Sock it to the Tax Man

How to fight fair and pay less tax

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There's no secret to getting rich: you make money, you keep money. And there's no secret to what eats your hard-earned dough faster than a famine — tax.

In days gone by, paying less personal tax was a game of complex wine box-type accounting. Andrew Tauber, tax partner with Ernst & Young Entrepreneurial Services, says alterations to tax laws over the past 10 years have led to a massive change in tax-saving strategy. Rather than elude tax by complex means, you're better to structure affairs to get an advantageous tax rate. And given the latest series of stories from the IRD horror file, you're better to stay on the right side of the law.

However, Tauber and colleague Jo Doolan are quick to point out that some tax is voluntary. The clever tax payer will identify these areas of voluntary taxation, structure his or her affairs accordingly and reduce the total tax bill. This is perfectly legal behaviour.

We asked the experts to isolate these voluntary taxes — and show how to save thousands of dollars as a result. Here's what they say.

General strategies

PAYE

Let's say you're earning a salary and have investments on the side — maybe property and shares. First, is there anything you can do about PAYE tax?

Yes and no. You can't make expense deductions on your salary or wages. But you can encourage your employer to load your employment package with benefits such as training, health insurance, income protection insurance, share options, a vehicle and other staff rewards like gym fees or food reimbursement. Almost all of these items are subject to the 49% fringe benefit tax, payable by the employer. Most employers don't pass on the cost of this tax to their employees — so to you, they are effectively tax-free. That's one of the joys of being an employee — make the most of it.

There's not a lot else you can do to address your PAYE tax — save quitting your job and going out as a free agent. There are pros and cons for making that shift — see below.

For the moment, let's look at what you can do to reduce the tax on your investment income outside of wages and salary.

Spread the load — income splitting

By spreading and splitting your investment income across family members and other legal entities, you can maximise the benefits, like lower tax rates and tax deductions.

Example

A single-salary couple own two investments: a rental property returning no net income (because the mortgage is higher than the rent, say) and a small but profitable business. By placing the income-producing asset (the business) in the non-salaried spouse's name, the business gets taxed at the lower tax rate of 19.5%. Meanwhile, the salary-earner keeps the loss-making property in his or her name and offsets the losses against PAYE.

In this example the couple are splitting the income. Our tax laws don't allow splitting salaries, but most other forms of income are up for grabs. For couples, Tauber and Doolan recommend forming a matrimonial property agreement. These agreements are often done to give a non-working spouse peace-of-mind: if the relationship hits the skids, he or she can claim ownership of half the matrimonial assets. But it also provides a chance to split the investment income.

There are other ways to spread income, probably the most common being the family trust.

Trusts

By forming a family trust you can spread income across your whole family, thus reducing the amount of income falling into the higher tax bracket. Typically, the beneficiaries will be your children and spouse, but can also include yourself.

Personal investment expert Martin Hawes is a great fan of trusts. In fact, he wrote the book: *Family Trusts — a New Zealand Guide* (Shoal Bay Press, $24.95). Hawes gives two examples of trusts at work.

Example

A couple, each earning more than $38,000 in salary, own rental properties generating $40,000 a year. Normally, the entire $40,000 would be taxed at 33% — because it is added to their salaries as total taxable income. But if the rental properties are owned by a family trust, the couple can distribute the rental income among the beneficiaries, bringing the trust into the 19.5% tax bracket. The tax saving amounts to about $5400 for each beneficiary.

Example

A family of five owns a business generating a taxable income of $190,000. Normally, the tax bill would be $57,570. If the business is owned by a family trust, the income can be spread across the five beneficiaries, meaning each earns $38,000 and their income falls into the lower tax bracket. The total tax bill is $37,050, a saving of $20,520.

The other advantage of a trust is tax deductibility. There's a whole array of tax deductions relating to trust-owned investments — including the mortgage payments and repair costs of the house you live in. These deductions are not available to people living in their own home. By deducting these expenses from the investment income, you reduce your total taxable income. For more on these deductions, see below.

Is there a downside to trusts?

Yes. There's the administrative hassle, legal cost and the scrutiny you'll invite from the IRD. It's also often remarked how vulnerable these structures are to legislative changes. And one day your children will turn 20 and be entitled to the income you've stashed away for them in a bank account. (Of course, it's perfectly reasonable to spend that child's income on expenses to the child's life — such as special educational fees and overseas travel.)

Hawes also says that trusts are not, in the first place, tax vehicles. They are best used to protect family assets from business failure, angry creditors and litigious enemies.

“There are tax advantages with trusts, but you shouldn’t set up a trust solely to save tax. Trusts suit families with large non-salary incomes or children with high and unusual expenses.”

Partnerships and companies

Other forms of spreading the income include partnerships, qualifying companies and limited liability companies. Partnerships suit sole traders who wish to share their tax burden with a spouse or business partner. By making his or her spouse a partner in the business, the one-time sole trader can split any profit, reducing the total taxable income — yet still keep the profit in house, so to speak.

Example

If a builder earns $100,000 a year after expenses, he could pay his partner $20,000 for keeping the books and pay himself $40,000. At these levels, almost all the couple’s salary income is taxed at the lower rate. The remaining $40,000 profit is then split $20,000 each way, again getting taxed at the lower rate, for the partner. One trick here is making sure the partner is doing some legitimate work — and keeping the salary reasonable.

A qualifying company is an ingenious device. It’s a halfway house between a partnership and a limited liability company. Like a limited liability company, a qualifying company is a legal entity in its own right. It quarantines your personal assets from creditors and enemies who are seeking recompense. Yet, like a partnership, a qualifying company allows you to pass on any losses directly to the shareholders. The shareholders — that’s you and your partner — can deduct the losses from your total personal income.

Example

A couple set up a home business which produces net losses of $75,000 for the first year. One spouse earning $100,000 from the business can deduct the loss from his or her salary, reducing the taxable income to $25,000.

When a company starts to make a profit, the surplus can be poured back in as capital expenditure or debt financing. There’s a strategy here: a growing company is a low tax-paying company.

Borrowing smart

So far we’ve discussed spreading the income to maximise tax benefits. You can get further tax savings if you structure your borrowing right.

The way Tauber sees it, many investors fail to buy their investments in the most tax-effective manner. For example, it’s better to pay off a house mortgage than having money in the bank — as the bank’s lending rate will always be higher than its deposit rate; you’re also hit for tax on bank interest earnings.

Example

A couple owns a house worth $500,000 with a $250,000 mortgage and has $250,000 cash in the bank.

The $250,000 cash in the bank is earning 5%, which yields $12,500 a year, giving them $8000 after tax at 33%.

The $250,000 mortgage at 8% interest is costing them $20,000 a year.

Bottom-line — they're $12,000 better off paying back the mortgage early.

Here's another example of how borrowing wisely can save you money by reducing tax.

Example

An executive owns her own home debt-free and through a windfall receives $250,000 in cash. She wants to buy a bach and make a $250,000 share investment. If she borrows to buy the bach she won't receive a tax deduction. But if she borrows to buy shares she can get a tax deduction on the total amount of interest, and miscellaneous items relating to share investing (see below for more details). So she buys the bach outright and gives the bank the bach as security against the loan without affecting the deductions against the shares.

Strategies for provisional tax

Anyone not paying tax at source — that is, as PAYE or resident withholding tax — must pay provisional tax. This is a three-times-a-year payment based on what you estimate your income is for the current year — or on last year's income, plus 5% or 10%.

Given the premiums on last year's income, Tauber recommends paying the tax on time. By paying provisional tax on or before the three instalment dates: July 7, November 7 and March 7 (for standard balance-date tax payers) you avoid the 12.48% charged by the IRD for use of money interest (another name for provisional tax interest penalties). Tauber recommends most people pay a top up or terminal tax — that is, the difference between a resident withholding tax (RWT) of 19.5% and the top personal marginal tax rate of 33%.

"While most prefer to spend their money on other things, they could consider overpaying their provisional tax to receive an upside on IRD's current interest rate. Those who can overpay may be better off. The IRD is currently paying more than bank rates." At the time of writing the IRD rate was 4.79% — though it may fall. An alternative strategy, Tauber says, is getting the bank to deduct RWT on term deposits at a higher rate to offset any IRD penalties.

Note: The use of money interest for companies and trusts starts to apply where end-of-year tax liability exceeds $2500. For individuals it only applies where the end-of-year tax bill is over $30,000.

Types of investment

Property

The best strategy for property investment follows the same rules as above: spread the income and borrow wisely.

Don't do this, for instance.

Example

Tauber tells of a couple who have a mortgage on the home they live in but own their rental property freehold. This way the largest deduction (mortgage interest) goes to waste. You can't claim deductions on the house you live in (unless it's owned by a trust).

Deductions, of course, are a great tax saving on rental property. You can go bananas on deducting expenses — from petrol costs of collecting rent and the cost of your home office to portions of your telephone bill and the depreciation of the curtains. The general rule of thumb is that any money spent on obtaining an investment income can be deducted from your assessable income.

And here are two points to keep in mind about property deductions:

- Repairs may not be deductible, according to Tauber. “If someone buys a house with a view to renting it out and it needs immediate repairs, these repairs are not tax-deductible. But they’re generally tax-deductible if done on a gradual basis over two to three years.”

- When buying a rental property, ensure you collate a full list of chattels and attribute values. These can be depreciated at a higher rate of up to 30% as opposed to 4% on bricks and mortar.

Can you be caught by a capital gains tax if buying and selling?

Yes. If the IRD suspects you intended to make a speculative gain, it will treat you as a trader and charge income tax up to 33%. Tauber says investors who have a pattern of trading may wish to quarantine their trading activity inside a limited liability company that protects longer-term investment from taxable gains. Or else, don’t buy and sell too often.

Negative gearing is the much-heralded method of gaining tax advantages in property. This is where rental property expenses are greater than the returns. The loss can then earn you a refund. The assumption behind long-standing negative gearing is that the capital gains will offset your long-standing annual losses. This may have been correct for property in the high-inflation environment of a few years ago, but is less reliable now. Losses are good for tax in the short term, but long-term losses in any investment mean one thing: you’re going broke.

New Zealand shares

Much of the same strategic advice applies to investing in the share market. Make sure the share income is earned in the most tax efficient manner by spreading the income wisely and borrowing in a way allowing deductions.

Also, two points are worth noting.

- Unless you’re deemed to be a trader, you’re unlikely to pay capital gains tax on shares, especially if they’re held over the longer term. While traders will incur income tax on holdings and speculative gains, they’re also allowed to claim on any trading losses — whereas investment shareholders aren’t. People who invest in shares should watch the frequency with which they buy and sell to ensure it’s not considered regular income and liable for tax.

- Buy stocks offering tax paid (fully imputed) dividends. Apart from simplifying matters, the dividends can offer benefits to someone within a lower tax bracket. The excess tax paid at 33% by the company can be converted to a loss and credited to the lower tax-paying investor.

Foreign stocks

Returns from stocks listed overseas are typically better than from those listed on the New Zealand Stock Exchange. But the downside is New Zealand residents can’t claim the often more favourable foreign taxes paid by foreign companies.

No tax allowances are given for dividends on foreign stocks, including Australia, where investors can pay 57% on tax on dividends because of lingering double taxation anomalies.

But Tauber says when an investor’s foreign share portfolio gets big enough (a dividend stream over $25,000) it could be worth setting up a limited liability company to invest in “grey list” companies in countries that have comparable tax systems to New Zealand’s, including Australia, Canada, Germany, Japan, Britain, the US and Norway.

By doing this you pay the tax rate of each respective country. In the Australian example, investors would pay the Australian tax rate of 36% and defer the double taxation until they start distributing dividends. If you have New Zealand shares within this company, you can begin by distributing these dividends first.

Retirement savings

Tax laws in Australia have spawned a huge industry around tax-effective planning for superannuation contributions. But apart from the “fear factor” that national superannuation won’t be around for the baby boomers, New Zealanders receive no incentive to save for retirement.

The Tax Credit Bill, TOLIS, designed to close the gap between the top tax rate and the basic rate for people earning less than $38,000 a year, was rejected at its third reading last December.

Passively invested index funds are currently exempt from capital gains tax. While group superannuation schemes that invested in passive funds were also enjoying the same tax advantage, the government has moved to close this loophole.

Debt instruments

For cash basis holders (less than $1 million invested in financial instruments), the maturity date will generally be the taxing point.

Hence, Tauber urges investors to look carefully at the maturity dates on cash deposits to defer taxation.

“For most people, it’s better to stagger the maturity date to just after year-end rather than before,” says Tauber.

For example, lump sum investments maturing before March 31, 1999 would be taxed in full-year 1999. But if it matures after April 1, 1999 it would be taxable in full-year 2000.

Becoming a free agent

Many employees dream of becoming a free agent. They imagine that among the joys of keeping their own hours and working closer to home, they can deduct almost every expense in their lives — and pay less tax.

Martin Hawes says if Labour gets in to power and introduces its proposed 39% tax on income over $60,000, this dream will lure many more executives away from their employers.

“With companies still only paying 33%, many executives will think it more beneficial to be self-employed than paying PAYE,” he says.

As attractive as it seems, though, throwing in your lot to become a consultant has its pitfalls, warns Hawes.

The deductions are attractive, but self-employment also comes with its own set of obligations, including filing GST returns, making provisional tax payments, keeping motor vehicle logs and receipts and the need to prepare a full set of accounts, usually requiring specialised and often costly tax expertise.

Example

The IRD can be picky. In a recent tax audit on a financial consultant, the IRD questioned why a Moro bar appeared on a petrol receipt.

As of next year, IR5 tax payers will not be required to file a tax return. Meanwhile, the self-employed must bear all their own tax risk and decide what options will best fit the way they operate. The self-employed must carry all their health, insurance and social costs themselves, while their employee mates drink the boss's beer, work out in the company's gym and pay their children's medical costs with subsidised health care.

Iain Craig, principal of Auckland-based accounting firm BDO, says key questions you must answer early include:

- Whether paying provisional tax saves more money than paying PAYE?

- How regularly you should pay GST and provisional tax?

- How current is the knowledge of your tax adviser?

Common mistakes made by free agents

Craig says PAYE earners who move to self-employment without seeking professional advice often make costly mistakes. These include:

- Failing to keep adequate records;

- Being unaware of tax payment obligations for provisional tax and GST;

- Not keeping money aside to meet tax commitments;

- Selecting an inappropriate investment strategy;

- Not taking advantage of the most appropriate tax structure;

- Putting cars inside the company structure and copping FBT and;

- Being unaware of the new penalties regime.

The key consideration for going solo is the trade-off between the simple but sometimes higher-tax cost of being an employee versus the hassle and, at times, lower tax cost of being self-employed.

Tips for the entrepreneur

There are a host of tax issues for the entrepreneur to juggle. Here are six key strategies.

- Remain flexible on how you want to allocate income. The tax benefits vary according to circumstance and timing. For example, say you're about to make a large sale close to the end of your tax year in March — by delaying payment until April, it's possible to defer the tax on that sale by 12 months.

- Consider what level of salary you want to allocate yourself versus profit. For example, the company makes $100,000 profit and allocates $100,000 in salary; hence, no profit. But under this option the entrepreneur is paying a tax rate of 33% plus Accident Compensation Commission earner and employer premiums. But if you started with $100,000 profit and paid $38,000 in salary, leaving $62,000 in profit, you could save the ACC costs on the $62,000 in retained earnings and allocate the profit by way of dividend to beneficiaries on lower tax rates (through a trust or similar tax vehicle).

- If you're about to sell the business, consider selling at April 1 as opposed to March 31 so it falls within the next financial year. Also, there are advantages to be had in carefully working out what gains qualify as tax-free capital gains and what becomes personal income.

- Ensure the shareholder current account is in credit and not overdrawn, to avoid penalty taxes.

- Ensure all bad debts are written-off before year's end to secure deductions.

- Time asset purchases to maximise the one-twelfth asset depreciation entitlement before the end of the financial year. For example, if you buy a $40,000 vehicle in the last month of the financial year on a depreciation rate of 31.2%, you'd receive an extra $1000 depreciation.

Tough love

The new penalties regime, introduced in 1997, is tough. Adding your numbers wrong or hitting the wrong key on the calculator can earn an instant 20% penalty for "failure to take reasonable care".

Claiming what the IRD deems to be unacceptable deductions can attract a 20% penalty for "taking an unacceptable interpretation".

"Gross carelessness" earns a 40% penalty. "Adopting an abusive tax position" earns a 100% hiding. "Obstruction" (as in not co-operating with the IRD's minions) collects penalties from 25% to 187.5%. Late penalty payments get hit between 5% to 37%, depending on the original offence. And don't forget to add 2% for every month you're late.

The definitions of these terms are set out in various tax guides — but many have yet to be tested in court.

So what's the best strategy?

Be careful out there. Get advice from your tax experts and hold them to it. Make them pay the penalty if they get it wrong. For important decisions, ask the IRD for a binding ruling. Buy one of the 1999 CCH tax guides and regularly read the business press for free tax advice. There's no substitute for business intelligence.

Borrowing wrong

A couple bought a new home and decided to let their family home. They borrowed $208,000 from the bank, secured by a first mortgage over both properties: $185,000 for the second property and $23,000 on an existing loan over the first property.

The couple assumed that because the mortgage loan was secured over both properties, they could claim interest tax deductions for the total $208,000.

But the $185,000 used to buy the private residence was deemed private and not tax-deductible. They lost about $15,000 worth of deductions.

Lesson: They could have taken the full mortgage on the first home (now a rental property) to maximise interest deductions.

Audit from hell — expatriate cops tax bill

A New Zealand resident worked in Hong Kong for seven years where he was being taxed at only 16%.

Although at one point he was out of the country for more than 365 consecutive days (and technically broke his residency status), he was still deemed to be a New Zealand resident because he retained a New Zealand home and made return visits to it.

This simple oversight meant the IRD assessed him on all his foreign earnings. He had to pay the difference between the local rate of 33% and the Hong Kong rate. How much over seven years? We're not sure, but it was a lot of money.

Lesson: He could have sold his New Zealand home and stayed at hotels when visiting or rented the property out and not had access to it. That way he would lose his New Zealand residency status and not have copped the tax bill.

Cardinal rules for provisional tax payers

· Be aware of how the provisional tax system works: It collects tax in three equal installments without regard for when the income was earned.

· If you don't have to be a provisional tax payer, it may not be your best choice.

· Avoid the use of money interest by paying enough or possibly overpaying.

· If you're operating a business, consider putting yourself under the PAYE system.

· You could ask the bank to deduct RWT at 33% instead of 19.5%, and place the balance in a high-interest term deposit.

· Prepare forecasts on expected tax liability throughout the year. Don't leave it until the end of the year.

· Consult an accountant practised in dealing with the IRD who can advise on tax planning opportunities, asset protection and statutory obligations like GST and provisional tax returns.

Avoid the 5% late payment penalties on provisional tax by paying by the due date. A further 2% penalty is charged for each month tax remains unpaid. Just do the maths: that translates to an annual penalty of about 30%.

What qualifies as self-employment?

The IRD has a 72-point checklist to differentiate the independent contractor from the employee. Underscoring this checklist is the requirement that individuals pay their own holiday pay and are responsible for the quality of the work provided.

The law uses five tests to determine what type of contract exists.

1. The independence test. The key is to look at the independence of the individual. Iain Craig of accounting firm BDO says ensure you get a contract for service as opposed to a contract to service, which is more of a master-servant relationship.

2. The intention test. Do the parties intend to act independently and within the spirit of prescribed methodology?

3. The control test. This looks at the degree of control the employer exerts over the way work is done, equipment supplied, jobs are prescribed, hours and methods.

4. Organisation/integration. Is it work commonly done by employees and integral to the business organisation?

5. Economic reality test. Does the type of business justify using an independent contractor; can the worker be dismissed; who's legally liable if the job goes wrong?

Five golden rules for reducing tax

1. Always structure borrowing so that interest is tax-deductible.

2. Consider investments in the name of someone on a lower tax rate, like a spouse or a child or inside a trust structure where there's flexibility in whom to allocate the funds to.

3. Ensure deductions are placed where they're most needed.

4. Establish an audit trail to secure tax deductions.

5. Discuss all borrowings with an accountant to ensure deductions fall where they can be used to offset PAYE.

Young executive with no family commitments, owns her first home and a small number of shares

Tax strategy:

· Evaluate benefits of becoming a contractor

· Consider selling the house and shares to a trust or qualifying company

· Negatively gear the investments

· Get a boarder for tax-free money

Married couple, both employees, have their house almost freehold, own a rental property, shares and have money in a small business

Tax strategy:

· Establish a trust for asset protection

· Do a matrimonial settlement and transfer the home and investments to a trust

· Maximise the mortgages on the rental property, and if freehold, borrow some more to invest again

· Consider capitalising the interest expense into the loan to increase it

Small-time entrepreneur has most of his assets tied up in his three businesses, employs 30 people, may sell the businesses one day

Tax strategy:

· Separate business and personal assets; protect personal assets in a family trust

· Develop an exit mechanism early to maximise tax-free capital gains and to avoid having to wind up the company; develop a succession plan

· Ensure employee benefits are managed to minimise FBT

· Structure debt and income to maximise tax benefits; focus on growth

Trader with a secure client list, a home office and is in partnership with his wife

Strategy:

· Use a trading trust rather than a partnership to protect assets and ensure continued income splitting

· Separate family and trading trusts

· Prepare a succession plan to maximise sale opportunities

· Claim everything you can; keep a log book and receipts