

health adviser

Grant Thornton 

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New Zealand profit outlook better than most

New Zealand businesses are among the most bullish in the world about profitability in the coming year, according to the 2005 Grant Thornton International Business Owners Survey (IBOS). New Zealand is more optimistic about profit than in 2003. New Zealand firms are second only to India in their profitability outlook.

Overall, business owners in India for the second year head the optimism / pessimism balance among the 24 countries surveyed with a score of +88%. South Africa, Ireland, Australia and Canada also remain very optimistic overall, with New Zealand tucked in just below them in the global league table on +64%, well ahead of the global average.

But when it comes to their feelings specifically about future profitability, New Zealand business owners have more hope than their Australian counterparts. Companies in India topped the optimism / pessimism balance in this category with a score of +75%, New Zealand companies followed with +62% (up from +55% last year), and Australian firms came out at +57%. Not surprisingly, New Zealand companies surveyed also had favourable expectations on increasing turnover and selling prices.

Given that there has been a significant increase in general optimism about the economy on a worldwide basis, it is very encouraging to see New Zealand right up there when measured against others. The fact that New Zealand is so high on the profitability outlook scale is particularly pleasing.

India is something of a phenomenon at this time, with business sentiment at an all-time high, foreign investment growing and the sharemarket index at a record level. Outside of India, New Zealand is the best of the rest when it comes to having an optimistic outlook on profitability, so it is no surprise that the New Zealand stockmarket is performing well.

Apart from the overall optimism / pessimism balance, the survey specifically charted companies' expectations on profit, exports, employment, investment in buildings and investment in plant and machinery. It also this year looked especially at whether terrorism had made an impact on firms' optimism.

New Zealand was mid-field among the companies surveyed when it came to outlook for investment in buildings as well as plant and machinery.

For further information on the IBOS survey please contact your local office or visit: www.grantthornton.co.nz

Considering year end tax implications

There are a number of issues that need to be considered when preparing year end financial statements. The timing and treatment of certain expense items can have tax implications, and in some cases the accounting treatments applied can result in tax efficiencies.

Typically accountants, in conjunction with the business owners, need to consider the treatment of:

certain expenditure, in particular whether it can be brought forward into the current period

- the general rule is that business expenditure is deductible in the tax year that it is incurred

repairs and maintenance

- if carried out before year end then the amount will be deductible in the current year
- the total cost of a service contract is deductible if it has less than three months to run at balance date and costs less than \$23,000 for a full year
- if purchasing a fixed asset and there is a warranty or service contract, ensure the warranty or service contract is separately identified, as these are deductible

stationery

- if re-stocking is about to occur in April or May, consider moving this forward to March

travel and accommodation

- advance bookings for business related travel and hotel or motel accommodation are deductible provided it is not more than six months in advance and does not exceed \$12,000

subscriptions

- newspapers, journals and periodicals are deductible without adding back unexpired amounts
- association memberships are tax deductible provided they extend no more than 12 months after balance date and the subscription does not exceed \$6,000

insurance

- insurance premiums are deductible provided they are not prepaid for more than 12 months and the total amount of such expenditure incurred in the income year in respect of the contract does not exceed \$12,000

advertising

- if the period of the advertising relates to no more than six months after balance date and the advance portion is less than \$12,000, then it is fully deductible in the current year

rent

- prepaid rent is deductible provided it is not prepaid for more than six months and the amount prepaid is less than \$23,000

consumables

- consumables used in conjunction with but not forming part of the final product can be deducted in the year of purchase, provided total stocks at year end do not exceed \$58,000

warranty and discount provisions

- if warranty income is received, the unexpired portion can be deferred
- if a prompt payment discount is offered to debtors, then a provision for the potential discount can be made and claimed at balance date

leave provisions

- amounts owing at balance date for holiday pay and long service leave are only deductible if paid out within 63 days of year end

bad debts

- bad debts are deductible, but only in the year that they are written off

staff bonuses

- any staff bonuses should be determined and paid within 63 days of the year end, otherwise they are not deductible until the following year

fixed assets and depreciation

- depreciation is claimed monthly, for each month the asset is used or available for use in the business
- assets costing less than \$200 (GST exclusive) can be expensed as repairs, rather than capitalised
- for any assets disposed of at a loss (either by sale or scrap), the loss becomes deductible in the year of disposal.

Note that whilst certain expenses can be moved into the current year and become deductible in that year, this can have cash flow implications.

Maintaining tax losses and imputation credits

It is not uncommon for the ownership structure of a company to change during the year. There are however issues to consider in terms of the continuing ability to carry forward tax losses and imputation credits.

In order for a company to carry forward tax losses and imputation credits, a certain level of shareholder continuity is required. The reason is that shareholders who were present when a tax benefit arose should essentially be the same people who take advantage of that benefit when it is used.

For the carry forward of losses, the level of continuity required is 49%. Breaching this will result in the forfeiture of any tax losses.

Imputation credits are how shareholders receive a credit for tax paid by the company, when they receive dividends. To carry forward imputation credits the required level of continuity is 66%. Breaching this level will result in the forfeiture of any imputation credits, with the practical effect of making any tax-paid retained earnings of the company subject to tax again when they are distributed to shareholders as dividends.

The continuity percentage is measured by comparing each shareholder's percentage interest from one period to the next, and then adding up the lowest shareholding percentage of each shareholder. There are "look through" provisions and other rules that are used to determine a person's interest in a company.

Example - ABC Limited:

	1/4/04	31/3/05	Lowest
John	40%	30%	30%
Grant	40%	10%	10%
Bob	20%	60%	20%
Total	100%	100%	60%

In the above example, the continuity of shareholding is 60%. This level of continuity is sufficient to carry forward any tax losses the company may have, but is not at a sufficient level to carry forward any imputation credits.

Assessing whether to be part of the qualifying company regime

Outline of the qualifying company regime

The qualifying company regime aims to treat small, closely - held companies in a similar way for taxation purposes as partnerships. This is achieved by deeming the shareholders and the qualifying company to be one entity for tax purposes. However, all the benefits of corporate ownership, in particular limited liability, remain.

Subject to certain conditions:

- directors and shareholders can elect that a company become a qualifying company
- a qualifying company is required to satisfy its income tax liability in the same way as other companies
- a shareholder must elect to become personally liable to pay his or her share of any income tax not met by the company
- a company may be liable to pay qualifying company election tax (QCET) once it becomes a qualifying company
- a qualifying company can distribute capital gains tax free without the need to liquidate the company (distributions of capital gains from non-qualifying companies are taxable as dividends, except on liquidation)
- only dividends with imputation credits attached are taxable to the shareholders
- net losses arising before the company became a qualifying company are forfeited on entry into the regime
- a qualifying company can, if its shareholders and directors elect, become a loss attributing qualifying company (LAQC)
- a LAQC must pass through or attribute to its shareholders any tax losses it incurs while it is a LAQC

(the shareholders can then offset those net losses or carry them forward)

- once a LAQC passes net losses through to its shareholders the company cannot carry them forward.

Advantages of being a qualifying company

The advantages of the qualifying company regime include the following:

- dividends paid by a qualifying company are either tax free to the individual shareholders or have maximum imputation credits attached
- capital gains (both realised and unrealised) can be distributed tax free without liquidation of the company
- shareholders of a LAQC can offset those net losses passed through from the LAQC against their net income (this can be very tax efficient)
- non-cash dividends distributed to shareholders of qualifying companies who are not employees are not subject to FBT.

Disadvantages of being a qualifying company

Some of the disadvantages of the qualifying company regime include:

- its complexity
- shareholders become personally liable for a share of any of the company's income tax liabilities
- qualifying company election tax may be payable (on entry into the regime) on taxable reserves, currently at a rate of 33%
- any company net losses from previous years are forfeited upon entry into the regime
- the continuing compliance costs.

Improving business performance

Initial assessment

A number of businesses come under pressure, at some stage of their business cycle. Whilst the statement of financial performance may indicate reducing profits, it is often the impact on cash flow that causes the greatest stress.

A structured approach is required to address these issues effectively. Once engaged by our client, the first step we take is to review:

- recent financial performance and the current financial position of the business
- the existing business strategy
- market factors, including competitive advantages and market positioning
- the turnaround or business development potential.

This initial assessment provides the foundation for performing a more detailed business evaluation, and for developing the strategy for addressing key financial and operational issues.

Detailed business evaluation

The next step is to complete a detailed business evaluation, and provide a clear strategy (including recommendations and action plans) designed to meet the needs of the business and its stakeholders. This process involves assessing:

- the strategic position of the business, the key issues to be addressed, and the options available
- the financial and operational risks of alternative strategies
- business performance, using benchmarking techniques
- the operational efficiency of the business
- the capabilities of the management team
- the effectiveness of governance processes
- the effectiveness of the internal control and management information systems
- working capital and financing requirements, including appropriate funding sources and structures.

Once a detailed business evaluation has been performed, then a business plan is prepared. As part of this process financial forecasts are prepared, reflecting the business strategy to be applied. We also provide assistance in negotiating funding requirements with financiers.

Strategy implementation and support

When implementing the business plan, it is critical to monitor progress on an ongoing basis. We provide on going support in the form of:

- hands-on assistance with implementing the strategy
- liaising with financiers
- monitoring operational and financial performance (including the development of management reporting processes)
- facilitating regular management meetings to review progress and business development opportunities.

The preparation of financial statements is only one important role that a chartered accountant performs. Real value is added when the business owner works with its business advisor to improve business performance.

If you require further information on any of these topics or would like details on any other accounting matters, contact your local Grant Thornton office:

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