ahead of the IRD's preferential claim and only behind the liquidator's fees and costs. However, directors' and some related persons' claims for such entitlements are specifically excluded from being a preferential entitlement.

There is no set ranking of creditor claims when a company is placed into voluntary administration. The priority of employee claims, if any, would be set out in the Deed of Company Arrangement ('DOCA') prepared by the company's administrator. The DOCA is a document typically detailing a restructuring plan for the company. Generally, the statutory priority afforded employees in liquidations and receiverships will be reflected in the DOCA.

Employee preference over a secured creditor

In a liquidation or receivership where a creditor holds a General Security Agreement over a company, preferential claims, including employees' preferential claims, will rank ahead of that creditor in respect of the realisation of the company's accounts receivable and inventory. Creditors with a security registered specifically over accounts receivable and/or inventory (as a Purchase Money Security Interest), however, will be entitled to these realisations ahead of a preferential creditor.

Continuing to trade whilst in liquidation, receivership or voluntary administration

If a liquidator, receiver or administrator can extract additional value from the sale of a business as a going concern, staff will generally need to be retained. Similarly, if the business cannot continue to trade but retention of some (or all) of the staff will preserve the value of the assets and increase realisations, then employment during liquidation, receivership or administration will need to be undertaken.

If the business is to continue trading, the liquidator, receiver or administrator will need to identify and employ the staff required to service the business and enhance its desirability to any potential purchaser.

If the services of employees are still required a new employment agreement will be entered into with each employee they wish to retain. A post liquidation/receivership employment contract does not affect the employee's rights in respect of the prior contract. For example, if they are entitled to a redundancy payment under the pre-existing employment agreement with the company, any subsequent employment by a liquidator or receiver will not affect that entitlement.

Conclusion

Employees' claims in respect of certain entitlements rank highly in a liquidation or receivership, in some circumstances even taking preference over a creditor who has a valid security interest. The decision to retain staff is not one taken lightly by insolvency practitioners and is generally undertaken in order to maintain the integral value of a business and maximise realisations.

Income Protection Insurance - the Deductibility is in the Detail

It is well known that premiums on income protection insurance policies are a deductible expense. However, the scope of what is considered income protection insurance is narrower than most people think, and the decision to claim the premium paid is often mistaken.

The most common error is mistaking personal sickness or accident insurance for income protection insurance. In reality there is a definite line between the two, and different tax treatment is needed for each.

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Income protection insurance policies are subject to tax in the sense that the premiums are deductible and receipts are assessable. Premiums paid under personal sickness or accident insurance policies, on the other hand, are not deductible and receipts are not assessable. The specific details of the policy must be analysed before the decision in relation to deduction is made.

If the benefit payable under an insurance policy is tied to a person's pre-disability income it is likely the policy will qualify as an income protection policy. There may be a minimum or maximum benefit payable; this will not affect the policy being classed as income protection insurance. However, if a policy provides that the recipient will receive a fixed amount upon injury, it is unlikely to qualify as an income protection policy. For example, a self-employed person earns $60,000 per year and, to protect his income in the event of injury, acquires insurance for that amount.

This will not qualify as income protection insurance as the benefit is not calculated with reference to earnings or profits lost as a result of the injury. It is not enough that at the time the policy was drafted the payment was based on the insured person's earnings, or that the payment will change in line with the Consumer Price Index (CPI).

A common error is for a policy to be referred to as income protection, even by an insurance company, even though it does not meet the requirement above, leading to deductions being incorrectly claimed. To rely on the title of the policy alone is not sufficient to determine if the premiums are deductible. It is the detail within the policy that determines the nature of the insurance. If you are claiming deductions for income protection insurance it may be worth checking that the policy benefit rises and falls in line with changes in your income.

Fines and Penalties

It is a common occurrence for businesses to pay fines. Many businesses view fines as a part of doing business. The question is whether these fines are deductible for tax purposes.

Consider the following scenarios:

- A courier driver receives a speeding ticket while delivering a parcel.
- A car dealer advertises his business by parking cars on the road-front and receives a parking ticket.
- A TV broadcaster has been investigating a particular crime and is subsequently fined for not providing the police with the name of an informant in respect of the crime.

Should the fine or penalty imposed be deductible? The IRD has recently released an exposure draft in which it outlines its position on the deductibility of fines and penalties. The IRD's view is that fines and penalties, even if incurred to derive income, are not deductible. The exposure draft states that fines and penalties are not deductible in New Zealand irrespective of whether:

- the infringement for which the fine or penalty is imposed forms part of criminal proceedings
- the fine is imposed by a court or another body
- the fine is imposed on the taxpayer, its employees, or third party contractors
- the taxpayer intended to break the law, or
- the fine is imposed in respect of a strict liability offence.

Most fines and penalties will be non-deductible on 'public policy' grounds. Public policy is based on the premise that the law should serve the public interest and that it is not in the public's best interest to allow a deduction for an expense, which in reality is a consequence for wrong-doing.

The issue was recently considered by the Taxation Review Authority ('TRA') in Case Z6 which involved a transport company that was fined for the alleged overloading of trucks. The TRA decided in favour of the IRD because an action that is in breach of the law is not within the permitted scope of the business and therefore cannot have a sufficient relationship with earning the taxpayer's income.

Past case law has commented that a fine could be incurred to derive income and could therefore be deductible, such as when a courier driver who is required to deliver an urgent package receives a speeding ticket. However, the Courts and the IRD have placed greater weight upon the public policy approach when disallowing the deductions. By allowing a deduction, businesses receive what is essentially a subsidy (by way of income tax benefit) for an action that is deemed punishable by way of the fine or penalty. The ability to claim a deduction for fines or penalties may encourage lawbreaking (which is not in the public's interest) and the view that such lawbreaking is a legitimate business option, especially if it results in deductibility.

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Snippets

“The Free House” wants Tax-Free Beer

An online petition launched by a Nelson pub, “The Free House” urging the Government to exclude boutique breweries from the one size fits all approach to the application of excise tax on alcohol, is gaining momentum both nationally and internationally. The Free House serves craft beer and its petition has been signed by craft beer fans from as far away as San Francisco. The petition comes in the wake of the Law Commission’s recommendations that raising the price of all alcoholic products could be part of the answer to hedging New Zealand’s binge drinking culture. Boutique breweries make up less than 3% of the total market for beer. Given the relatively small number of boutique brewers, the tax breaks would have little effect on Government coffers, is the argument by the Free House. Will the petition be successful? Watch this space.

Mortgages and Residential Properties in Australia

Generally, if a person pays interest to an overseas party, the person must deduct Non-Resident Withholding Tax (‘NRWT’) from the interest payments and pay the NRWT to the IRD. The IRD has recently clarified its position on whether New Zealand residents who borrow from Australian banks to purchase investment properties in Australia should be liable for NRWT on the interest payable.

To establish if NRWT needs to be deducted from interest payments made to Australia, the first question that needs to be asked is whether the lender trades in New Zealand?

Scenario 1: *Funds are borrowed from an Australian bank which has operations in New Zealand.* If the mortgage is with an Australian bank which also operates in New Zealand, then the New Zealand resident borrower will not be required to withhold NRWT.

It is important to note the difference between a bank operating in New Zealand compared with a bank owning a subsidiary company in New Zealand and trading via that separate subsidiary company. Most of the big Australian banks in New Zealand operate through separate subsidiary companies. If the funds are borrowed from the New Zealand subsidiary, NRWT deductions will not be required. If the mortgage is with an Australian parent, NRWT may still apply.

The second question to answer is whether the investment property or properties are managed from Australia?

Scenario 2: *Funds are borrowed from an Australian bank which does not have a branch in New Zealand.* If the property or properties are managed directly from New Zealand, NRWT must be deducted from interest paid to the Australian bank. If there is a property manager based in Australia who is a manager only for the particular New Zealand borrower (i.e. not in the business of managing properties) and is able to act on the borrower’s behalf in relation to the property NRWT will not be required. But, if the property manager operates an independent business looking after various properties then NRWT is likely to apply.

If you have any questions about the newsletter items,
please contact me, I am here to help

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