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NEWSLETTER

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Selling a Business

When a business is sold, there are a number of tax issues that must be considered depending on the type of business structure that the vendor has. Typically, businesses are operated by sole traders, partners in a partnership, or through a company. Before embarking on a sale it is generally advisable for a vendor to seek professional advice on possible strategies for exiting the business and the commercial and tax issues that may arise.

The tax issues that need consideration when a business is sold include:

Depreciation recovery – the vendor will have depreciation recovery income if the sale price of the business's fixed assets is greater than their book value. Where the sale price is greater than the cost - which is often the case when a building is sold - the excess over the cost will be a non-taxable capital profit. If the vendor is a company and the sale is to a related party, the capital profit arising will not be immediately taxable, but will be taxable when that profit is distributed to shareholders when the company is wound up in the future.

Trading stock – the sale of trading stock will always give rise to taxable income to the vendor.

Goodwill – In the sale of a business where goodwill is part of the selling price the vendor will want that component of the sale price to be a tax free capital receipt. Goodwill can be a tax free receipt if it is personal (or business) goodwill that is included in the sale price. If the goodwill relates to the premises from which the business operates (generally known as site goodwill), the goodwill will be taxable to the vendor. This situation can arise either from the vendor granting a lease to the purchaser (if the vendor owns the premises) or sub-leasing the premises (if the vendor is the lessee of the premises). This goodwill income can be spread over the year of receipt and up to five succeeding years. Where the vendor is the lessee of the premises and sells the lease (rather than sub-leasing) to the purchaser, that sale will be a tax free capital receipt to the vendor.

Employee Leave Provisions – when a business is sold, the employees of the business are frequently taken over by the purchaser. The vendor will have accrued leave provisions in relation to employees' holiday pay, sick pay and so on. The legislation relating to leave provisions when a business is sold provide that where a business is sold, the vendor is allowed a tax deduction for the employee leave provisions that have been accrued. However, if the sale is to an associated person, it is the purchaser that gets the deduction when the employees are paid their leave entitlement by the purchaser.

GST – the vendor must account for GST on the sale unless the vendor is not registered for GST, or if the sale of the business is as a going concern (for GST purposes). If there is any doubt whether or not GST is applicable to the sale, it is advisable to have the purchase price as being "plus GST if any". This is to ensure that where there is GST payable on the sale, it is the purchaser that bears the cost of the GST.

Sale of Shares – if the vendor is a company, it can consider selling the shares in the company instead of selling the assets in a business. A sale of shares will generally result in a capital non-taxable receipt to the vendor – unless the shares were acquired by the vendor for the purpose of on-selling them. Selling a business by share transfer allows the issues that have been outlined above to be eliminated as the company is retaining the business. This option tends to be the more attractive one for the vendor mainly because of its tax free nature, and also the simplicity of the transaction.

There are obviously a number of issues to be considered when selling a business. Therefore, it would definitely be advisable to seek professional advice before embarking on a sale.

Depreciation of Your Rental

In recent times the IRD has expressed the view that separating a residential rental property into its component parts for depreciation purposes was unacceptable. This view had been publicised in a media statement.

The IRD has now taken the next step in supporting this view. A draft interpretation statement has been released that explains the IRD's position. The document itself is 69 pages long and goes into considerable detail.

Where a depreciation deduction is claimable on an asset, the next step is to define that asset. For applying this rule the IRD has carried out a historical analysis of case law developed from the Income Tax Act 1976. Under this Act a deduction for depreciation or repairs was allowed in respect of an "asset". Disputes often arose when taxpayers claimed what they considered were "repairs and maintenance", but which the IRD considered to be capital improvements. This resulted in a considerable amount of case law which sought to identify the "asset" that has been repaired or improved.

The Court's approach has been to determine if an item for which expenditure has been incurred would be part of an asset (i.e. part of the building or separate from it). The IRD has followed this approach. Two distinct tests have been identified in the interpretation statement;

they are referred to as the physical separation test and the functional separation test.

Physical separation considers whether or not the item is “fixed” to the building. For example, can the item be removed and relocated without difficulty? Functional separation looks at whether or not the item carries out a function separate to the function of the building. For example, would the building be regarded as complete without the item? The view is taken that if an item is part of the greater asset (i.e. part of the building) it cannot be separately depreciated; it must be depreciated with the rest of the building.

The document analyses a number of common examples, and the following items are considered to be part of the building and not separately depreciable:

- Plumbing and piping
- Electrical wiring
- Internal walls
- Internal and external doors
- Garage doors (internal access)
- Wardrobes and cupboards (built into the wall)
- Kitchen and bathroom cupboards
- Linoleum and
- Tiles (floor and wall)

The following items can be regarded as separate assets and can be depreciated at different rates:

- Wardrobes and cupboards (not built into the wall)
- Carpets
- Curtains
- Blinds
- Water heaters
- Hot water cylinders

Because the tax legislation does not prohibit depreciating an asset based on its component parts the correct position is currently unclear. However, the IRD has gone to great lengths to support its view that it does not favour separation of assets. The IRD has indicated that if a dispute were to arise it would take the matter to Court to prove its point.

Kiwi Savings

On 1 July this year the long awaited Government organised superannuation savings scheme will come into effect. KiwiSaver is a voluntary savings scheme aimed at helping New Zealanders save for their retirement.

What does KiwiSaver involve?

Employers are required to provide new employees with information on joining KiwiSaver, and they are responsible for making deductions from their employees' pay. All new employees are automatically included in the scheme unless they sign a form to opt out. An employee who has opted out and who wants to stay out must continue to opt out every time they change employers. If they do not opt out every time they change employers, they will automatically be included in the scheme. Current employees are exempt from the scheme but they can voluntarily join if they wish. Employees who participate will have either 4% or 8% of their gross salary or wages deducted and allocated to a superannuation provider, who will either be an IRD default provider or one of the employee's choice. Once employees reach the New Zealand superannuation qualification age – which is currently 65 - they will be able to access their money and will hopefully have a nice tidy nest egg to see out their retirement.

What are the benefits?

The Government sees KiwiSaver as an opportunity for people to make a commitment to saving for their retirement. Once savings are put into KiwiSaver, there is no ability to withdraw the funds in the scheme until retirement – which could seem a long way away if you are only 20 years of age. The inability to withdraw funds from the scheme is seen as a mechanism to curb the temptation for people to access their savings for frivolous purposes. The only exceptions to this rule are where the person:

- makes withdrawals to assist with the purchase of a first home (but only after at least three years membership);
- has significant financial hardship;
- has serious illness; or
- permanently emigrates

Every person who joins KiwiSaver will have $1,000 placed in their account by the Government. The Government will also provide $1,000 per year up to a maximum five years in certain circumstances to assist with a home loan deposit.

What are the drawbacks?

The deductions of 4% or 8% of wages could be quite a burden in some cases. Some employees may not realise the effect of having less cash in the hand for each pay period until it is too late. Employees have a window of opportunity of six weeks to opt out of the scheme or they will automatically be included in the scheme until retirement. Employees can opt out, at the earliest, on the 14th day of employment. What this means is that even if employees want to opt out from day one of their employment, it appears that the employer must deduct the KiwiSaver contribution for any pay that falls within that 14 day period. After contributing to the scheme for a minimum of 12 months, employees can apply to have a "contribution holiday" of up to five years. As previously mentioned there is an inability within the scheme for employees to access their savings until they reach the superannuation qualification age. Whilst the age is currently 65, it may be pushed out to age 70 by the time individuals from Generation Y reach their twilight years. Also of major concern would be the lack of guarantees in place to safeguard employees' savings and the fact that there is no guaranteed minimum rate of return on the savings.

Before deciding whether or not to join the KiwiSaver scheme, all potential participants need to have as much information as possible in order to make an informed choice. For further information please visit www.sorted.org.nz or www.kiwisaver.govt.nz.

Snippets

IRD Interest Rate Rises

From 8 March 2007 the IRD increased the interest rates it applies to unpaid and overpaid taxes. The rate applying to unpaid taxes rose from 13.08% to 14.24%. The interest rate paid by the IRD on overpaid taxes also rose from 5.71% to 6.66%.

GST Due Dates

The first of a number of changes regarding GST and provisional tax discussed in previous issues has come into effect. GST returns and payments were previously due on the final working day of the month. For GST periods ending on or after 31 March 2007, the GST return and payment are due on the 28th day of the month (or the next work day) following the return period. There are two exceptions, being the returns for the periods ending 30 November and 31 March, which are due on 15 January and 7 May respectively.

Minor Beneficiary Rule Clarification

It is stated in the income tax legislation that income received from a trust by a beneficiary who is a minor is not subject to the minor beneficiary rules if the income is $1,000 or less for the year. There has been some confusion as to whether the $1,000 referred to relates to the total distributions a beneficiary receives for the year or whether the $1,000 amount relates to the distribution the beneficiary receives from each trust.

The IRD has released in draft form its view that the exemption for trust distributions to minors of $1,000 per annum applies to each trust's distribution to a beneficiary and not all trusts' distributions to a beneficiary. This means that a minor's marginal tax rate will apply to each distribution of $1,000 received from each trust of which he/she is a beneficiary. Therefore, a minor who is a beneficiary of say, three trusts, is able to receive up to $3,000 per annum (no more than $1,000 per trust) and pay tax at his/her individual marginal tax rate.

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