

Attributing Income for Tax Purposes?

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Tim Zonneveld - Senior Solicitor

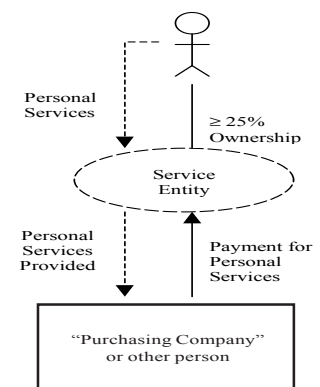
Taxpayers have now had the chance to fully apply the Attribution Rules (the Rules) contained in the Income Tax Act 1994 (the Act). This update for taxpayers briefly looks at some interpretation issues that have arisen when applying the Rules.

Structures affected

Where a person or company purchases the services of an “individual taxpayer” (or their associate) from a “Service Entity”, who is associated with the individual taxpayer, an amount must be attributed to the individual taxpayer.

A typical example of an affected structure would be one where a software engineer has at least a 25% ownership interest in a company, and that company’s only business is the provision of the engineer’s services to a particular software developer.

This structure and flow of services is illustrated by the following diagram.



In this situation, the engineer’s company would be required to attribute an amount to the engineer and the engineer would be taxed on that amount at their marginal tax rate (i.e. 39% instead of the company tax rate of 33%).

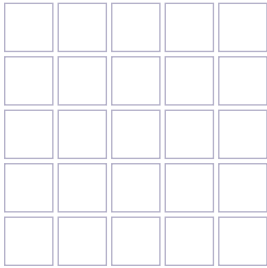
Issues that have arisen

The Rules adopt a “catch all” approach. However, exemptions exist to narrow the scope of the provision towards the targeted taxpayers. Unfortunately, various interpretational issues continue to arise under the exemptions, and these issues cause difficulty when taxpayers seek to apply the exemptions.

There is an exemption which provides that the Rules will not apply where less than 80% of the Service Entity’s gross income from personal services is derived from the sale of services to the Purchasing Company or their associates.

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David McLay - Partner

An issue arises under this exemption as to the meaning of the term “personal services”. Although this term is of critical importance, it is not defined in the Act or case law. In fact, the term has been intentionally left undefined as the Government considers that any definition will introduce doubt as to the boundary of the term!

This issue arises throughout the regime as the term largely drives the operation of the Rules. We consider the better view is that the term focuses on the intellectual and manual personal effort performed by the individual “in person”. Therefore, if you are not providing the services “in person”, it is unlikely that the Rules will apply to you.

Even by using the “in person” approach, difficulty can still arise when a distinction needs to be drawn between the sale of personal services and a contract for work and equipment/processes (which

obviously includes the personal services of the Individual). The latter becomes even more difficult to unravel where one global payment is received for the completed work. The question becomes whether the payment is attributable to “personal services” or not (eg. rental of equipment). This will always be a question of fact. Whether an apportionment can be made will depend on the circumstances of the situation.

Under another exemption, the Rules will not apply where “substantial business assets” are a necessary part of the business structure used to derive the gross income referred to under the first exemption. Substantial business assets are defined as depreciable property which on balance date costs more than either \$75,000 or 25% of the gross income for that income year. To consider a software engineer’s business with a gross income of \$200,000 and computer hardware with a depreciable value of \$60,000, the Rules would not apply as the 25% income threshold would be exceeded (assuming that there is no private use of the computer).

An issue arises under this exemption. Depreciable property does not include “assets” such as shares in the Purchasing Company, or particular types of intangible property such as internally generated assets, systems or methodologies. Therefore, if the software engineer has no tangible assets, but shares worth \$800,000 in the

Purchasing Company, the substantial assets exemption would not apply. Taxpayers therefore need to be careful in applying this exemption.

Amount to be attributed

Where the exemptions do not apply, the Service Entity is required to attribute income to the taxpayer. Income is required to be attributed on a “net” basis. Three different tests are provided and the taxpayer must attribute under one of the three.

While two of the tests are relatively straightforward, the most commonly applicable test requires “net income” from personal services to be attributed to the taxpayer. The taxpayer is required to consider the “personal services” issue and also determine the level of “net income” derived from the personal services. In practice, this “net income” concept is seen to be unclear.

While this issue is yet to be resolved, Inland Revenue has provided some general comment as to the application of the “net income” concept under this exemption. Essentially, they consider “net income” to be income less “head office expenses” which the Service Entity would have incurred had the non-service gross income not been derived. Examples include accounting and company office fees.

Our experience is that the approach applied in practice is for the Service Entity to offset operational expenses directly incurred in deriving the service income prior to attributing any income to the individual, but not to reduce the income by expenses unrelated to the derivation of the service income. Unfortunately, it is not possible to avoid dealing with this issue as the Act requires the lesser of the amounts to be attributed, meaning that the calculation must always be performed.

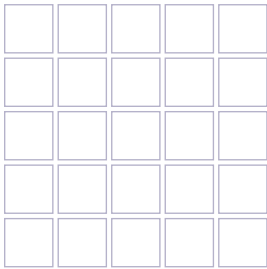
Avoidance

Given the interpretational problems that arise, we have often been asked whether it is possible to pay a dividend, amalgamate, sell or change the form of the Service Entities in order to remove the application of the Rules. The answer to this question is not simple. Where structures are changed to directly circumvent the Rules, there is a high risk of the restructure constituting tax avoidance. However, when commercial factors dictate a change in structure, this may present opportunities to mitigate the impact of the Rules. In any event the likelihood of tax avoidance purposes or effects existing will need to be determined on a case by case basis.

“Where the exemptions do not apply, the Service Entity is required to attribute income to the taxpayer.”



Niels Campbell - Partner



The verdict is in

International Financial Law Review, Asian Awards, March 2002 New Zealand Law Firm of the Year	
The Asia Pacific Legal 500, The Guide to Asia's Commercial Law Firms, 2001/2002 edition New Zealand's Leading Law Firm <small>More top rankings than any other New Zealand law firm</small>	The International Who's Who of Business Lawyers, 2002 edition New Zealand's Leading Law Firm <small>More nominated lawyers than any other New Zealand law firm</small>
The Clients' Guide to Law Firms in New Zealand, 2001-2002 edition New Zealand's Leading Law Firm <small>Ranked in all 29 areas of law More top rankings than any other law firm</small>	Global Counsel 3000, 2001/2 edition Top equal New Zealand Law Firm <small>Equal number of top rankings</small>

Bell Gully would like to thank our clients, and congratulate our staff whose hard work and commitment have made these outstanding results possible.

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