

health adviser

Grant Thornton 

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Increase in Annual Holidays

In the Autumn 2006 issue of this newsletter, we alerted you to changes to the minimum annual holiday entitlement for employees which comes into effect on 1 April 2007.

These changes could have an accrued liability impact, and therefore a potential financial impact for businesses could occur anytime from 1 April 2006, depending on an employee's anniversary date.

If your company has an annual close-down or a company anniversary date, there could be some clarity needed in determining the anniversary date.

We recommend that you discuss with your legal adviser, the EMA or similar organisation what anniversary date is appropriate for your employees.

Financial fraud, an unpleasant reality

Effective internal controls help safeguard an organisation's assets, prevent irregularity and fraud, promote operational efficiency and encourage adherence to management policies.

Internal control is an integral part of an organisation's management. Its aim is to provide reasonable assurance that the organisation's objectives are being met in the following categories:

- effectiveness and efficiency
- reliability of financial reporting
- compliance with its laws and regulations
- safeguarding and accountability of assets (including company's funds and cash)
- preventing and detecting errors and fraud
- achieving targets through effective stewardship of company's resources.

Effective internal controls should achieve the following general objectives:

- orderly, ethical, economical, efficient and effective operations
- fulfilling accountability obligations, whereby management and those charged with governance as well as the individuals within the business are held responsible for their decisions and actions. These include stewardship and all aspects of performance
- compliance with laws and regulations
- safeguarding resources against loss, misuse, and damage due to waste, abuse, mismanagement, errors, fraud and irregularities

The central proposition is that implementing a system to prevent fraud is one thing, creating a climate in which people don't wish to commit it is another.

It is therefore the responsibility of management and those charged with governance to:

- integrate cost-effective internal control into all of its operations
- monitor the effectiveness of its internal control operations and the outcomes

Get back to basics:

- improve your culture - understand that fraud is linked with culture and does not depend wholly on internal controls
- automate your controls
- maintain your risk framework
- institute an internal control programme
- ask 'what can go wrong?' questions
- conduct a fraud 'health check' - identify red flags

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Financial fraud, an unpleasant reality (Cont).

Ask these questions:

- Has your organisation undergone major change such as new responsibilities, reorganisation, funding cuts, expansion of programmes, or changes in management?
- Are you understaffed and/or has workload drastically increased?
- Are your staff having difficulties handling operational workload?
- Do your employees understand which behaviour is acceptable or unacceptable?
- Are your employees satisfied or generally disgruntled?
- Is management aware of actions taken at the lower level of the organisation?
- Is there lack of clarity around roles, responsibilities and accountability?
- Is the business structure inefficient or dysfunctional?

Depending on the answers, you may need to address the red flags. We have to recognise that fraud is a real threat. Your business is not immune, but there are ways to protect it. Remember, the way your practice functions can have a major effect of the incidence of fraud.

Taxing investment income - an investor's overview to the proposals in the Bill introduced 16 May 2006

The general tenor of the proposals for the taxation of portfolio investment income is no doubt well-understood: repeal of the grey list, and the extension of tax on unrealised capital gains on certain investments held outside New Zealand and Australia, subject to certain limited exemptions, and a \$50,000 de minimis rule.

Submissions closed on 7 July, and no doubt before the legislation is passed there will be amendments to the proposals in the Bill - possibly major amendments.

Clients are naturally concerned how the proposals will affect them, and in our recent experience no two clients will experience exactly the same impact on their present portfolio. Each situation depends on the individual's residence status; their current portfolio - the size of the portfolio; the location of each investment, and whether the investment is held directly (personally), indirectly (through a fund - New Zealand or foreign) or indirectly through a family trust (or a family company).

We don't know what the legislation will finally look like, but we do know what it is at present, and how the proposals differ from the present legislation.

Accordingly, in the paragraphs following we set out briefly the impact on each of the classes of investor mentioned above, if the legislation were to be passed in its present form. In our view it is a little early to be taking corrective action - we recommend to clients that they should wait a few months for further clarity on the

proposal but we can advise clients on the impact on their particular situation of the Bill proposals.

The key elements of the proposals for individual investors are:

1. Direct investors

- No change from the present for domestic (New Zealand) investments, and direct investment in Australian listed companies. That is, dividends are taxed, imputation credits are subject to existing rules, and realised gains are not subject to tax, except to traders.
- Direct investment in Australian unit trusts, managed funds, and other unlisted entities - the new foreign investment fund (FIF) rules will apply. The FIF regime taxes New Zealand interest in certain offshore entities where the taxpayer does not have a controlling interest.
- Direct investment anywhere else in the world - the new FIF rules will apply.
- A \$50,000 de minimis rule will be available however - the new FIF rules will permit total investments at a cost of up to \$50,000 before the FIF regime kicks in.

2. Indirect investors, through a New Zealand fund

- Investment through New Zealand Portfolio Investment Entities (PIEs) such as most New Zealand unit trusts and superannuation funds will no longer suffer the tax on capital

gains currently paid by professional fund managers, provided that the PIE invests in New Zealand, or in Australian listed companies

- Investment through a PIE in other Australian investments, or anywhere else in the world will be subject to the new FIF rules.
- All tax will be withheld at source by the PIE, at the personal investor's marginal tax rate of 19.5% or 33%. The tax will therefore be a final tax for all, including 39% taxpayers.
- Since many investors will not need to file an income tax return, the benefit of tax losses and excess tax credits in PIEs will be provided to investors via a tax rebate from the Inland Revenue Department.

3. Indirect investors, through an Australian fund, or any other foreign fund

There are many New Zealand investors, particularly immigrants and those who have at some time lived in Australia or elsewhere, who have portfolio investments held through Australian and foreign-domiciled managed funds.

- The new FIF rules will apply, even to New Zealand and Australian listed company investments, since the Australian funds (and any other non-New Zealand fund) cannot be PIEs.

4. Indirect investors, through family trusts (and other New Zealand entities)

Many New Zealanders have transferred their investment assets into family trusts. The trustees invest either directly, or they utilise the services of portfolio managers and financial planners.

- There is no de minimis exemption as applies to individuals. The \$50,000 exemption from the FIF regime does not apply now, and the Bill indicates that it will not apply in the future.
- In all other respects, the FIF rules applying to indirect investors (above) will apply to investors through entities such as family trusts.
- However there will be no withholding of tax by PIEs, and losses and excess tax credits from PIEs will flow through to investors, to utilise in their tax returns.

5. Non-portfolio investors

- For individuals investing offshore, holding more than 10% of a foreign company, but less than a CFC interest, the "grey list" will still apply.

6. The \$50,000 de minimis exemption

For investors who cannot remember the cost of their investments that they have held for several years, they may choose to take half of the value at 1 April 2007, for investments acquired before 1 January 2000.

7. Non-resident investors

- Direct investment - no change from the present; that is, non-resident withholding tax at the rate of 15% or 30% applies, and the Foreign Investor Tax Credit regime allows access to Supplementary Dividends, and to some imputation credits in the case of Trans-Tasman companies.
- Indirect investment through a PIE - subject to tax at the rate of 33%, withheld by the PIE.
- Indirect investment through a New Zealand trust - beneficiary income subject to non-resident withholding tax as for direct investment.

8. Taxing methods

Finally, we shall not discuss the methods proposed to tax gains subject to the new rules, as these proposed rules may also change. The rules proposed in the discussion document released a year or so before the Bill changed somewhat when the Bill was introduced, and no doubt there will have been submissions on these proposed methods. We suspect that over the course of the next few months the content of some of the submissions may be published, and we may receive some indication from the Select Committee as to how it has reacted to submissions.

IRD v The Property Investor

What constitutes a separately identifiable asset?

If you ponder this question and are left scratching your head, you are not alone... welcome to the wonderful world of tax where "what ifs" and "maybes" rule supreme.

The significant gains that have arisen from investment in the residential rental property market have prompted substantial interest with both New Zealand investors and the Inland Revenue Department alike.

Over recent years we have seen the Inland Revenue Department target popular geographical areas that have seen significant land subdivision activity where investors were seeking to maximise their returns. Locations such as Wanaka and Nelson were subject to specific projects run by the Inland Revenue Department to impose income tax on the gains that many investors thought would be capital.

These same areas had purpose built residential rental properties constructed and sold to investors on a promise of capital gains while generating large tax refunds. This prompted further investigations by the Inland Revenue Department to determine whether the tax position that had been taken was correct.

Amongst the findings were that the developers were being aggressive with the breakdown of the depreciable portions of the buildings. That is, they were creating a shell building, and then itemising every other cost that went into completing the asset. Items that are not separately identifiable assets such as internal walls, electrical wiring, plumbing, vinyl flooring, internal/external doors, wardrobes/cupboards (built into the wall), bathroom and kitchen cupboards were identified as assets in their own right and depreciated accordingly.

This had a two-fold effect:

1. The investor could claim accelerated depreciation (also making the investment more appealing); and
2. The eventual depreciation recovered upon resale was reduced (as it could be argued that the building - not the fitting increased in value).

The Inland Revenue Department have recently announced that this is unacceptable. The types of expenditure referred to above represent part of the building asset itself and cannot be depreciated as assets that are separate from the building. Taxpayers that have been using this approach are expected to add the value of the various components they have been depreciating individually into the cost of the building and also combine the depreciation claimed for those individual assets into the accumulated depreciation of the building.

This will have the effect of placing cash flow strain on those investors who are relying on the level of tax refunds the property generates to meet the outgoing obligations, while increasing the tax cost on eventual disposal (through depreciation recovered).

The Inland Revenue continue to accept that assets which do not form part of the building and are separately identifiable as assets may continue to be depreciated at their individual depreciation rates. The key to this policy statement is to identify those assets which are considered part of and affixed to the building and so cannot be considered separately identifiable assets.

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