O'Connor Richmond

Chartered Accountants and Business Advisors

NEWSLETTER

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INSIDE THIS EDITION

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BUDGET 2012

The Government's Budget was announced on 24 May 2012. Compared to previous years, there are few, if any, changes impacting business. Some of the changes that have been made are outlined below.

MIXED-USE ASSETS

The term 'mixed-use assets' is used to describe assets that are used for both private and business purposes. The classic example is the kiwi bach, which might be used for only a few weeks during the year, but available for rent during the rest of the year. Under the current rules, tax deductions can be claimed for the period a mixed-use asset is available to derive income, regardless of whether it actually derives any income. Going forward, tax deductions will be based on how much an asset is actually used personally versus its use to derive income.

TAX CREDITS

Three tax credits have been removed as they were seen as "outdated" and no longer serving their original policy intent. They are the tax credits for:

- **Income under $9,880** – this was introduced in 1986 to ensure low paid full-time workers were not worse off due to tax reforms. A taxpayer earning less than $9,880 could claim the tax credit for every week they were in paid work for 20 hours or more.
- **Childcare and housekeeper tax credit –** this credit (of up to $310) was first introduced in 1933 and last revised in the 1984/1985 tax year. Since then Government support programmes such as Working for Families and free early childhood education have been introduced.
- **Tax credit for active income of children –** this was introduced in 1978. The policy intent was to reduce the compliance cost for employing children part-time. The tax credit meant that employers of children on low annual salaries did not need to withhold tax i.e. PAYE. This will be replaced by a limited tax exemption for income not taxed through the employer's PAYE process.

The tax credits will be repealed from the 2012 - 2013 income year. Taxpayers will still be able to claim them for the 2011 - 2012 income year.

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LIVESTOCK VALUATION RULES

A further notable change is to the livestock valuation rules. The livestock regime caters for the fact that some farmers might hold stock on capital account versus other farmers who might hold stock for resale (or both). The purpose for which a farmer holds livestock was intended to determine which valuation method is to be used, as that determined how increases and decreases in stock values are taxed. However, under the current rules farmers are able to switch methods causing a disconnect between the purpose for owning the livestock and the tax outcome. This was not intended and the rules have been tightened to restrict switching between valuation method.

REPAIRS AND MAINTENANCE EXPENDITURE: IS IT CAPITAL OR REVENUE?

The phrase "repairs and maintenance" ("R&M") is typically used to refer to costs for repairing, altering or maintaining a capital asset. These costs are immediately deductible if they are revenue in nature and not subject to the capital limitation. In practice it can be difficult to determine whether costs are of a capital or revenue nature, as there is no succinct legislated provision to be "ticked off". Instead, the question is answered with reference to a considerable body of case law and the specific facts in a given scenario.

In June this year, the IRD finalised its Interpretation Statement (IS 12/03) setting out its view on what it considers the general principles for determining whether expenditure qualifies as R&M. The statement has replaced previous commentary issued by the IRD. Although the IRD's view has not changed in any substantial way, the latest statement is 55 pages, compared to the previous five page statement released in 1994.

Broadly, a two step process is used to determine whether expenditure is R&M. Firstly, the relevant asset is identified. Secondly, the nature and extent of the work is considered in the context of that asset.

As a general rule, if work carried out on an asset results in the reconstruction, replacement or renewal of the asset or substantially the whole of the asset, the cost of that work will not qualify as R&M. However, costs to repair or maintain an asset, or restore an asset to its original condition, without going so far as to reconstruct, replace or renew it, will qualify as R&M and will be deductible.

The line between restoration of an asset versus its renewal can be difficult to identify and one of the examples provided by the IRD is of concern. Example 23 of the Interpretation Statement involves a residential rental property in a good state of repair that was damaged in an earthquake. To get it back to a tenantable state the foundations are replaced, the floors reconstructed and three external walls are rebuilt and the roof replaced. The IRD considers the costs would be capital in nature as the work results in the "effective renewal" of the asset. However, case law provides strong support for this work being revenue in nature and therefore R&M. That case law suggests the work is to repair something that previously existed, it is not to produce something new, it does not significantly improve the asset or make it different in kind by changing its character, and thus does not increase its value or extend its useful life. It does no more than restore it to its original condition and should therefore qualify as R&M.

The Interpretation Statement sets out the IRD's current view and therefore reflects the view that can be expected to be taken by the IRD's investigators. Unfortunately, it is a matter of opinion, not fact, as to whether it is correct.

WORKING FOR FAMILIES – WHAT'S YOUR INCOME?

Entitlement to Working for Families (WFF) payments is based on a family's income, which is calculated using very specific rules. These rules have undergone a number of changes over the past few years to close potential loopholes and make the system fairer. The need to calculate the 'income' amount correctly was recently highlighted in a decision by the Taxation Review Authority (TRA).

The decision of *'X v CIR'* involved a couple who owned five rental properties that incurred losses. These losses were included in the calculation, which reduced the taxpayer's 'income' for WFF purposes and increased their entitlement. At issue was whether or not the activity constituted a business, in which case the losses are ignored.

The IRD disputed the income calculation and took the view that the rental activities of the partnership constituted a business and therefore their income should not be reduced by the losses. The taxpayers argued that they only ever intended to make capital gains from the properties, and therefore their rental activities were not a business. They were unsuccessful and the TRA upheld the IRD's view.

The case is a timely reminder that income for WFF purposes needs to be calculated correctly, especially given the recent changes.

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