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HIDDEN ECONOMY – HOW BIG IS IT?

A recent report issued by the Tax Justice Network stated that the New Zealand Government is losing around \$7 billion a year in lost tax revenue as a result of the hidden economy (refer to www.taxjustice.net for more information about this group). The hidden economy includes undeclared income from cash jobs, cash wages (under the table), proceeds from criminal activity, undeclared income from on-line trading and undeclared offshore investment income.

The Government could have used this unrealised tax revenue to fund education, health and other social services. Sharing the cost across all taxpayers can also enable the Government to reduce the burden placed on individual taxpayers. Although it is hard to determine the size of the cash economy in New Zealand, research carried out by the Tax Justice Network estimates that it could be as large as \$20 billion per year, which is 12.4% of GDP.



Over the past two years, the hidden economy has been a focus of the IRD's annual compliance focus document and the IRD has received specific funding from the Government to target the hidden economy. The IRD has invested in compliance and intelligence tools, completed industry specific audits, developed relationships with key industry groups and undertaken education work.

The compliance focus document sets out several methods adopted by the IRD to identify individuals who evade their tax obligations, including:

- Visiting people who are engaging in on-line trading but not declaring their income. A Trade Me spokesman has recently stated that Trade Me works with government agencies, such as the IRD, to identify people who are regularly selling goods and services on the website.

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- Developing industry profiles in order to better target specific businesses that may be taking part in the hidden economy.
- Publishing industry benchmarks to help businesses compare their performance to what is expected in that industry. Businesses that fall outside their industry standards will be reviewed by the IRD, and investigated if necessary.
- Improving information streams from industries, supplier networks and overseas treaty partners to identify tax cheats through third party information.
- The anonymous information service has been improved making it easier for people to report those

they suspect are cheating the tax system (www.ird.govt.nz - search anonymous).

Typically the IRD will initiate an investigation by issuing a letter to the taxpayer. However, it has the power to arrive unannounced, accompanied by a police escort and demand access to a taxpayer's business records. This approach has been seen in the past if a taxpayer is suspected of evading their tax obligations.

As revenue authorities share methods and resources, and the information age makes it easier to target participants in the hidden economy, the risk of being caught is continually increasing for those operating outside of the law.

POST-ELECTION AGREEMENTS

After the election in late November, the new National-led Government was formed in early December 2011. The National Party has now signed confidence and supply agreements with the Māori Party, ACT and United Future.

Although all three coalition partners hold relatively few seats in Parliament, the importance of their support to the National Party has been reflected in the policies these parties have agreed with the National Party in return for their support.

Some specific policies included in the agreements are:

NATIONAL/ACT AGREEMENT:

- Adopting the recommendations from the Welfare Working Group. This will see employment placement services for beneficiaries contracted out to the private sector and community organisations, and the introduction of payment cards for some beneficiaries.
- To reduce the regulatory burden on businesses and individuals, including reform of the Resource Management Act with particular focus on the planning area.
- A limit to core Crown spending, such that operating expenditure is not allowed to grow any faster than the annual increase in the rate of population growth multiplied by the rate of inflation (operating spending excludes finance charges, spending on the unemployment benefit, asset impairment i.e. reductions in the carrying value of an asset based on its market value, and the costs of natural disasters).

NATIONAL/UNITED FUTURE AGREEMENT:

- The reinstatement of the Income Sharing Bill ; currently awaiting its second reading. The Bill, introduced in August 2010, is targeted at couples with dependent children, and would allow couples to split the parent's income evenly between them for tax

purposes. The Finance and Expenditure Committee ('FEC') evaluated the Bill and reported in March 2011 that the idea had merit, but would be too costly to implement in its current form. The FEC recommended that several changes would need to be considered, and warned that the scheme could be considered to be discriminatory. The agreement does not stipulate to what extent the Bill will be supported by the National Party.

- Limiting the sale of public assets to private interests to no more than 49% and limiting the shareholding a single entity may hold. There will be no sale of any part of Kiwibank or Radio New Zealand.

- Agreement to complete a discussion document to investigate United Future's 'Flexi-Superannuation' policy. This policy gives people the option to take superannuation at a reduced rate from age 60 or at higher rates if they don't take superannuation until between 66 and 70. It is intended that KiwiSaver would become compulsory to work alongside this scheme.

NATIONAL/ MĀORI PARTY AGREEMENT:

- It is acknowledged that the Māori Party does not support the intended partial asset sales.
- A number of social initiatives and policies in the areas of housing, employment and training, education, health and poverty have been agreed upon.
- The review of New Zealand's constitutional arrangements and the advisory panel established to lead public discussion on relevant issues. The National Party has agreed it will not seek to remove the Māori seats without the consent of the Māori people. Accordingly the Māori Party and the National Party will not pursue the entrenchment of the Māori seats in the current Parliamentary term.



FRAUD RISK

Economic crime, including fraud, corruption and cyber crime, is increasing within New Zealand businesses. Business conditions are challenging enough as a result of the current global financial crisis and the additional cost of fraud could put some businesses over the edge.



A recent report released by PwC set out the results of their annual Global Economic Crime

Survey. This survey covered 78 countries and included results from 93 respondents in New Zealand. Although New Zealand is often viewed as having low levels of fraud and corruption, the New Zealand respondents surveyed showed that almost 50% had suffered some sort of economic crime over the past 12 months.

The top four types of economic crime in New Zealand from those surveyed were asset misappropriation (74%), accounting fraud (30%), cyber crime (24%) and intellectual property infringement (13%).

In order to reduce the risk of fraud, there are many checks and procedures that a business can put in place including:

- Performing an assessment of fraud risk including the susceptibility of the company's financial information to the following:
 - deliberate incorrect application of financial reporting standards,
 - management override of controls,
 - manipulation of revenue recognition,
 - susceptibility of assets to theft.

- Business owners need to understand the process of all key cycles (revenue and accounts receivable, purchases and accounts payable and payroll) to ensure that controls are in place that would prevent or detect fraud or errors.
- A number of small to medium sized companies have non-complex IT systems and therefore are limited to what automated controls they can have in place. Given this constraint, it's important companies have manual controls in place to ensure financial information is reliable. Common types of controls include preparation and review of key reconciliations, comparison between budgeted and actual revenue and expenses (variances should be identified and explained), segregation of duties between staff who input data and pay creditors, and dual authorisation for payments both on-line and signing cheques.
- Reviewing or implementing controls in respect of changes to standing data. This can avoid the set-up of, or payment to, false creditors.
- As companies are more commonly using on-line banking it's important that they approve those persons who can authorise payments and always have dual authorisation. Frauds have been noted in the past year in relation to fraudulently signed cheques. A review of banking schedules is key.
- Ensuring that mechanisms of review are in place to ensure that misstatement/errors are identified and rectified in a timely manner.

It is important that any business, no matter how big or small, has considered its risk for fraud and has adequate checks in place to minimise the risk of losing hard earned revenue.

WHO NEEDS CONTINUING PROFESSIONAL DEVELOPMENT?

Continuing professional development is a fundamental requirement of many professions. Doctors, lawyers, engineers and other professionals have to demonstrate that they have completed a minimum number of hours of professional development each year in order to have their annual practicing certificate reissued.

It is understandable that people who fill these professional roles have a need for continuing professional development. It would perhaps be disturbing to think that a doctor or engineer, who trained in the 1960's, did not do any further professional development after graduation.

The same requirement does not however extend to business owners or employers. There is no standard of skill or training that people must achieve before they are able to set up a business or become an employer.

However, you will find that every successful manager consciously works on continual development of their skills. The larger the business and the more senior the role, the greater the investment in professional development, and the greater the priority for making time to do it.

People have different learning styles and many successful entrepreneurs do not have formal tertiary or business related training. They find ways of learning that suit them and there are many different options:

- experimentation and analysis,
- finding a group of people with similar business interests and sharing ideas,
- formal or informal mentoring,
- academic study,

- personal reading programme,
- attending seminars,
- participation in structured networking groups like the Chamber of Commerce,
- professional development programmes through organisations like the NZ Institute of Management or the Institute of Directors.

The important part of every development method is that the person is exposed to new ideas that can enhance their business. This often means that existing ideas and ways of working are challenged and changed.

Major changes in business practice, for example when GST or EFTPOS were introduced, require changes in

systems and procedures. Changes in management style



and strategy are harder to maintain but are just as important to ensure the business is in good health to take advantage of opportunities and manage the inevitable setbacks that arise.

Continual professional development is an essential part of a successful manager's "keep-fit" regime. Whatever the nature of the organisation the manager works in, continuing to develop management skills and knowledge is just as important as continuing to develop technical skills.

SNIPPETS

THE IRD - BUILDING FIT-OUT INTERPRETATION

From the 2011/12 income year, depreciation on buildings reduced to 0%.

Acknowledging that some taxpayers may have previously taken the conservative approach of classifying fit-out as "building", the new legislation does provide the



option of allowing some depreciation at 2% (straight line).

In contrast taxpayers have been exploring the option of reclassifying fit-out from "building" by:

- Employing a quantity surveyor to split a building's current book value between fit-out and building proper, and then depreciating the fit-out going forward at fit-out rates,
- Using original records to calculate what the book value of fit-out would be if it had been correctly depreciated and using that value to depreciate the fit-out going forward,
- Recalculating depreciation not claimed due to it being classified as "building" and making an application to the IRD to claim that depreciation by retrospectively amending past income tax returns (or putting a deduction through their current income tax return) and depreciate the applicable items as "fit-out" going forward.

The IRD has now released draft 'questions we've been asked' QWBA ED 0140: "Depreciation of commercial fit-out", which sets out the IRD's view that the only option to depreciate such fit-out is to use the 2% pool option. The view appears unfair as taxpayers that have previously been conservative are now worse off.

Irrespective of the building versus fit-out scenario, the wider implications of the IRD's view in situations where a

taxpayer has used the wrong depreciation rate is unclear. Can that rate be corrected? Potential for further cost exists as depreciation recovery income is calculated on the premise that the correct rate was used. Strong submissions against the IRD's view are expected.

HOLIDAY PAY AND PARENTAL LEAVE

An employee's annual leave entitlement accrues while they are away on parental leave as the leave is considered to be part of the employees' continuous service. However, a little known fact amongst employers is that the method of calculating holiday pay for employees who have returned from parental leave is different to the normal holiday pay calculation.

Holiday pay is normally calculated as the higher of either the average weekly earnings for the 12 months immediately before the end of the last pay period before the holiday is taken, or the employee's ordinary weekly



pay at the beginning of the holiday. However the calculation changes when the employee takes holidays in the 12 months following parental leave.

The calculation for holidays taken within 12 months of return from parental leave is based on the average weekly earnings for the 12 months immediately before the end of the last pay period before the holiday, and is not compared to the ordinary weekly pay. This means that it is very likely that the amount of holiday pay may be less than the employee is expecting.

It is important that both employers and employees are aware of the difference in calculation methods before annual leave is taken.

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