NEWSLETTER

August/September 2003

ASSET BREAKDOWN & MAXIMISING DEPRECIATION

In a previous newsletter we discussed property investment along with aggressive depreciation strategies. These strategies apportion the property value by splitting out building components and placing a heavier weighting on chattels and building components as compared with the building itself. This allows the taxpayer to claim a higher amount of depreciation for the building components and the chattels than the rate available for the building as a whole.

The IRD readily accepts that certain components of a building can be broken out and the depreciation rate for those asset components can be used, for example: roller doors and alarm systems. If an asset is separately identified in the IRD's Depreciation Guide, a depreciation rate will be available to calculate the allowable depreciation deduction.

We are aware that sections of the IRD are considering the practice of breaking out other significant parts of the building, in particular electrical wiring, plumbing and non-load bearing walls. The matter has been referred to IRD Head Office Policy Section for their review.

The law in this area is not entirely clear and the IRD may conclude that items like non-load bearing walls are not a separate asset for all buildings. Taxpayers acquiring a new property should obtain an independent valuation if they want a breakdown of the building components and chattels that maximises depreciation deductions. And, it is important to note that even with that breakdown there is still some uncertainty.

It is a case of "watch this space" to see whether the rules change. There is a risk that a change could overturn earlier depreciation deductions. Hopefully any changes will not be retrospective. Penalties should not apply to depreciation deductions already claimed as the practice is acceptable under the current depreciation rules.

LAND TRANSACTIONS & BOUNDARY ADJUSTMENTS

The hinterland of our cities and towns is undergoing subdivision. Two key questions arise for the subdividing landowner.

- Is the gain on sale subject to income tax?
- Will GST apply?

Generally income tax does not apply to land owned for more than 10 years unless the scheme involves significant work. This is usually associated with a large scale development. There are also special rules for certain taxpayers who are in the

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business of property development, land dealing and building.

Land that is subdivided within 10 years of acquisition may be subject to income tax where the subdivision work is of more than a "minor nature". Simple, low cost and low effort subdivisions involving the creation of one additional title are likely to be regarded as minor and outside the tax net.

More complex subdivisions may be caught, for example, when a taxpayer cuts a 10 acre property into three titles and the Council requires connection of the usual services and a sealed right of way for access. Due to the added complexity of the roading and earthwork involved, this subdivision may be subject to income tax.

GST applies where the subdivision involves continuous or regular activity. The court concluded in one case that the division of land into two titles (in total) was not sufficient to require GST registration. In another case, five titles did require GST registration and the vendor had to account to the IRD for 1/9th of the sale price. Subdivision into 3 or 4 titles is in the grey zone.

However, there is more to consider than just the number of titles created. Whether the sale will be caught for GST depends on the work and activity involved – what the courts have called, a question of "fact and degree".

If you are contemplating subdividing, even if it appears to be work of a "minor nature", please contact us before you start the process. We may be able to help with strategies to minimise the income tax and GST cost.

GST ADJUSTMENTS

In October 2000 the GST rules relating to "change of use" adjustments were amended. These rules deal with GST input claims for goods and services transferred from an exempt or private purpose to use in a GST registered business. For example, a private vehicle introduced into the business and used for business travel.

The rules allow a GST input claim for the business proportion based on the lesser of:

- The cost of the goods or services; and
- The market value of the goods or services.

The input claim can be made:

- In each GST period where the goods or services are used in the business; or
- Annually; or
- As a one-off adjustment for assets costing less than $18,000 providing the asset is used 100% in the business.

A one-off adjustment can be made for assets costing more than $18,000 that are used fully in the business. An application must be made to the IRD for permission to make the adjustment before the GST input is claimed.

In most circumstances a one-off adjustment will give a better result. It is important that the timing of the input tax adjustment is considered when the business use commences. Please call for a recommendation on the best GST adjustment to use for your situation.

INTERESTING CASE DEVELOPMENTS

Evidence of Purpose or Intent: Case W2

A recent case has highlighted issues arising on the sale and purchase of property. In 1988 a partnership of investors purchased a Wellington commercial property. The property was sold eight years later for an all-up loss of $478,737. The partnership recognised the loss in its tax return and some of the downstream partners claimed a proportionate share of the loss in their tax returns.

The general tax principle for gains and losses is: Where property is purchased with the purpose or intention of resale, any profit on sale is taxable and any loss is deductible.

The IRD refused the losses claimed by some of the partners and the case went to court. The judge concluded that the loss was on capital account and not deductible for income tax.

The judge's decision focussed on the purpose or intention of the partnership at the time of acquiring the land. This is a question of fact. The original investment proposal envisaged a sale of the lease on the property (not the property itself) in year six. The lease was sold. However, this was not proof that the property was bought with the intention of resale.

Later, the investors decided that the venture was financially unsound and the decision was made to sell. Some of the investors tried to claim that they had a purpose or intention of resale at the time of acquiring the land and that their share of the loss on sale was tax deductible.

The evidence provided in court included letters to potential partners, the partnership deed, diary notes of financiers and IRD interview notes. This evidence indicated that the partners had a range of motives for participating in the investment. On balance, the information demonstrated that the property was bought to earn income and not intended for resale.

The case is a reminder of the importance of correct paperwork to support investment decisions. The IRD has wide powers of access. Information obtained from banks, financiers, valuers and advisors can be used to establish the purpose or intention behind a variety of transactions when property is acquired.

Taxpayers can have a mixed portfolio with some property intended for resale and other property owned with a longer term investment purpose. "Property" has a wide meaning and includes land and other assets. An intention with regard to one property does not necessarily taint other property owned. However, for clarity, it may be better to separate the ownership of the two categories of property.

Our comments above are general. Special rules apply to taxpayers in the business of property development, dealers and builders. If you fall into one of these categories, we recommend seeking specialist advice.

Depreciation & Intangible Property: The Simkin Case

In general, it is the owner of an asset who may claim depreciation. But there are exceptions. An interesting quirk arises in the area of depreciable intangible property.

Intangible property is an asset that is not physical, such as trade marks, copyright, design ideas and patents. Intangible property includes the right to use assets – both tangible and intangible – such as plant and machinery.

Tax law lists specific types of intangible property that can be depreciated. This property has a finite economic life that can be estimated with a reasonable degree of certainty when the asset is created or acquired. For example, the cost of obtaining the patent (or buying it from someone else) can be spread over the patent's life. By contrast, business goodwill, whether purchased or created cannot be depreciated as it does not have a finite life.

In the Simkin case, the courts confirmed this position. When the owner of a depreciable intangible asset allows someone to use that asset for a specified period, the owner has granted a "right to use". The owner can no longer claim depreciation. The user can depreciate the "right to use" providing the right is included in the list of Depreciable Intangible Property.

Franchised or licensed businesses, e.g. McDonalds or Hire-a-Hubby, have a formulaic approach to marketing and packaging goods or services. Taxpayers thinking about buying a franchised or licensed business will need to weigh up the commercial and tax advantages. Will an agreement that grants a "right to use" the business formula for a fixed period give a better result than an open-ended arrangement?

A "right to use" depreciable intangible property for a fixed period will permit a depreciation deduction over that same period. But, from a commercial perspective, if the right is not renewed at the end of the period, the business may be vulnerable.

Contrast this with payments under an agreement granting an indefinite right to use depreciable intangible property. The payments will not be tax deductible but the open-ended nature of the agreement does mean that the business owner has continuity. These rules apply regardless of whether the payment for the right is a lump sum or a regular amount.

UPDATES FROM THE IRD

Paying Tax by Instalments

Clients who are unable to pay their tax can enter into an arrangement to pay by instalment. If the arrangement is entered into before the tax is due, an initial 1% late payment penalty and use-of-money interest will be charged. No further penalties will be charged provided the agreed payments are made on time.

A Simpler Donation

Earlier this year we highlighted the increase in the maximum charitable donations threshold for individuals from $1,500 to $1,890 for the 2002-2003 income year onwards.

Some companies may also benefit from changes to the donations rules. Any company that is not a close company can claim a deduction for donations to approved charities. The upper limit on the deduction has been simplified to just one threshold of 5% of net income calculated before deducting the donation.

A close company cannot claim a deduction for donations. A close company is one where 5 or less shareholders or their associates control more than 50% of the shares. People associated (e.g. husband and wife) with one another are regarded as one shareholder. If yours is a close company we recommend making donations in your own name.

Mutuality Principle

Special rules apply to the taxing of incorporated societies and mutual associations. There is a general principle known as "mutuality". Mutuality starts with the notion that a person cannot make a profit from trading with himself or herself, or with a group or association where the person is a member.

Mutual transactions of these groups or associations are not taxable. These associations are taxable on transactions outside their mutual circle of members. Transactions that are taxable include: the sale or purchase of trading stock, the supply of services to outsiders or the borrowing of money. Subscriptions paid by members of the society, association or organisation are not taxable.

Adjusting Incorrect Returns

Once your tax return has been filed with the IRD, the department issues a Notice of Assessment. If you realise that there was an error or omission in your tax return, you must notify us as soon as possible. There is a two month period for disputing the assessment. This period runs from the date the IRD's notice of assessment is issued.

Changes can be requested after the two month period, but, where you require a reduction in your tax, you are dependent on the IRD's discretion to reopen your return beyond that date.

FBT Interest Rate Change

The FBT Rate for low interest employment related loans has been reduced from 7.83% to 7.74% effective from 1 April 2003.

Provisional Tax Changes Signalled

The July 2003 Budget proposed that provisional tax payments be linked to GST transactions with the payments aligned to GST dates. This system would be similar to the provisional tax system in Australia where businesses fill out periodic activity statements that are used as the basis for provisional tax. The aim is to align provisional tax payable with the actual income of the business. Payments will vary with any seasonal fluctuations and this system should significantly reduce the cost of "use of money" interest for businesses.

The changes also propose that businesses pay provisional tax in their first year of operation. Currently tax payments for a new business can be deferred and paid in one lump sum on terminal tax date.

ACC NEWS

The ACC Invoicing System

ACC are now issuing advance invoices for the 2003/2004 income year. Companies and other employers have already received or will receive a range of invoices including:

- 2002/2003 Wash Up Invoice for ACC based on the shareholder-employee salary noted in your company's tax return.
- Provisional Invoices for ACC on your expected 2003/2004 shareholder-employee salaries.
- Adjustment to 2002/2003 ACC based on actual wages paid to employees for that year.

The advance or provisional invoices are based on the most recent salary information obtained by ACC from the IRD. For shareholder-employees this detail is obtained from your company's most recently filed tax return. For wage and salary staff, the payroll information is collated from the IR348 Employer Monthly Schedule.

Once actual shareholder-employee salary and payroll figures are known, a wash-up invoice or refund is issued.

ACC is a significant cost for businesses. If you are undergoing changes in your business and payroll, it is important to compare this year's invoice amount with the ACC paid last year. You can request that ACC revise your provisional invoice downwards to reflect expected changes in your business wage bill.

ACC also offers an instalment arrangement for premiums of $500 or more. The instalment plan permits spreading payments over 10 months and incurs a flat 5.4% premium over the original invoiced amount.

Deductibility & Shareholder-Employees

ACC invoices for earner and employer premiums payable on shareholder-employee salaries are usually issued to and paid for by the company. For income tax, the employer premium is deductible while the earner premium is not. The earner premium should be recorded as drawings if paid by the company.

Please ensure that you include the ACC invoices with your annual accounting records to help us identify any non-deductible portion.

WITHHOLDING TAX – A CORRECTION

A previous newsletter discussed the obligation of businesses to deduct withholding tax from payments to certain contractors. The article stated that it was only necessary to deduct withholding tax when the contractor was an individual. This was misleading as the withholding tax rules also apply to "partnerships" of individuals.

The rules apply to particular types of work listed in the Withholding Payments Regulations. If you would like a copy of the list of businesses covered by the Regulations, please contact us.

Withholding tax does not have to be deducted from contractors who operate through a company. In a few special situations withholding tax may not need to be deducted from payments to a partnership, for example, if a professional partnership provides directorship services to a company client.

MINIMUM WAGES

The minimum wage rates were revised upwards with effect from 24 March 2003. The new rates are:

	Youths (16-17)	**Adults (18+)**
Per hr	$6.80	$8.50
8 hr Day	$54.40	$68.00
40 hr Week	$272.00	$340.00

The minimum wage rates apply to all types of work and workers aged 16 years and over (including full-time, part-time or casual employees; homeworkers, commission and piece rate workers) with the following exceptions:

- Under Rate Permits – granted by labour inspectors for workers incapable of earning wages at the appropriate minimum rate prescribed.
- Training Rates – applying to apprentices working under apprenticeship contracts covered by the Industry Training Act.
- Board and Lodging Deductions – which may reduce the minimum wage by up to 15% for board and up to 5% for lodging.

Note, there is no minimum wage for people under the age of 16.

If you have any questions about the newsletter items please contact us, we're only too happy to help.