Session II
Paper (d)

THE INLAND REVENUE
(A Home Truth You Cannot Dodge)

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The direction and understanding of most tax planning revolves around the tax rates which are as follows :

1987/88

0 - 9,500		15c
9 501 - 30,000		30c
30,000 +		48c

1988/89

0 - 9,500	19.5c
9,501 - 30,000	27.0c
30,001 - 30,875	36.0c
30,876 +	40.5c

1989/90

0 - 30,975	24c
30,976 +	33c

1. PROVISIONAL TAX SYSTEM

THE PRESENT SYSTEM

If you are a provisional tax payer you do not pay tax as you earn (PAYE). Your tax liability cannot be determined until the end of your financial year. At that time your accounts are prepared, finalised and a tax liability established. Any provisional tax paid in advance is taken off and the balance is called terminal tax. Provisional tax is added on for the next financial year which is effectively tax in advance based on the prior year. Their terminal and provisional tax are then the total tax payable. To explain this more clearly let us use an example.

First Year of Operation *(Start up 1st April 1987)*

1988 TAX	*$1,000.00*
LESS: PROVISIONAL TAX PAID	*0.00*
	$1,000.00
1989 PROVISIONAL TAX (Based on 1988 Year)	*1,000.00*
TOTAL TAX for year	*$2,000.00*

PAYABLE AS FOLLOWS

1/3 Provisional (7th July 1988)	*333.00*	
1/3 Provisional (7th Nov 1988)	*333.00*	
1/3 Provisional (7th March 1989)	*334.00*	
Terminal Tax (7th Feb 1989)	*1,000.00*	
		$2,000.00

Second Year of Operation

1989 TAX	$1,200.00
LESS: 1989 PROVISIONAL TAX PAID (See Above)	1 000.00
	200.00
PLUS: 1990 PROVISIONAL TAX (Based on 1989 Year)	$1,200.00
TOTAL TAX FOR YEAR	$1 400.00

PAYABLE ON THE FOLLOWING DATES

1/3 Provisional	(7th July 1989)	400.00
1/3 Provisional	(7th Nov 1989)	400 00
1/3 Provisional	(7th March 1990)	400.00
Terminal Tax	(7th Feb 1990)	200.00

$1,400 00

PLEASE NOTE THAT THE ABOVE PAYMENT DATES ARE BASED ON A MARCH BALANCE DATE.

If you have an alternative balance date please refer to the schedule below which sets out the payment dates for different balance dates

Month of Balance Date	First Provisional Instalment (one third)	Second Provisional Instalment (one third)	Third Provisional Instalment (one third)	Terminal Tax
October	7 February	7 June	7 October	7 September
November	7 March	7 July	7 November	7 October
December	7 April	7 August	7 December	7 November
January	7 May	7 September	7 January	7 December
February	7 June	7 October	7 February	7 January
March	7 July	7 November	7 March	7 February
April	7 August	7 December	7 April	7 February
May	7 September	7 January	7 May	7 February
June	7 October	7 February	7 June	7 February
July	7 November	7 March	7 July	7 February
August	7 December	7 April	7 August	7 February
September	7 January	7 May	7 September	7 February

CASH FLOW

Cashflow wise over a three year period the following occurs presuming income levels are identical :

Year One - No Tax
Year Two Double Tax
(Terminal Tax on year one and Provisional Tax on year two)
Year Three - Provisional Tax on year three

Year one is an artificial tax holiday, year three is the norm and manageable but year two is the bogey.

In year two you effectively pay two years tax in one hit. Further if this 's not planned for you could be saving ѡwo years tax from one years income. It is therefore prudent to save some tax in year one.

Equally if your income rises the same effect occurs as you have to pay terminal tax on the increase of last year the provisional on that same increase for next year. A way to ease the burden is to put some funds away monthly. I am not an advocate of this where you are in overdraft as the funds are earning 15% on deposit and costing 22% on overdraft.

When you make your first tax payment or alternatively when your income rises dramatically, you are subject to a 'oubled up tax bill. It is therefore, prudent to put some funds away during your first year rather than have to save two years tax in one year. It is also prudent to perhaps put some funds away monthly rather than to have to find the entire figure at year end.

RE-ESTIMATION

As the provisional you pay during the year is tax in advance for that financial year it can be re-estimated downwards should you consider that that years income will be down. This should be done in consultation with your advisor as a 10% penalty can be charged for any underestimation. This option should not be taken lightly as the penalty is calculated on the difference between your estimation and actual tax for the year rather than the tax you should have paid

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1987 Tax	$10,000
Therefore 1988 Provisional	10,000
1988 Re-estimation	7,500
1988 Actual Tax	12,500

Penalty is calculated as follows:

1988 Actual Tax	$12,500
Less: Provisional Estimated	7,500
Shortfall	5,000
10% Penalty	500

PENALTY COST

The 10% penalty is claimed to be cheap interest. It is a penalty for six months so if the arrears are not paid within six months a further 10% penalty is charged on the balance. Effectively then, the 10% is a flat rate for six months so the true rate is 17% after tax, as the penalty is not tax deductible, ie. deductible interest has a lower net cost once the tax saving is taken into account.

TAX DEFERMENT

A lot of tax planning with the rate reductions coming revolves around deferring income. If you outlay one dollar, one year earlier than you need to, when interest rates are say 20% it costs $1.20 rather than the $1.00 a year later.

ie.

Year 1 Spend		$1.00
Interest for 1 year at Bank OD rates say 20%	.20	
Less Tax saving @ 30 cents	.06	
		.14
		$1.14

This can obviously be applied to taxation. If you defer tax one year by some means the cost is lower once you take into account then funding cost. If you pay tax at 24 cents in year one it is more expensive than paying that tax in year two.

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Tax on $100 income @ 24%	$24.00
Provisional Tax for next year	24.00
Cash flow outgoing	$48.00
Interest Cost on 48c @ 20%	9.60
Less: Tax Saving @ 24%	2.30
Cost of Funding	7.30
Plus: Initial Tax Cost	24.00
Total Cost	$31.30

If the earnings were higher in year two and the marginal tax rate rose the deferred income would be taxed at the higher rate of 33 cents in the dollar. With rates averaging down there is a strong incentive for tax payers with high profits to have those profits taxed later at lower rates of tax. there are two ways of doing this. Firstly be deferring income, (eg. making a sale later to get it into the next financial year) or secondly, by dragging expenditure back into an earlier year. These moves are up to you to implement.

Equally because the tax payer is winning by deferring income the Government is losing by having to fund the receipt of the tax revenue for a year. Hence the new tax system.

THE NEW PROVISIONAL TAX SYSTEM

On the 17 December, Roger Douglas announced the Governments intention to change the provisional tax system. The system announced meant that every tax payer had to estimate their income and pay provisional tax accordingly in three equal instalments. Any underestimate would be subject to a 23% non-deductible penalty and any overestimate would earn 11% taxable interest.

A bill was introduced to Parliament on the 5 May 1988 which modified the initial proposal. A Bill has to be passed before it is law so we are still dealing with proposals. The proposal changes the provisional system for instalments made on or after the 7 November 1988 so there is still a time lag for the legislation to be passed and us to get to grips with the system. A large number of submissions have been made so there is a real likelihood of further change.

The system provides that every provisional tax payer must estimate their next years income. This estimation establishes their category and the action they need to take.

The categories and action for existing provisional tax payers are as follows:

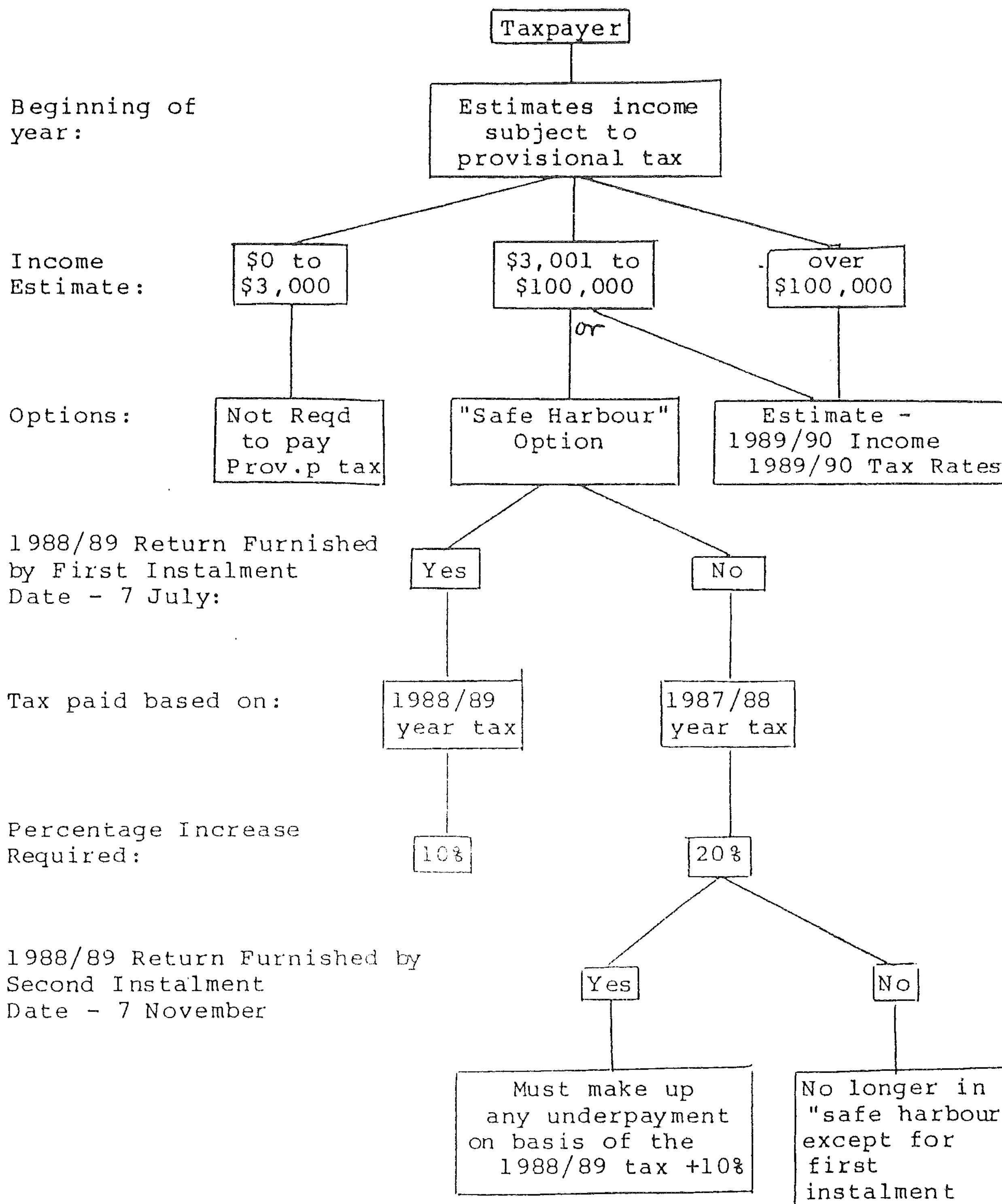
1. Income level less than 3,000 - pay no provisional tax and pay terminal tax on the 7 December
2. Income level between $3 000 and $100 000 - these taxpayers have the option of estimating their probable income tax liability and paying three equal instalments, or making three payments amounting to 110% of the tax paid in the previous income year.
3. Income level greater than $100,000 - these taxpayers must estimate their tax liability and pay the amount in three equal instalments.

Virtually all my clients will fall into the second category. This system is more manageable in that the estimation and interest requirements are eliminated. Paying 110% of last years tax has some cashflow effect but you can re-estimate downwards if that is appropriate. As soon as you do re-estimate you open yourself up to the interest regime.

There is, however a major proviso, which only seems to apply from the 1989/90 provisional tax onwards. The prior years return must be filed by the second provisional instalment date otherwise you must estimate rather than pay 110%. A tax payer with a March balance date must have the 1989 return filed by the 7th of November 1989 and a May balance date tax payer by the 7th of January 1990 to use the 110% basis. This is a tall order considering some clients do not bring their records in until after

NZSA TAX UPDATE
IRD SUMMARY OF NEW PROVISIONAL TAX RULES

Chart for Determining 1989/90 "Safe Harbour" Provisional Tax Payments



Christmas. For those that are organised enough to get their records in early, this should not pose a problem.

New tax payers are also caught by the regime. If a tax payer commences self employment 30 days earlier than a provisional instalment date provisional must be estimated.

The proposals provide for 18% non-deductible interest on any underestimation and 9% non-assessable interest on any overpayment. This proposal makes it relatively unattractive to be caught by the estimation regime.

When a clear fell operator pays his first instalment of provisional he does not know what the last quarter of the year will bring. His company may get a large order late in the year for export logs at a very good price. He may be asked to put on extra men, work six days a week and be allowed to overproduce with the result that his earnings increase dramatically for that year. I am sure this sort of example can be quoted from any industry and that many submissions have been made in this vein.

1989 Provisional Tax Payments Made:	*7th July 1988*		*$2,500*
	7th November 1988		*3,600*
	7th March 1989		*2,000*
		$8,100	
1989 Actual Tax			*9,000*

The following calculation would need to made when the 1989 return was filed.

1st Instalment 7th July 1988	*1/3 of Tax Assessed*	*$3,000*
	Less: Instalment Paid	*2 500*
	Underpayment	*$ 500*
2nd Instalment 7th November 1988	*1/3 of Tax Assessed*	*$3,000*
	Underpayment from 7th July 1988	*500*
	Penalty from Underpayment ($500 @ 18% pa for 4 months)	*30*
		$3,530
	Less: Provisional Paid	*3 600*
	Overpayment	*$ 70*

3rd Instalment		
7th March 1989	*1/3 of Tax Assessed*	*$3,000*
	Less: Overpayment from 7th Nov 1988	*(70)*
	Less: Compensation for overpayment	
	($70 @ 9% pa for 4 months)	*(2)*
		$2,928
	Less: Provisional Paid	*2,000*
	Underpayment	*$ 928*
Terminal Tax		
7th February 1990	*Underpayment from 7th March 1989*	*$ 928*
	Plus: Penalty for Underpayment	
	($928 @ 18% pa for 11 months)	*153*
	Terminal Tax Due	*$1,081*

Remember, these rules do not apply until the 7th of November 1988 so we have some time for the legislation to clarify the position.

I will talk to this part of the paper and discuss other interpretations of the proposals. I also keep reiterating that they are proposals and not law, so extensive changes could still result. What is clear in my opinion is that the Government are reliant on lowering their budget by bringing forward their tax revenue. Even if the proposals are watered down the initial tax holiday followed by the double take will change. Tax is a major expense so it would pay to follow the announcements closely.

2. GST

The impact of GST on businesses is not great most of the time. Essentially you are receiving GST on your income, paying it on your costs and accounting for it to the Inland Revenue Department. If a business is making money it must be receiving more GST than it is paying out. At the end of each period that net difference, should be sitting in the bank and must be paid to the Inland Revenue Department. On top of this, large components of a logging contractors costs do not carry GST. Both Debt servicing and wages are GST exempt while GST on drawings is non-recoverable so widening the gap between GST received and paid. GST is then an accounting and budgeting exercise rather than a tax on your business. Outside your business it is undoubtedly a tax on consumption.

ACCOUNTING FOR GST

Every accountant has their system for recording GST so I am not going to show you how you should do your recording. I will say, however, that accounting for GST is not beyond the normal small businessmen. Barring the adjustment for personal use it is an extremely simple exercise. For some people however, numbers are just not their cup of tea. While others find that their time is best spent getting the most out of their operation rather than accounting. It depends on you, whether you set up your own system or get your accountant to do it for you. I should be noted that GST auditors are now very active.

CASH FLOW

Nine times out of ten you will receive more GST than you paid, so at the end of

the period you pay the difference to the Tax Department. You carry the accumulating difference through the period so you have the use of their money for that time. The interest you earn on that could add up to $1,000 pa That net GST has to be available on due date or you are subject to penalties.

Some people put a little money away out of each cheque they receive so they have enough on due date. It your cash flow is always tight this is probably a good way to ensure you have sufficient cash to pay the GST on due date. Remember, however, overdraft rates are higher than deposit rates.

Occasionally more GST is paid than received ie. a major item of plant is changed. In this instance the Inland Revenue department will owe you GST so you will be financing the GST difference for the period rather than holding the GST. This is unfortunate but inevitably will happen every now and then. To minimise this effect you should endeavour to buy as close to the end of your period as possible so you get the GST back quickly. When equipment is hard to sell you may be able to negotiate with the dealer to leave the GST owing on account until you get it back from the Tax Department. Finance companies will often cover the GST with a repayment of the GST at a determined point of time.

CASH VERSUS INVOICE BASIS

If you have turnover of less than $500,000 you can adopt the cash basis rather than the invoice basis. The cash basis is more simple so should be adopted everytime. The commissioner has a discretion to allow tax payers with a turnover greater than $500,000 to adopt the cash basis where their accounting system is inadequate to account on an invoice basis. There have been cases recently where this discretion has been enforced. If your turnover is not to far over $500,000 application should be made for the commissioner to apply his discretions.

SIX MONTHLY VERSUS TWO MONTHLY RETURN PERIOD

If your turnover is less than $250,000 you may adopt a six monthly return period rather than two monthly. There are arguments for and against the longer period.

For

- Only requires forms to be filled in twice a year
- You get the use of their money for longer
- more cost efficient if your accountant prepares your returns.

Against

- Includes a large number of transactions, a lot more work in one hit and goes further back in time so harder to remember
- Means two large cheques per annum rather than six smaller ones so better financial control is required.

In summary, there is room to profit six monthly but is is reliant on you controlling your finances and recording adequately.

3. SELF EMPLOYED ACC LEVIES

You paid a Self employed ACC Levy at a flat rate of 3.94% on your 1987 net profit. As a result of last years ACC review your 1988 levy will be payable at the rate for your industrial activity. This industrial activity rate is the same as that used for calculating the employees levy. This means that the self employed levy will either go up where your industrial activity rate is higher than 3.94% or come down. For example the industrial activity rate for Bushmen is 11.4% which virtually triples the 3.94% rate. Those tax payers in high risk industries will be paying a higher ACC Levy on the 7th February 1989 and should be planning accordingly. In my opinion the scheme has become a cash gobling monster and cheaper premiums could be paid to private institutions for the same cover.

B NEW DEVELOPMENTS AND DIRECTION OF PLANNING

It was not many years ago that the tax scales were as follows :

Individual	0 - 6,000	20c
	6,001 - 24,000	33c
	24,001 - 30,000	45c
	30,001 - 38,000	56c
	38,001 +	66c
Corporate		48c

In the 1989/90 year the rates will be as follows :

Individual	0 - 30,875	24c
	30,876 +	33c
Corporate		28c

We have seen a dramatic reduction of tax rates but we have also seen the introduction of a number of other taxes (GST, FBT), the elimination of a number of deductions (life insurance and employment related expenses) and the probable introduction of additional taxes (capital gains). All this will probably mean we will pay the same amount of tax but under different names. Our thinking is having to change when making tax plans to take into account the number of taxes and the flattening of the rates.

The entire thrust of our old planning revolved around income splitting. The husband/wife partnership was utilised to divide the income between the two spouses and so use the bottom end of the tax scale. It is important to remember that no matter how high your income is, your first dollar is still taxed at the lowest marginal rate. If income is transferred from one spouse to another, the first dollar transferred will be taxed at the lowest rate in the other spouses name, provided he or she has no other income.

eg.
If a family business earnt $50,000 in total then the following tax position would result depending on whether the income is left in one spouses name or divided between the husband and wife.

	Sole Trader	*Partner 1*	*Partner 2*
Income	*50,000*	*25,000*	*25,000*
Tax Thereon (using 1985/86 rate)	*21,939*	*7,276*	*7,276*

Sole Trader Tax	*21,939*
Partners Tax ($7,276 x 2)	*14,552*
Tax Saving	*7,387*

Clearly there is a significant difference in the tax paid if all the income is taxed in one name as opposed to two and this is achieved simply by trading as a partnership as opposed to a sole trader.

The thrust of tax planning was to spread the income among as many tax payers as possible. Trusts are an extremely effective way of transferring income from the husband's and wife's names to the childrens to utilize the cheap rates.

The margin between 1989/90 top and bottom rates is a lot closer so the saving is a lot less. Lets take the same facts from the above example but use the new lower rates of tax.

	Sole Trader	*Partner 1*	*Partner 2*
Income	*50,000*	*25,000*	*25,000*
Tax Thereon (using 1989/90 rates)	*13,721*	*6,000*	*6,000*

Sole Traders Tax	*13,721*
Partners Tax ($6,000 x 2)	*12,000*
Tax Saving	*1,721*

There is still clearly a saving but no where near as great as under the earlier example and further income splitting with a trust for example would be of no further assistance as the two partners are both being taxed at the bottom rate.

A flatter tax rate reduces the gains from income splitting; a flat rate would have eliminated all gain. The change in the corporate rate has created another splitting option.

DIVIDEND IMPUTATION AND CORPORATE STRUCTURES

One of Douglas's recent tax changes introduced Dividend Imputation from the 1st of April 1988 and lowered the corporate tax rate to 28 cents per dollar. This fits between the 24 and 33 cent individual rate giving the corporate trader a tax advantage when the individual shareholders earn over $30,875. The imputation provisions eliminate the disadvantage of double taxation in a company structure.

Imputation works as follows :

Corporate Income	$100.00
Less: Company Tax (old rate)	48.00
	$ 52.00

If this retained profit of $52.00 was passed out as a dividend it would be taxed again in the shareholders hands at possibly the old top individual rate of 48%

Dividend	$ 52.00
Personal Tax (old top rate 48%)	25.00
	$ 27.00

Of the original corporate income of $100.00 only $27.00 made it through to the shareholder because it was taxed twice; firstly in the company and secondly in the shareholders hands. Imputation radically changes this system and works as follows :

Company Profit	$100.00
Company Tax (new rate)	28.00
Retained Profit	$ 72.00

When a cash dividend of $72.00 is received by the shareholder it is included in a tax return as $100.00 but with an imputed credit of $28.00 for the company tax paid. Thus the shareholders taxation position would be as follows :

Dividend	$100.00	$100.00
Tax Thereon	24.00	33.00
Less: Imputation Credit	28.00	28.00
Tax (Credit) Payable	$ (4.00)	$ 5.00

Thus the shareholder ends up paying tax at his marginal tax rate on his share of the company income. It is proposed that the credit can be offset against other tax or carried forward but not refunded. Because companies have a lower tax rate than the top individual tax rate and imputation eliminated double taxation they will become a viable option for those taxpayers with high incomes.

As can be seen the disadvantage of a company structure, with respect to double taxation, has been removed. The company structure now has the following pros and cons :

Pros

- the company tax rate of 28 cents is lower than the top personal rate of 33 cents
- limited liability
- the option of dividend and interest versus salary with respect to ACC levies
- taxation delays with alternative balance dates
- a more flexible structure
  - tax deduction of personal interest
  - fancy tax schemes

Cons

- involvement with the Companies Office and company rules
- overdrawn current accounts
- Fringe Benefit Tax on vehicles used privately

I believe we should be using a corporate structure now in order to take advantage of the lower corporate tax rate and to take advantage of a more flexible structure.

The greatest difficulty with tax planning today is the rapidity of change. What you put in place today could be redundant tomorrow very easily. Also the gains are far more marginal because of the flatter rates and the wider tax base.