NEWSLETTER

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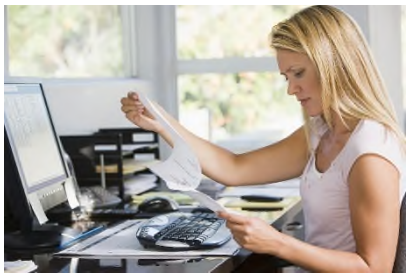
When errors are made

Tax compliance can be complex, between income tax, GST, PAYE there is often a lot to manage and get right. It is therefore inevitable that from time-to-time mistakes will happen. When these moments occur the question then becomes "what do we do?".



The Inland Revenue requires taxpayers to make a correct assessment of their tax liability when a tax return is filed. If an error has given rise to an underpayment, taxpayers are obligated to submit a voluntary disclosure to Inland Revenue to have the tax return amended, thereby ensuring the assessment is correct.

To make a disclosure, details of the error need to be provided. Inland Revenue will then review the information and decide if they agree that an adjustment is required.

Where an adjustment is required that gives rise to an increase in the amount of tax payable, Inland Revenue will consider whether a shortfall penalty should be charged. Shortfall penalties also apply if the adjustment reduces the amount of a tax loss.

There are five different categories of penalty which can apply. These penalties range from 20% for taking an unacceptable tax position or exercising a lack of reasonable care, right up to 150% for tax evasion.

The nature of the error and the facts surrounding how it occurred determine what type of penalty should apply. There are various concessionary provisions which can apply to reduce a shortfall penalty. For example, if a voluntary disclosure is made prior to being notified of an audit or investigation a shortfall

penalty can be reduced by 75% or even 100% in certain scenarios.

Where the taxpayer has already been notified of an audit or investigation shortfall penalties are only able to be reduced by 40%.

Some taxpayers will choose not to make a disclosure. This comes with the risk that Inland Revenue may themselves identify the error and if it becomes clear the taxpayer knew about the error and chose not to disclose it, the shortfall penalty implications could be worse. In addition, the perception on Inland Revenue's part that the taxpayer is 'non-compliant' could give rise to increased scrutiny in the future.

The reduction in shortfall penalties for making a voluntary disclosure provides a material benefit to do so and should be the default option. Inland Revenue practice in the context of a voluntary disclosure is also typically a positive experience, given the circumstances.

Therefore, if a "what do we do" moment does occur, making a disclosure may come with some short-term pain, but be better in the long run.

Effective decision making

In today's business environment, effective decision-making is key to navigating change and achieving sustainable growth.

For small to medium sized enterprises where there can be fewer individuals at a senior decision-making level, there is arguably a greater need to have a strong decision-making process to ensure decisions are not made in a vacuum.

However, how many business owners make decisions, is ad hoc, 'on the fly' and inconsistent.

There are various decision-making frameworks that can be beneficial in ensuring that decisions are clear, well thought out, and have the business's vision in mind. Some common elements to those frameworks are:

- Define the criteria against which a decision will be tested and ensure the criteria is transparent, measurable and where possible assign explicit probabilities to whether the criteria are achievable. For example, rather than aiming to 'increase profitability', aim to 'increase gross margin by 5% over an 18 month period' and assess the likelihood of achieving that objective.
- Discuss the decision with others. Whether discussing a proposition at the dinner table or with a trusted business advisor or ideally an independent Director (whether formal or someone who provides that support informally), valuable feedback will be received. The process of 'thinking out loud' will also help crystallise your own thinking and help form a view.
- Pro-actively seek out and consider information that might contradict the investment hypothesis.
- Consider whether the decision to proceed aligns with the strategic objectives of the business and is in alignment with previous decisions.
- Is there an opportunity cost? This could be readily identifiable or something unforeseen, i.e., commitment to a path now may rule out the option of pursuing a different opportunity later.
- Is the rationale, expected outcomes, and plan for implementation able to be clearly communicated to others.
- Finally, there is the consideration of speed. Sometimes decisions do need to be made quickly. But ideally, pause, and take your time. It's a bit like the decision to reply to an angry text, email, Facebook message or on-line review as soon as you read it … we all know it is best to not hit reply, but to wait and reply later when you are cool and calm.

The above list is not based on a formal decision making framework, but it does provide a sense of what it takes to ensure good decisions are made.

By employing a structured process business owners can test their ideas at a fact-based level to ensure the best possible outcome.

PAYE and personal grievances

Although not desirable, it is not unusual for an employee to raise a personal grievance with their employer. Section 123 of the Employment Relations Act 2000 (ERA) provides for a number of remedies where an employee has a personal grievance.

If an employee suffers humiliation, loss of dignity, or injury to feelings one remedy is for a compensatory payment to be made, whether as part of a court ordered award or an out of court settlement.

The question often then arises regarding how the payment should be treated from a tax perspective. Depending on the circumstances, such compensation is not considered to be derived "in connection with employment" and is therefore non-taxable, and there is no requirement to withhold PAYE. However, because the treatment is very fact specific it is common for payments that are treated as non-taxable to be reviewed by Inland Revenue or as part of a due diligence process.

Because of that potential scrutiny it is important to have key documentation, guidance, and evidence to support the treatment adopted.

In June 2006, Inland Revenue released BR Pub 06/05 providing further commentary on the topic. The key conclusion from the commentary is that payments that are genuinely and entirely for compensation for humiliation, loss of dignity, or injury to feelings, under section 123(1)(c)(i) of the Employment Relations Act 2000, do not meet the definition of income per section CE 1 of the Income Tax Act 2000, and PAYE does not apply.

The IRD's view in this publication is that there must be sufficient evidence to prove that firstly, there is the presence of a genuine Personal Grievance, secondly, that there is a sufficient nexus between the amount paid and the severity of the claim, and thirdly, that the payment made is entirely tied to the grievance and not another statutory payment obligation.

One of the key areas of this section is determining whether the payment is genuinely and entirely in relation to the Personal Grievance. Payments made under section 123(1)(c)(i) are a benefit in money. An employer would therefore need to demonstrate that the payment was not actually made "in connection with the employment or service" of the recipient. For example, a payment which is in substance based on lost wages, but labelled for 'humiliation' would be at risk of being taxable.

In Inland Revenue's view there needs to be valid and documented proof of the Personal Grievance which would usually require an admission in writing by the employer that they acted in a manner that was unfair or unjust.

However, in a settlement scenario it is common for the employer to not make such an admission and often have asserted otherwise, and therein lies the 'catch 22'. In the absence of an admission, it becomes very difficult to demonstrate that a payment is for humiliation, loss of dignity, or injury to feelings.

When is a motor vehicle subject to Fringe Benefit Tax?

A common complaint about Fringe Benefit Tax (FBT) is that it is too complex, particularly when it comes to motor vehicles, which becomes a point of frustration given it is one of the most commonly provided benefits. This is borne out by how common it is for mistakes to be identified during an Inland Revenue investigation or due diligence process.

One of the most common mistakes arises from not properly understanding the circumstances in which the provision of a vehicle to an employee for private use is subject to FBT.

There are three broad classifications of motor vehicle under the FBT regime.

Private Use Vehicle: As akin to a catch-all, if a motor vehicle is made available to an employee for private use it is likely to be subject to FBT, unless a specific exemption applies, such as the work-related vehicle exemption (discussed below).

Private use includes the use, or availability for use of the vehicle outside of business purposes. It is important to note that home to work travel is specifically defined as private use. Hence, even if private use is prohibited, but an employee uses the vehicle to drive to work, FBT could still apply.

Work-Related Vehicle: Not all vehicles provided to employees attract FBT. A vehicle may qualify as a work-related vehicle if it meets four criteria, being:

- sign written,
- not be designed principally to carry passengers (e.g. a ute),
- required to be stored at an employee's home as a condition of employment, and
- not be available on a particular day for private use, unless it is incidental to business use.

If a vehicle meets the criteria on a particular day, it is not subject to FBT on that day.

The key difference between the private use vehicle and work-related vehicle is that travel between home and work may be treated as exempt if the motor vehicle qualifies as a work-related vehicle. Supporting documentation and spot checks are essential to ensure the work-related vehicle exemption applies.

Pool Vehicle: A pool vehicle is another category that can be exempt from FBT. Pool vehicles are shared among employees for business use and should not be used for private purposes. These vehicles are kept on the business premises when not in use and must be available for multiple employees, i.e., not taken home by an employee.

Understanding the FBT implications of providing motor vehicles to employees is essential for compliance. Complexity can arise in specific situations, such as when an employee's home 'might' qualify as a place of work and therefore travel between home and work itself is 'on work' and not subject to FBT.

Given the complexity it is not a surprise that mistakes in this area occur - which begs the question as to whether the rules are fit for purpose.

Snippets

Schedular tax activity by Inland Revenue

The schedular tax regime falls under the PAYE rules and typically applies to require tax to be withheld from self-employed individuals if they perform certain types of work, such as modelling or shearing.

On its website Inland Revenue have noted non-compliance has been identified within the horticulture industry in relation to contractors not meeting their tax obligations. This is likely to give rise to an increase in the use of prescribed rates where additional tax needs to be withheld from payments to such contractors.

Ordinarily, most payments to companies are not subject to schedular tax. However, payments to companies for the supply of labour in relation to cultivation contract work are subject to schedular tax. Inland Revenue has also identified non-compliance in this situation.

In practice, Inland Revenue are requiring businesses that have already made payments to horticultural contracting companies without schedular tax being withheld, to require the applicable amounts to be paid to Inland Revenue.

From a commercial perspective, this is problematic because the company paying the tax to Inland Revenue then needs to revert back to the company that provided the services to seek a partial refund to reimburse it for the tax payment.

Understandably, this can be frustrating for both parties involved, particularly where the company that provided the services has effectively used the cash to pay their provisional tax.

Paying for flu vaccinations

Flu vaccinations are exempt from fringe benefit tax (FBT) if they are provided to employees either through a clinic set up on work premises, or where a voucher is given to the employee to use at their doctor or another clinic. This is because the vaccination falls under a specific exemption targeting a health and safety risk in the workplace.

However, there has been an inconsistency in the legislation. If an employee pays for a vaccination themselves and is then reimbursed by their employer, the reimbursement is actually taxable and subject to PAYE; due to health-related expenditure being considered to be private in nature.

This is a product of the standalone nature of the FBT rules and the employee reimbursement provisions. Something which is often misunderstood by employers.

A proposed new section of the Income Tax Act aims to resolve this issue, to ensure employers are not worse off if they follow the reimbursement path, by prescribing that an amount paid by an employer to or on behalf of an employee for a flu vaccination will be exempt income of the employee.

The draft legislation states that the amendment will be effective for the 2025 – 26 and later income years.

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