

NEWSLETTER

May/June 2003

DEBT MANAGEMENT – AN INTEGRATED APPROACH

Many businesses sell goods or services on credit. The flip side of extending credit is that you must collect the money due. Managing your debtors and cash flow is an important part of running your business well. If you haven't got cash on hand you can't meet your commitments including payment of your creditors, interest due on loans, and personal living expenses.

Most businesses experience problems with debt collection. The process of collecting money can be difficult and may spark emotional responses. This does not help the collection of the debt or maintaining the customer relationship.

The most essential ingredient to successful debt collection is communication, both internal and external, and underlying all the communication should be your debt management plans and procedures. A formal debt collection system should ensure that any legal steps are both efficient and effective.

Some of the questions that should be considered in developing your debt collection process include:

- How will you explain business and credit terms to customers? Credit terms should be in writing and easy to understand.
- Are payment delays related to the ability to pay or a performance/product fault? Identifying the issue and

dealing with it promptly is critical to getting good debt management results.

- Are there any security or guarantee issues to be considered, e.g. the Personal Property Security Act?
- How strictly will credit terms be enforced? By whom? Why might some clients be treated more leniently than others?
- At what point will you abandon the chase? Write the debt off? Pass it to a third party to pursue?
- On what basis will you do business with customers who habitually breach credit terms?
- Do you need to address the pricing of your product/service? It is easy to enforce pricing that you can comfortably justify.

Debt management also involves a number of legal and tax issues. Seek advice to check that your processes are within the law and will achieve the desired result. Specialist involvement will give your procedures credibility in the eyes of your customers.

At the outset you need to evaluate the risks attached to your particular business:

- What is the risk that you sell a good or service and not get paid? On time? In full? Or, paid at all?
- How much money is involved in typical transactions?
- Does the cost of providing credit outweigh the benefits?

The debt management process you adopt for your firm will reflect the nature of your business. Document

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the process. Make it available to all staff from sales people through to the individual responsible for chasing payment. Everyone needs to understand the process and be able to follow it through.
Remember: Cash is king!

INTEREST DEDUCTIBILITY FOR PRIVATE INVESTORS

In the last newsletter I outlined recent changes to the rules on interest deductibility for companies. Since then I have been asked a number of questions about interest deductibility and its application to residential property and investment portfolios.

The general interest deductibility rules have not changed. As a refresher, this article highlights three key principles:

- The right to an interest deduction depends on the **purpose** of the borrowing.
- Interest on borrowings with a mixed purpose must be **apportioned**.
- Interest paid on a mortgage to **retain** interest earning investments is not deductible.

Let me look firstly at the **purpose** of a taxpayer's borrowing. It is the purpose rather than the asset used to secure the borrowing that will determine deductibility.

For example, an individual might borrow against a private home to invest in the sharemarket to obtain both dividend income and capital gains. The house which is the underlying security for the loan has no connection with the shares and the shares may not pay a dividend each year. But, the taxpayer will still get a full deduction for the interest cost because the predominant **purpose** of the borrowing was to earn income.

The second principle is that interest on borrowings with a mixed purpose must be **apportioned**. The taxpayer will only be entitled to a deduction on that part of the interest which relates to earning income or carrying on a business. Apportionment

affects home owners wanting to buy another property to live in and keep their existing private home to rent out.

Home owners often look to step up when their mortgage has reached a manageable level. The scenario at the time of the step up may look something like this:

First home value (to become rental investment)	\$150,000
(Less) Mortgage	(\$50,000)
Equity in first home	\$100,000
Savings	\$50,000
New Residence cost	\$260,000
Borrowings needed	\$210,000
Borrowing funded by:	
Increasing the mortgage on 1 st home to 90% of its value i.e. to \$135,000	\$85,000
New mortgage on 2nd home	\$125,000

In this scenario the interest deduction on the rental property is limited to the interest on the mortgage remaining (\$50,000) before the increase in borrowings to fund the new house. The interest expense on the new loans totalling \$210,000 is not deductible because the borrowing was put in place to provide a new home. The borrowing was for private rather than income earning purposes.

There may be a better way. Possible solutions include: transferring the original home to a private company and restructuring the loan or repaying the original mortgage and drawing down fresh loans. These restructuring steps require careful planning to maximise your interest deduction.

If the taxpayer had started out with a \$260,000 home and subsequently obtained a \$135,000 mortgage for the purpose of buying a rental property worth \$150,000, the answer would be different. The full amount of the interest on the \$135,000 mortgage would be deductible as the purpose of the borrowing was to earn rental income.

And the third principle: That interest on a mortgage taken out to **retain** income-earning investments is generally not deductible.

An example of this situation occurs when an individual taxpayer with an investment portfolio decides to raise a mortgage rather than liquidate investments to obtain funds for private spending, e.g. a new house or car. The taxpayer asks: Can I offset the mortgage interest against the income earned on the investments? Case law has tested this area and concluded that the immediate and direct purpose of the borrowing was to finance private spending.

Although the advance was obtained to preserve income-earning assets, the link between the income-earning activity and the borrowing is insufficient to obtain an interest deduction.

A more tax efficient result could have been obtained by selling the investment portfolio, carrying out the private spending and then borrowing to reinstate the investment portfolio. The interest cost of the subsequent mortgage would be fully deductible.

These stories demonstrate some of the anomalies and pitfalls taxpayers face. If you would like me to look at your private borrowings and consider options to maximise your tax deductible interest – please call.

DEPRECIATION RULES

Depreciation acknowledges that assets used in your business are subject to wear and tear. The allowance lets you take a deduction each year until the asset is sold, disposed of or scrapped. Once the asset is written off you cannot take any more deductions. No deductions are available for any revaluation portion of the asset's value.

Generally depreciation rates are set by formula. The formula allows a loading of 20% to the rates for most new assets, but not buildings. Depreciation is calculated on a monthly basis. If you buy an asset part way through a year, you will be entitled to depreciate the assets for the number of months owned, not the full year.

You cannot claim depreciation in the year of sale, unless the asset is a building. Losses on sale are deductible. Where an asset is sold for more than its book value, to the extent that the gain recovers depreciation already claimed, the gain must be returned as income. Any excess over and above the original purchase price will be a capital gain and not subject to income tax.

The sale of buildings has its own set of rules. Any loss on sale is not deductible, but you can claim depreciation for the part of the year in which the asset is sold.

Some assets cannot be depreciated, for example trading stock and land. Also, items that do not decline in value cannot be depreciated.

Other assets have special rules. Whether or not a franchise or licence cost can be amortised (or spread over multiple years) will depend on the legal agreement. Payments made under open-ended agreements cannot be amortised, but the cost of licence or franchise that has finite duration may be able to be spread over the life of the asset.

Assets costing \$200 (excl GST) or less are deductible in the year purchased. However, if you bought the asset as part of a larger purchase from the same supplier, the asset must be capitalised and the depreciation rate of the larger purchased item used. Small items that become an integral part of an existing asset must also be capitalised, for example, materials used to build a wall in a retail shop.

Assets that are transferred from business to private use are deemed to have been disposed of when the change of use occurs. You will need to obtain a market value to work out the depreciation recovered or loss on sale and calculate the GST payable, if any.

Each year I am asked for details of any items costing more than \$200 coded to repairs and maintenance. These larger value items will be considered on a case by case basis to work out whether the cost should be:

- Capitalised to another asset
- Treated as repairs and maintenance
- Recognised as part of a larger purchase and capitalised.

Matrimonial Agreements and Depreciation Rules

Matrimonial agreements are used to recognise the assets owned by each party living in a matrimonial relationship or to divide those assets on separation.

After the matrimonial agreement divides up the assets, providing both people involved intend to use the assets for business purposes, they will continue to depreciate using the rates and values applying originally. The parties to the agreement are deemed to have acquired the asset at its written down (or book value) at the beginning of the year when the agreement takes place. No depreciation gain or loss occurs until the ultimate disposal of the asset when the owner must account for all of the depreciation recovered or loss on sale. An unexpected tax bill may result. Evaluating the possible depreciation recovery and future tax cost attached to each asset should be considered as part of the matrimonial agreement.

SMALL ACORNS

Use of Money Threshold for Individuals

Most individuals make their personal provisional tax payments based on the standard option. This means that they pay provisional tax based on their most recently filed tax return plus an uplift factor.

The use of money interest (UOMI) rules include a threshold for individual taxpayers using the standard option. A recent amendment increases the threshold from \$30,000 to \$35,000.

From 1 April 2003 individuals earning less than \$112,128 will be under the \$35,000 threshold and UOMI will apply from their terminal tax date, i.e. 7 April for

taxpayers using a tax agent. Practically, these individuals will usually clear their terminal tax before the due date and pay no UOMI.

Individuals who are over the threshold are subject to UOMI from their first provisional tax date each year.

FBT News

31 May 2003 is the due date for fourth quarter and annual FBT returns. As Queen's Birthday weekend falls across these dates, your FBT return and payment, are due on Tuesday, 3 June.

Refer to the IRD's Website: www.ird.govt.nz/library/newsletters/fbtnews/

Which FBT rate should I use?

Quarterly filers who have used the 49% rate for quarters 1 to 3 must do a multi-rate (wash-up) calculation for the fourth quarter. Those filing annual returns and quarterly filers who have used the 64% rate for quarters 1 to 3 can either continue to pay at 64% or do a multi-rate calculation.

Can I use a Different FBT Return period?

Taxpayers registered for Fringe Benefit Tax have three choices of FBT Return filing: Annual, Income Year or Quarterly Returns. Check the guidelines below and call me if you think you may be eligible to file FBT Returns on a different basis. Changing options requires notification to the IRD within a set time frame.

Annual FBT Returns are available to taxpayers with PAYE and SSCWT (Superannuation Withholding Tax) deductions totalling \$100,000 or less in the previous year. Annual Returns must be filed by 31 May for the year ending 31 March.

Income Year FBT Returns are for companies where only shareholder-employees are receiving fringe benefits. Income year returns are

due for lodgement by the end of the period within which the company must file its tax return. For example, a company with a 31 March 2003 balance date must file its Income Year FBT Return by 31 March 2004. Usually the Income Year FBT Return will be completed as part of your annual accounting work.

If ordinary employees are enjoying fringe benefits you must use the **Annual or Quarterly Return** basis.

Quarterly Returns are automatically allocated unless you request an alternative option.

LEGISLATION CHANGES

Charitable Income Tax Exemption

Previously charitable organisations had to have a membership which was wider than those with blood ties. This served to prevent narrow groups of people obtaining exemption from income tax by obtaining charitable status.

As from 1 April 2003 this limitation has been removed. The change will be most relevant to Maori organizations whose membership is defined by whakapapa.

Transfers of Excess Tax

New rules govern the transfer of tax between taxpayers. Taxpayers are able to transfer overpaid tax to another tax period or tax type or to a close associate at the date that is most beneficial to them.

These new rules are an improvement. If you have paid excess tax, and want to arrange for a transfer, please ask me to look at your situation.

Contractors and Withholding Tax

Payments made to certain individuals who contract to businesses are subject to withholding tax. The types of work covered by the withholding tax regulations includes: commissioned

sales staff, company directors, agricultural workers, labour only contractors in the building industry, journalists, and honoraria to committee members. If you would like a full listing of the occupations and rates covered by these regulations, please call me.

Note: Where the contracting party invoicing you is a company or partnership, you are not required to deduct withholding tax.

People who are in business for themselves can obtain a Certificate of Exemption ("CoE") from the IRD.

If a worker has a Certificate of Exemption ("CoE"), you can make payments to the individual without deducting withholding tax. The CoE is valid for one year only and must be renewed by 1 April each year.

Employers should check to ensure:

- The CoE is valid and current;
- The person is doing the same type of work as specified on the CoE.

Where a CoE does not match the work done or is invalid, employers must deduct withholding tax.

Individual Salary & Wage Earners and Refunds

The IRD issues Personal Tax Summaries (PTS) to individuals summarising income and tax deductions for the year. The PTS should be checked and the IRD advised of any changes required.

For the year ended 31 March 2003, refunds showing on the PTS of less than \$200 will be automatically paid within 30 days of the PTS being issued. Larger refunds must be confirmed with the IRD before they can be released. The refund threshold for earlier years was \$50.

IN A FIX (ASB BANK COMMENTARY)

As much as the term "interest rates are heading up or down" is bandied about, the truth is there

are many interest rates. And the rates do not always head in the same direction. This discontinuity could be more apparent in the N.Z market over the coming months.

One point of difference concerns the fixed term of the loan. In general short-term interest rates such as the 90-day bank bill yield or the Variable Home Loan rate are strongly influenced by near-term Reserve Bank policy. At the other end of the yield curve there are rates such as the 10-year government stock yield or the 5-year Fixed Home Loan rate. Here the key influence is offshore 5 and 10 year rates.

Often these influences work to move rates in the same direction. Offshore fixed rates will tend to fall when global growth slows. Likewise the local economy will often slow due to coinciding forces or a higher NZ dollar, and the RBNZ will lower our cash rate.

Now and again the overseas and domestic influences get out of sync. This appears to be happening now.

The NZ economic growth rate is about to slow just as global growth is picking up. The local trend will probably mean further RBNZ cash rate cuts and lower local short-term interest rates. The wider international trend will probably elicit higher global fixed rates and hence push local longer-term fixed rates higher. Stranded in the middle are medium-term fixed rates for 1-3 year loans/investments.

So should you fix your borrowing rate or not? As always that depends on your circumstances. For those people with loans where the impact of high interest rates can be extreme – high leverage and/or high commitments – the lower fixed rates of recent months do provide a good opportunity to minimise risk and lock in historically attractive at lower interest rates.

If you have any questions about the newsletter items please contact me, I am only too happy to help.