NEWSLETTER

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Short process rulings

It is inevitable that at some stage a person will undertake a transaction where the applicable tax treatment is complex or unclear. This could be due to a complex factual scenario, new legislation, new Inland Revenue commentary, or the existence of complex or poorly drafted legislation.

An option to mitigate risk and acquire certainty is to apply to Inland Revenue for a ruling in which Inland Revenue agrees, on a binding basis, how the law will apply to a specific situation. There are a few different types of rulings. Prior to 1 October 2019, businesses would typically apply for a private binding ruling. However, with an Inland Revenue cost of around $10k - $20k (depending on the issue), plus advisor fees to prepare the application they are more commonly acquired by large businesses or wealthy individuals and involve large tax amounts.

This changed from 1 October 2019 when the 'short-process ruling' was introduced – these make for an interesting proposition.

Inland Revenue charge a set amount of $2,000 for a short process ruling. This makes the cost very reasonable and in some cases could be less than what a tax advisor would charge to advise that a matter is unclear.

There are eligibility criteria to satisfy:

- The applicant must have an annual gross income of less than $20m.
- If the applicant is a company, that is a member of a group of companies, the gross turnover of the group must be less than $20m.
- The tax involved in relation to the subject of the short-process ruling must be less than $1m.

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There will also be the cost of preparing the application and responding to any questions Inland Revenue raise as they work through the matter. But overall, the cost and the process is not onerous.

This only leaves the question of whether to apply for a short process ruling. There are both strategic and emotional elements to this question.

If the question is whether a tax deduction is available for a particular expense, a person has the option of taking the deduction anyway, knowing it is unclear, and knowing Inland Revenue may challenge it if they identify it. That is an ordinary commercial decision. However, a short process ruling application may be successful and will provide peace of mind that the deduction can be claimed and cannot be challenged later. The downside though, is that if Inland Revenue take a conservative view of the law they may decide the tax deduction is not available. Now in that scenario a person could withdraw the ruling and take the deduction anyway, but the deduction is being taken with the knowledge that Inland Revenue disagree and there may be a greater risk of review by virtue of the short process ruling being applied for in the first place.

Notwithstanding the pros and cons of applying for a short process ruling, they provide a very cost effective way to resolve uncertainty and should always be considered an option.

Inflation pricing pressures and consumer engagement

From initial fears of a prolonged economic slump due to Covid-19, the global economy has seen a resurgence led by unprecedented demand. To experience such strong activity following months of lock-down where key industries cut back on activity to reduce costs, a backlog has been created such that global supply chains may take years to catch-up. Coupled with skill shortages across all industries, the past 12 months have seen inflationary pressures reach a new high for the 21st century.

Faced with increasing input costs, businesses have had little choice but to pass these costs on to consumers. Price increases are however an uncomfortable conversation in all business settings. How much of this cost can the business assume? How will consumers react? What are our competitors doing? These are just some of the questions to cause a headache. Moreover, with the power of social media, consumers can have more of a say on price surges than ever before. Hence, the reaction of consumers and the impact on business reputation can have long term consequences if changes are not communicated clearly.

Considering the consumer reaction to price rises, businesses must evaluate how the long-term impact on customer relationships will be managed. With the increased emphasis on environmental, ethical, and social factors impacting a consumers decision making process, society values transparency and businesses who maintain a strong dialogue with the community in which they operate. An open dialogue explaining the reason why prices are increasing will more likely assist with a consumer associating themselves strongly with the business and made to feel an integral part of its success. In a volatile market, poor communication poses the greatest risk to a customer switching to a competitor. Not having the opportunity to consider or discuss upcoming changes can create a shock to consumers which can harm the relationship.

Disruption historically leads to innovation. Inflationary pressures encourage consumers to seek alternative solutions. Businesses must either provide these alternatives or risk consumers going elsewhere. Hence, although the current environment is challenging, investment into technology and new skills is more crucial than ever.

Businesses that can innovate and increase the value proposition are in turn more likely to establish a customer base which will not get deterred by price, and instead focus on the value being delivered. Value based pricing could enable businesses to shift the focus from inflation to future growth.

Tax due diligence when buying or selling

The summer break is a time for reflection on the year that has been. For business owners, this break is an opportunity to evaluate their future strategy and consider whether it is time to exit, or conversely, grow by purchasing someone else's business. Whether buying or selling, it is a demanding exercise.

A business sale can either be in the form of a share sale, where the shares in the company that owns the business are transferred, or an asset sale, where the underlying assets of the business are transferred. If the transaction is by share sale, the purchaser takes on the past risks and obligations of the target company. It is therefore important to

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understand if there are any ‘skeletons in the closet’. This risk is mitigated by undertaking ‘due diligence’. This same risk does not arise in an asset sale, because the vendor’s ‘history’ is not transferred to the purchaser.

For the vendor, due diligence might subject the business to a level of scrutiny not experienced before. For the purchaser, a large volume of information may be presented and it will be important to remain focussed on information that is material and relevant.

From a tax perspective, due diligence is aimed at confirming whether the target company has satisfied its historic tax obligations and therefore no risks exist that a tax liability might arise in relation to a period prior to the change of ownership. There is both a qualitative and quantitative element to this process.

The tax return filing history will be reviewed to confirm that there are no outstanding returns and to what extent past returns have been filed on time. Not just income tax returns, but also GST, FBT, PAYE, etc. Past tax advice will be requested and reviewed to determine whether the positions taken are correct and reasonable. The general business profile will be reviewed to identify what tax adjustments need to be made and this will be cross checked against the tax position taken to ensure there is alignment.

Common risk areas will be reviewed, for example a business that engages contractors may be scrutinised to ensure these individuals are not actually employees. The treatment of Covid subsidies could also be reviewed. Has non-deductible capital expenditure been identified and adjusted. Does the target have a large number of vehicles on its fixed asset register, if yes, how have they been treated for FBT purposes… the list goes on.

Generally, Inland Revenue is able to reassess a tax return if it was filed in the past four to five years (the time bar period). Hence, due diligence is typically undertaken on the four most recently filed tax return periods.

Finally, the qualitative element comes into play. The team performing the due diligence will form a view of the target company’s approach to tax compliance based on what they have seen. For example, if a company files its income tax returns late, does not use an external accountant and does not seek advice on material transactions, a negative view will form.

This, along with other issues identified, may ultimately lead to more comprehensive warranties and indemnities, a portion of the sales price being placed in escrow or, at the extreme, a reduced price for the business.

Broader effects of Covid-19

Over the last two years most of us have had to deal with working from home in some way, shape or form, and for those who are parents, added difficulties arose with trying to entertain and educate children whilst also fulfilling employment duties.

Employers have helped employees as much as possible, in some cases providing specific time to deal with home pressures with no impact on the employee’s income. But after initially focussing on continuing to work and operate during lockdowns, emphasis has increasingly started to shift to how Covid-19 has impacted children and the broader family unit.

Globally, children have had to live through an average of six months of required and recommended nationwide lockdowns since early 2020 when the Covid-19 pandemic began. Venezuelan children have had to endure one of the longest periods, with intermittent lockdowns preventing children from attending school for up to 16 months. Although New Zealand schools were not closed for this length of time, it would be naïve to think that the months spent at home away from friends and routine during our level 3 and 4 lockdowns have not had an impact.

A survey was undertaken in May 2020 involving nearly 2,500 10 and 11 year-old New Zealand children. On a positive note, eight in ten children reported very good to excellent health. Nearly 80% reported having a good time with their family in lockdown. Children living in a larger bubble (six or more people) during Alert Level 4 were more likely to experience better health and wellbeing.

However, mental health was impacted with around 40% of children showing symptoms of depression and anxiety, due to reasons such as concern about their family’s financial situation. Māori and Pacific children recorded lower depression and anxiety, which was attributed to greater family connection.

An Argentinian study undertaken in mid-2020 found that 62% of the participants showed sleep disorders,

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girls more than boys, with the percentage increasing with age. The majority of the children (62.4%) spent less than 30 minutes a day reading, and 36.2% spent less than 30 minutes a day undertaking physical activity.

Most of the children communicated with their friends/family outside of the household at least once a day via WhatsApp (65.5%), social media (32.2%), or online gaming (38.1%), and this percentage increased with age. Social media was used by 14.1% of the children and 19.5% played online games constantly or on-and-off throughout the day, especially boys.

Almost half (47.1%) of the parents were worried about getting/transmitting Covid-19 and 27.9% were afraid to leave the house for essential activities such as work or essential shopping. Besides, 59.1% reported being worried about their children's screen time, and 68.4% found it stressful to keep children entertained during lockdown. Also, 16.6% of the parents felt lonely, 18.8% did not feel capable to help their child with school homework and 45.1% did not have time to play with their children.

A significant amount of research has been undertaken that generally suggests there has been a negative impact on children's mental health. More research is needed to understand the long-term effects of the lockdowns, not just on mental health, but also development, learning, academic and eventually on future work-place behaviours. Perhaps today's children will become known as Generation C.

Snippets

Online reviews – what might they reveal

Engaging with customers is always important and in the current environment, online interaction with customers has become exponentially relevant. In a 2017 survey, 87% of people said that a business needed an online rating of at least 3 stars for them to use the business, and 84% trusted online reviews as much as a personal recommendation. The same survey reported that on average, one negative review can cost a business 30 customers.

However, sometimes online reviews are not always as they appear. A review by a Texas man on Speartip Security Services's ('Speartip') Google page was made just days before multiple arrests were made. The review read as follows:

"Speartip is very professional and on top of it. They get the job done in an expedited time. Couldn't imagine using anyone else!!" To which Speartip responded: *"Thank you for the kind words. Always a pleasure working with you."*

Although the interaction appears innocent enough, the reviewer was apparently referring to assistance in helping orchestrate a double murder, involving the review writer's former girlfriend and her current partner.

An individual who was also suspected of being involved with the murders had left a review on Speartip's Google page eight months earlier, praising the business for being "very professional" and for responding quickly to their concerns and "immediately" covering their needs.

Next time you're reading a customer review, there might actually be more than meets the eye.

Common error – claiming GST on FBT

For those of you who prepare and file FBT returns on behalf of a GST-registered employer, you will be familiar with the GST on FBT adjustment that forms part of the FBT return.

The adjustment itself is straight-forward and involves calculating GST on the gross taxable benefits that are subject to GST, and including this as part of the FBT payable. However, a very common misunderstanding is that this GST amount is then able to be claimed in the GST return.

A benefit provided to an employee (e.g. a Christmas Gift) is deemed to be a taxable supply for GST purposes (akin to a sale). The GST adjustment in the FBT return is the mechanism by which the GST on the deemed supply is paid to IRD. Another way to think of it – when the employer originally acquired the Christmas gift the GST was claimed on purchase. However, because the gift is consumed privately (i.e. not used in the business) the GST shouldn't be claimed and the GST on FBT adjustment is the mechanism to reverse the original claim.

It is common to see the words "GST" and split the total FBT payable between the two taxes for coding purposes, resulting in the GST being re-claimed in the next GST return. But this is incorrect – it is akin to claiming GST on a sale.

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

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