

PricewaterhouseCoopers Insights & Solutions



2010 Budget



Budget 2010 delivers a principled tax reform package that includes across the board cuts in personal tax rates and an increase in the GST rate to 15%.

The big surprise is a reduction in the company tax rate from 30% to 28% from 1 April 2011, two years ahead of a similar move in Australia.

Another surprise is the extent of the personal tax cuts. The lowest personal tax rate is falling from 12.5% to 10.5%. The second rate that applies to income between \$14,000 and \$48,000 falls from 21% to 17.5% - a bigger drop than expected. The 33% rate falls to 30% and the top 38% rate (applying to income over \$70,000) falls to 33%.

The tax rates for most portfolio investment entities (PIEs) and bank interest also fall from 1 October 2010.

Not a surprise is that the Government is targeting the property sector. Tighter rules will apply from 1 April 2011.

The key change is in relation to depreciation. From the 2011 / 2012 income year landlords and businesses will no longer be able to claim depreciation on buildings with an estimated useful life of 50 years or more.

The current 20% depreciation loading on new plant and equipment will be removed for assets purchased after today.

The reforms are in line with many of the Tax Working Group's key recommendations

We are expecting the tax rate changes will be included in legislation to be passed under urgency.

A team of PricewaterhouseCoopers experts has assessed the implications of this year's Budget. Our analysis is available online at:

<http://www.pwc.com/nz/budget/>



The Budget speech is available on the Treasury website:

<http://www.treasury.govt.nz/budget/2010>

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GST Increase – Be Prepared

As a business owner/operator it is worth taking the time to consider what effect the GST increase will have and what planning can be done to minimise any disruption.

The change in the GST rate should be considered from various angles. There is the mechanical aspect, i.e. the methodology of preparing and filing a GST return through the “change” period. Also, the behavioural aspect, such as, will the rate increase affect patterns of supplier and customer behaviour? Finally, there are other points, including cash flow issues, that will be helpful to keep in mind. The following looks into these various aspects.

If the GST rate increase comes into effect part way through a business’s GST period, two GST returns have to be completed. For example, with the rate increase to be effective from 1 October 2010, a GST return that ordinarily covers the two month period ending 31 October 2010, will need one GST return for the month to 30 September and another for the month to 31 October.

The process of transitioning to the new rate varies depending on whether a person is on the payments or invoice basis.

Payments basis - debtors and creditors existing at the time of the change are subject to a notional 2.5% conversion and then all payments or receipts are subject to 15%. The notional conversion has the effect of deeming payments or receipts relating to transactions prior to the rate increase to be at a net 12.5%.

Invoice basis – the transition process for those working on an invoice basis may be more complicated. Most accounting packages are set up with a default GST rate of 12.5%. However, in various circumstances an accounting package will need to simultaneously cater for GST at 15% and 12.5%. For example:

- Purchases subject to GST at 12.5% may be claimed after the rate increase, along with other purchases that are subject to GST at 15%, or

- Credit and debit notes need to be issued or are received at the old rate because of when the original supply took place.

As this transition process is potentially complex, it is advisable to seek guidance from an accountant so that it is navigated correctly.

Systems set up to automatically code repeat transactions will need to be reviewed or switched to manual coding during the transitional period. If an accountant is completing the GST return(s), the client will need to specify which rate applies to every transaction, especially in the periods immediately after the change.

It is likely that businesses will experience an increase in sales to consumers prior to the increase coming into effect. This increase in activity could be in the form of purchases, purchase arrangements where the old rate is “locked-in” or the pre-payment of recurring expenses. Where possible steps should be taken to meet, or take advantage of this demand.

Other points to keep in mind include:

- Reviewing contracts with suppliers and customers to confirm that the effects of the rate change will be neutral. Generally, the GST Act deems a contract to be altered to align with a GST rate change, unless the contract specifies otherwise, or the contract is entered into more than three months after the rate increase.
- Increasing the amount of a deposit when selling large value assets to avoid having to fund the GST output liability to the IRD prior to full payment being received.
- The increase from 12.5% to 15% represents a 20% impact on cash flow when waiting for a

GST refund to be released by the IRD.

Planning should be undertaken now to determine if your business and your GST return process are properly geared up for the transition and new GST rate. It may be helpful to consult an accountant to enable a smooth transition.

Cash Flow Forecasts and Budgets

It is often said that “failing to plan is like planning to fail”. In today’s economic climate the need to plan is critical to the ongoing success, and in some instances survival, of your business. Two effective tools for planning are budgets and cash flow forecasts.

A budget encourages you to look forward and forecast what your income and expenses will be for the upcoming year. Once the budget is set, regular comparisons against actual performance will enable you to investigate any variances and take action where necessary. This pro-active approach will help you to make informed decisions.

The budget can be used to help you start planning for your cash commitments. However profitable your business may appear to be, cash is still the lifeblood of any organisation. Common questions asked by business owners are, “if the business made a profit for the year why does the bank balance not reflect this?” and “where has the money gone?” Unfortunately sales do not always equal cash and this can make it difficult when it comes time to pay the bills. Collection of cash from customers can at times prove challenging. Likewise, business owners need to be able to live, and often drawings are overlooked when it comes to cash management.

A cash flow forecast enables you to anticipate any shortfalls that may occur and to make plans accordingly. For example, if it looks

like cash is going to be tight when a taxation payment is due, there are various options available to you to minimise underpayment penalties and interest – whether it be organising a payment plan with Inland Revenue or purchasing tax from a tax intermediary. The cash flow forecast can also indicate whether you may need to review your current banking arrangements. Perhaps you may need to re-negotiate payment terms with your suppliers or introduce measures to encourage debtors to part with their cash earlier, such as early payment discounts or penalty interest for late payments.

Regularly reviewing your liquidity and where your business is at financially will also mean that when the bank manager requests this information you have it on hand. As banks are becoming more cautious with their lending, there has been an increase in the request for up-to-date financial information. If you are able to produce budgets and cash flow forecasts for your bank manager in a timely manner it demonstrates you have a good grasp on the financial state of your business. Of course the quality of this financial information is crucial. It would be a wise move to engage an accountant to assist you with this process.

There are numerous tools that can be used to prepare budgets and cash flow forecasts, whether they are part of your current accounting system, an excel spreadsheet or a more sophisticated specialist piece of software. What is important is that they do become an integral part of your business planning.

Paying Income Tax from Trading

It is well known that the IRD have comprehensive powers to request information for the purposes of enforcing the collection of tax. A recent project by the IRD saw those powers directed at identification of on-line traders (using auction websites such as TradeMe) who collectively had not paid over \$1.2 Million of tax over the past three years.

The IRD website advises that as a “general guide”, business income from trading online should be declared (and taxed) if:

- the goods were acquired for the purpose of on-selling,
- the purpose of the activity is to make a profit, or
- the business involves dealing in these goods.

It is important to note that, despite the fact that the IRD’s message is specifically in the context of on-line trading, the same principles can be applied to all types of trading activities.

Irrespective of what a person is doing, whether it is on-line or otherwise, the IRD is likely to apply one of two criteria, namely:

- have goods been purchased with a purpose of resale, or
- does the level of activity indicate that a business exists.

If either criterion applies all profits from the trading are taxable.

In order to determine “purpose”, the IRD is likely to rely on documentary evidence. Without evidence it becomes an argument over a person’s intention, which is difficult to establish at the best of times. If a person does not have a purpose of

resale the IRD could instead argue that a business exists, which case law has shown can be proven on the facts of a particular case. As stated in the Court of Appeal decision of *Grieve v Commissioner of Inland Revenue* in 1984, “whether a business existed turned on the intention of the taxpayer as evidenced by his conduct”.

In the *Grieve* case the taxpayers had to prove that their farming activities were a business in the 1976 and 1977 income years, even though it had been operating at a loss. The result was a thorough analysis of what, in the context of the Income Tax Act, is meant by the term “business”. The tests arrived at by the Court are:

- statements by the taxpayer as to intention
- the nature of the activity
- the period over which the activity is engaged
- the scale of operations and the volume of transactions
- the commitment of time, money and effort
- the pattern of activity
- the financial results
- whether the activity is run in the same way as other businesses in that particular trade

It is better to consider the tests above, reach your own conclusion and gather evidence that a business exists, before the IRD come knocking on your door.

Making Change Stick

Many organisations have had to make changes to their organisational structures during the recession. Some have been substantial changes and others have been small refinements, but all face the same challenge of getting real value in return for the pain that the team has to go through.

Statistics show that 75% of change projects fail to deliver the expected benefits (McKinsey Research 2006) and 60% are not successful (McKinsey Research 2008). Due to this failure rate, managing the project all the way through becomes critical to ensure the implementation process is as optimal as possible.

The real key to effective change is not the tasks or organisational structures, but rather people's ability to assimilate change. People's behaviour is the most difficult to quantify and to change, and because of this it can be a long process. This is especially the case if management don't recognise their behaviour must also change.

Substantial change projects typically have a comprehensive project plan with allocated tasks and milestones and stages to be completed. All comprehensive project plans have to be linear – one task follows another, there is a clear order, and when a task is done it is ticked off.

In contrast, behavioural change can be chaotic. It happens by experimentation and exploration. Such change is influenced by successes and failures, trial and error and is somewhat similar to learning to ride a bike. It is hard to teach and hard to learn but you know when you have 'got it'. It is not obvious to a third party if a person has 'got it' unless they are there to observe the process.

And, like learning to ride a bike, not everyone 'gets it' at the same time and some never really do.

When managers monitor the success of the change project according to the project plan, and are satisfied it is all in place by merely ticking off the last box of the project plan, they miss the point of the behavioural changes.

There are many different models for implementing change. The most effective focus on the following:

- what is changing,
- what will be different because of the change, and
- who is going to lose or gain because of the change.

The managers of the change project should acknowledge to the staff that there will be some things that will end and others that will start and a long period of overlap when things are adjusting, which will be fluid. Staff may be reluctant to accept the changes and embrace the new processes, consequently it is important to talk about the changes candidly. Make sure that the systems that underpin the new structure get reviewed, rather than having them constantly push staff back to the old way of working.

Above all, the change managers have to make sure they see it through to the end, not just expect matters to take care of themselves while they move onto the next exciting project.

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

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