

# **‘A’ Taxing the Farmers**

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## **Introduction**

Once upon a time, New Zealand farmers were not required to pay income tax. That all changed with the election of the first Labour Government and the demise of the Liberal Party. Since then, farmers have been caught by the ever-expanding net of tax gathering by successive Governments keen to continue feeding their voracious appetites to spend taxpayers’ hard earned income.

To many New Zealanders, taxation has become a dirty word. We are taxed on income, fuel, alcohol, cigarettes, investments, purchases and supplies of goods and services, travel, the recreational use of an increasing number of our national treasures and resources, we even faced the threat from the incumbent government of the implementation of the now infamous FART tax. With additional levies such as ACC, rates and resource consents, the costs of being in business are onerous.

This paper is designed to enhance farmers’ awareness of legitimate tools and strategies that can be employed to minimise taxation. The reality is that without considered taxation planning, for some farmers the benefits of being in business are outweighed by compliance costs.

## **Tax Planning**

Legitimate tax planning is not unethical, it is not avoidance and it is not evasion. The tug-of-war between the Inland Revenue’s interests on the one hand and the benefits for the taxpayer on the other is on-going. Indeed, there is a fine line between legitimate tax planning and avoidance. It can be argued that the role of a tax adviser is to scout those boundaries, to protect them and where possible gain a little ground. If we don’t ask the questions, if we don’t take the risks, there is a danger that we will be pushed back to a position that is untenable and unprofitable, where our clients could be out of business. At times this may seem like a David and Goliath struggle; the Inland Revenue has deep pockets to test these cases and often the

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taxpayer has limited means. But clearly parliament intends taxpayers, particularly those in business, to utilise legitimate means of tax mitigation.

Tax aggressive accountants are the boundary riders. They represent the rights of taxpayers to maximise the returns they receive for their labour, to minimise their costs and thus provide a better life for their families and those they employ. Wealth creation has spin-offs for every New Zealander.

## **Structuring your affairs**

So how can farmers best structure their affairs to minimise costs and maximise profits? The answer lies in flexible business structures as a starting point, followed by careful taxation planning. Business structuring is not and cannot be all about tax. There are multiple considerations when choosing the most appropriate structure including asset protection, succession planning, employment issues, the nature of the business and family circumstance. Structures must be well planned, well justified and avoid the appearance of a sham.

## **The right to structure affairs**

It is well established in law that any person has the right to structure their affairs as they choose. The reality is, that in any business plan, taxation will be one of the factors to be considered. This has been acknowledged in the New Zealand courts: “It is a recognized reality that most business or family transactions have tax minimization (to use a neutral term) as one of their purposes or effects, and with a degree of significance such that it cannot realistically be termed incidental. Read literally s99(2) avoids for tax purposes the majority of business and family transactions” *BNZ Investments Ltd v C of IR* (2000) 19 NZTC.

In what has become known as the *Duke of Westminster* principle, the House of Lords stated that “Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be.” *Inland Revenue Commissioner v Duke of Westminster* [1936] AC 1.

The view was confirmed in the Privy Council case, *O’Neill v Commissioner of Inland Revenue* (2001) : “...the adoption of a course of action which avoids tax should not fall within s99 if the legislation, upon its true construction, was intended to give the taxpayer the choice of avoiding it in that way.”

And most recently in the New Zealand Taxation Authority Barber J in an interim decision known as *Case V20* confirmed the taxpayer’s right to structure affairs in a tax efficient manner: “I would hesitate to refer to it as unusual in that, until about 1990, dentists (and other professional persons) were expected by their ethical rules to operate as sole traders.

## Trusts

Builders, plumbers, shopkeepers, and most types of business people have for decades been permitted flexibility of business structures based on corporate and trust models without there being any suggestion of tax avoidance, except in extreme cases.”

“...it seems to me that if a person structures his/her business activities on a corporate or trust model rather than that of a sole trader, which a businessperson must be perfectly entitled to do, it is standard practice to place some ownership of assets with the person’s family whether by way of a family trust or by their holding shares in the trading company or a holding company or whatever.”

It is clear therefore, that both Parliament and the Courts intend taxpayers to have the freedom to structure their affairs as they see fit. Regardless of this fact, the Inland Revenue is in the process of launching an attack on trading trust structures in particular. Why? Because they work too well.

Trusts in general have enjoyed a gigantum increase in popularity in the past 20 years. Although the concept of divesting oneself of personal assets for the benefit of others has been around for hundreds of years, it is only recently that the full import of their flexibility has been understood and utilised in New Zealand.

## Trust advantages

The advantages of trusts have been well documented. Practical uses include the following:

### ***Relationship property claim protection***

Property settled on a trust before the commencement of a relationship can be clearly identified as separate property and not subject to relationship property claims (with some exceptions).

### ***Asset protection from creditors***

Business people trading on their own account and holding assets and/or giving guarantees in relation to the business, can be placing such assets in jeopardy.

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### ***Protection from asset means testing***

As a discretionary beneficiary only, with a mere expectancy, there is no requirement to disclose any trust assets or the receipt of any benefit, other than income from the trust. As such assistance may be available where otherwise it may not have been (i.e Family Assistance, Unemployment Benefit, Community Services Cards). Again arrangements cannot be made for these purposes. They must be incidental and should be in place well before any possible need.

### ***Protection in old age***

Assets held in trust can be protected from poor decision making by aging beneficiaries or settlors. Likewise, assets can be protected from undue influence over the beneficiaries or settlors by others who stand to gain from the acquisition of those assets.

### ***Distribution***

The ability to distribute the income between all or any of the beneficiaries enables utilization of any of their lower tax rates.

### ***Protection from Family Protection and Testamentary Promises Estate claims***

As assets are held by the Trust, not personally, a diminished estate is less likely to attract testamentary promise or creditor claims.

### ***Taxation***

Income received by the trust is taxed at 33 cents in the dollar if retained by the trust or it will be distributed to the beneficiaries at the beneficiary's tax rate. If the beneficiary earns less than \$38,000 the tax rate will be 19.5%, a tax saving 13.5%. This is particularly effective where a beneficiary has reached the age of 16 and is not earning or is on a low income. For beneficiaries who are minors (under 16), the beneficiary income is taxed at 33% after the first \$1,000.

### ***Income spreading/income deferral***

By utilizing trusts, income can be deferred by payments in advance between entities.

### ***Provisional tax deferral***

By spreading income over a number of beneficiaries, substantial provisional tax deferral can be gained in terms of the \$2,500 provisional tax threshold test.

### ***Protection from wasting by children***

Whereas assets might otherwise be distributed in accordance with the terms of the will, the use of a trust can maintain those assets but still have them available to assist where

appropriate. The Memorandum of Wishes will guide the Trustees in terms of the settlor's wishes.

### ***Avoiding family disputes***

Because the beneficiaries are discretionary only, they have no specific entitlement to a particular share. Flexibility is provided.

### ***Succession planning***

Trusts provide the ability, indirectly, to control succession. Retirement and continuity after death can be more readily facilitated in a trust structure. On-going daily business matters can be attended to without assets being frozen

### ***Flexibility to add and remove beneficiaries***

It is possible, by appropriate drafting of the clause which defines discretionary beneficiaries, to widen or narrow the possible list of beneficiaries who could benefit.

### ***Special purpose funds***

For example, the education of children.

### ***Charitable purposes***

To preserve capital or income or both for charitable and similar purposes.

### ***Protection from unfavourable legislative change***

For example, the containment of assets in a trust may be protection against the re-introduction of death duties or the introduction of a wealth tax.

### ***Lawsuit***

This can be particularly relevant for professional practitioners. However, it is prudent to protect ones assets against a negligent act or mistake.

### ***Less bureaucracy on distributions***

In a company, any distribution of profits to its shareholders must now be accompanied by a Solvency Certificate, whereas this type of bureaucratic paperwork does not exist for Trading Trusts. In the light of the decision in *Kitchener Nominees Limited v James Products Limited*

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(2002) 9 NZCLC which resulted in the clawback of distributions to shareholders held in current accounts, the Trading trust structure is even more appealing. Distributions made to beneficiaries of a Trust and held in their current account are indefeasible, in other words the funds have vested in the beneficiary and cannot be clawed back by creditors.

### ***Simplicity of capital distributions***

For a company to reduce its capital or repurchase its shares, a considerable amount of bureaucracy is involved and there can be tax complications if things are not done exactly right. However, with a Trading Trust, these problems do not exist – subject to the wording of its deed, a trust can always make a distribution to its beneficiaries without any of these types of complications.

### ***No restrictions on the ability to carry forward losses***

In a company, carrying forward of losses can be a problem where there is a change in shareholders. With trusts, there are no restrictions on the ability to carry forward losses even if the original beneficiaries are deleted and the new beneficiaries substituted pursuant to powers under the Deed of Trust.

### ***Avoiding problems of company groups***

Groups of companies can be a problem from a taxation point of view, in that sometimes it is difficult to off-set the losses in some of the group companies against the profits in other group companies for taxation purposes. Where the group companies are all Trading Trusts, this problem would not generally exist, because it would usually be possible to distribute profit from the profit making trusts to the loss making trusts so as to achieve the required off-sets for tax purposes.

### ***Unknown future circumstances***

To take into account changes in circumstances of beneficiaries which are not certain at the date of settlement but which the settlor wishes to recognize should they arise. For example, claims from future spouses of the settlor's children.

The concept of family trusts is well entrenched in New Zealand. However, using a trust structure to operate a business is a relatively new approach, one which we have been slower to embrace than our trans-Tasman counterparts.

## Trading trusts

Where a trust is operating a business, the trend has been towards the trustee being a company, to limit the liability of the trustees who act as directors of the Company. The company does not hold any assets; it is like a shell company. It can be argued that there is thus a two-pronged defence against creditors. However, it is important to remember that the corporate veil does not diminish the personal liability for directors who act recklessly or fraudulently. Natural person trustees of a trust which operates a business would potentially have unlimited personal liability for the debts and obligations of the business, whereas any recovery in an action against the corporate trustee would be limited to the trust assets and perhaps the Company, which has no assets.

When a Trading Trust borrows money from a financing institution, the settlors are generally required to enter into personal guarantees, as the trust has few assets. This reduces the limited liability of the settlors to the extent of that loan. The risk associated with this should be taken seriously, but also kept in perspective. It is standard business practice for individuals to provide personal guarantees for business borrowings.

One of the advantages of a Trading Trust is that there are no fringe benefit implications for beneficiaries having overdrawn current accounts with the trust. This is a problem that bedevils the ordinary family company. Interest must be paid on overdrawn shareholder current accounts, failing which fringe benefit tax may be payable, or worse, liability for deemed dividends incurred.

The other clear advantage of a Trading Trust over a closely-held company is the potential for income splitting. In a company, the profits are taxed at a flat rate of 33%. While there is some scope for reducing the effective rate of tax in companies by distributing profits with full imputation credits to shareholders who pay tax at their own individual tax rates, companies do suffer the disadvantage that distributions must in general be made to shareholders in the proportion in which they own shares in the company.

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A discretionary beneficiary does not have a legal interest in the trust assets, but rather a right to be considered, so the assets of the trust cannot be attacked by beneficiary creditors, unlike shareholdings in a company.

No percentage share of the profits of the business are earmarked for any given beneficiary. The beneficiaries would normally include the settlor's children and grandchildren so the business profits can be distributed among that class of beneficiary in such a way as to achieve the optimum tax savings. A company structure does not generally have the flexibility to achieve this.

Perhaps the greatest disadvantage of a Trading Trust is the inability to pass tax losses on to beneficiaries. In comparison, with a loss attributing qualifying company (LAQC) the losses can be passed to the shareholders to use in their individual capacities. However, this perceived disadvantage can be offset by other benefits.

A Trading Trust can be highly effective when used in combination with a Family Trust. Whilst affording additional asset protection, the interface between the two can allow for inter entity loans, distributions, and sales and purchases. A simple example is where assets are transferred to the Family Trust, and leased to the Trading Trust. Profits can be distributed to beneficiaries, who then settle funds on the Family Trust, begin an active gifting programme, and firmly protect those profits from any attack by creditors on the Trading Trust.

Another option is to incorporate an additional company which can lease assets to the Trading Trust. The shares in the company can be owned by the Family Trust. The complexity of structures will depend on the complexity of the taxpayer's affairs. It may not always be prudent for all assets to be held by the same business or asset protection entity. Where there is a husband and wife partnership, it may be wise to establish two trusts to trade as a Trusts Partnership.

Clearly, the ideal structure for any given business needs to be considered on a case-by-case basis. However, in any business structure, care must be taken to get things right, preferably from the outset. The recent decision by Barber J in *Case W33*, the final decision on the *V20 Case* sounds a cautionary note in this area.

The case concerned a highly successful dentist who had been in business for several years. For personal and asset protection purposes, he restructured from being a sole trader to a Trading Trust. There were resultant tax benefits. The case centered around the "market salary" that was paid to the dentist. The court looked at what the dentist had earned prior to the restructuring, then the salaries paid subsequent to the new trading structure being established. Barber J accepted that there was no tax avoidance in the first year of trading, but revised the dentist's salary in the second year due to increased profits. This is a disturbing outcome and one unlikely to have been intended by the court. Taken to the extreme, it suggests that where a business makes a profit, salaries must be adjusted upwards in that year. Logically then, if the

business made a loss, then nothing would be paid by way of salaries at all! Where is the return for risk and investment which every business expects in the long term? According to this decision, the bulk of profits needs to be paid out in salaries, and not even market salaries, but salaries based on profits. Unhelpful as this case may be, it does signal the importance of setting realistic salaries, signaling transparent transactions and avoiding any appearance of a sham. Tax mitigation must be incidental to the business structuring and not the driving factor.

Inland Revenue and the Law Commission have both signaled an intention to scrutinize the use of Trading Trusts with a view to restricting certain distributions. The Law Commission proposes a solvency test, similar to that which must be met by companies, before distributions are made. The Inland Revenue are targeting market salaries and insisting on justifications for capping beneficiary salaries below the top tax bracket.

The key to keeping the Inland Revenue sweet is documentation. Trustees must be ever vigilant in recording their decisions, substantiating them and reviewing them. In any business structure sound record-keeping and excellent advisers are the key.

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