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Mileage rate increased

Inland Revenue's mileage rate has increased from 70 cents per km to 74 cents per km for the year ended 31 March 2011.

Software development costs

From 1 April 2011 the costs of unsuccessful software development were no longer deductible for tax purposes.

Following submissions from the software industry around productivity and innovation Revenue Minister Peter Dunne announced today that these costs are now deductible from 1 April. This effectively means there has been no change.

Look Through Company Update

Remember that LAQCs cease to exist from 1 April 2011 and any LAQC at 30 September 2011 which hasn't made an election to become a Look Through Company (LTC) will default to a Qualifying Company (QC), backdated to 1 April 2011.

If you are still likely to be making losses from your rental property after building depreciation has been removed from 1 April 2011 and you wish to offset that loss against your other income then you will have to elect that your company becomes an LTC. This process is completed through Inland Revenue not the Companies Office.

You can defer your decision till 30 September 2012 but any loss for the year ended 31 March 2012 will be retained in the company for that year.

If the property is not making significant losses after the loss of the building depreciation claim has been taken into account then defaulting to a QC may be the most appropriate option, that is, doing nothing.

If you haven't made a decision yet about whether to be an QC, LTC or some other option please call us.

The Budget and you

The Budget announcements on 19 May 2011 have less of a direct impact on most clients than last year's changes which of course included across the board tax cuts.

While this year the focus was on reducing Government spending, additional funding was provided to the Inland Revenue department. Of the \$119.3m allocated over 4 years in 2010, the department managed to recover \$115m in unpaid taxes in the first 9 months, a great return on investment for the government! With these increased resources every taxpayer should expect to be audited in the future.

One of the main Budget items was the reduction in Government contributions to Kiwisaver. While the \$1,000 kickstart remains, the Government contribution halves to a maximum of \$512.50 a year from 1 July. Working for families tax credits (WFFTCs) were also targeted with those on higher incomes losing eligibility and a narrower definition of income has been introduced. For example, investment losses can no longer be used to reduce income for WFFTC purposes and the value of fringe benefits must be included if

obtained through a business over which you hold control. WFFTC changes are expected to net savings of \$448m over 4 years.

Student loans were also targeted with restrictions on further borrowing for students in default for more than \$500 for longer than a year, for living expenses for students aged 55 and over, for part time students, repayment holidays for students overseas reduced from 3 years to 1 year and there is now no inflation adjustment to the loan until 1 April 2015. The student loan changes are expected to earn around \$277m over the next 5 years.

The Government also announced further reviews on the deductibility for the mixed use of assets such as holiday homes and the ability of farmers to manipulate their tax liability by switching livestock valuation methods between years.

More about these changes in our next newsletter.

Self Assessment system

NZ operates a self-assessment income tax system. This means that you can file an income tax return and IR will generally accept those figures (unless clearly wrong!) and produce an assessment based on those figures.

However this doesn't mean they have accepted your position and IR can come back and review your tax at a later stage. That's why they ask you to keep records for 7 years.

There are 3 main reasons you may be audited:

1. Your figures stand out because, for example, they are different to others in your industry or may be large compared with prior years,
2. You belong to an industry or group that IR is looking at in more detail. Recently these groups have included casual horticultural staff, painters etc,
3. Random audit –it's just your turn!

In any case the process is daunting and IR can ask for a large volume of information. They can easily extend their review especially if they find matters of concern. For example, a simple query about a GST return can expand into a review of the last five years worth of GST returns and PAYE as well.

Remember that the onus of proof is on the taxpayer so you need to be able to prove that you incurred costs, earned only a small amount of income etc. This can be particularly important in a year when you may have earned very little, and lived off your capital or investments. If IR is concerned that you have been receiving cash for your work then you will need to be able to prove that you had cash from other sources.

The importance of keeping good records cannot be overemphasized.

Rental property maintenance

There is significant confusion around whether residential rental property repairs and maintenance costs should be capitalised and depreciated or expensed in the year incurred and this confusion has increased with the removal of depreciation from buildings from 1 April 2011.

Although the distinction between capital and repairs and maintenance has not changed, Inland Revenue (IR) has provided an interpretation on the items that constitute buildings, and the chattels that may be separately identified. This IR interpretation is set out in IR10/01 (available at <http://www.ird.govt.nz/resources/8/3/833f770042195e7982c3f34fc1b24342/is1001.pdf>). It sets out a three step process for identifying whether a cost is capital or expenditure.

1. Is the item attached or connected to the building? If the answer is no, then the item is likely to be a chattel which is capitalised and depreciated. If yes then go to step 2.
2. Is the item an integral part of the building ie would the building be considered incomplete without it? If the answer is

no then the item is likely to be a chattel.
If yes then go to step 3.

3. Is it attached or connected in such a way that it would be considered part of the “fabric” of the building? If the answer is no then the item is likely to be a chattel. If yes then the cost is likely to be an expense.

Looking through further detail of the interpretation, our understanding is that items such as partitions, fitted furniture such as shelving or kitchen cabinets, electrical reticulation, plumbing fixtures, roof, garage door etc are an integral part of the building. Although chattels valuers have assigned separate depreciation rates to these “chattels” IR’s interpretation is clear that such items should be considered part of the building.

This means that any repair to these items would be fully tax deductible as long as it is not improving the building. Improvements to buildings are capital costs and there is now no depreciation on building capital costs.

Fully deductible repair and maintenance costs should then include painting, roof replacement and even a new kitchen as long as it was of a similar standard to the old kitchen, even though a more modern variant. The amount spent doesn’t affect the capital expense/ decision.

However if the costs were incurred soon after purchase the IR could argue that it was deferred maintenance, a capital cost. Similarly if you sold the property shortly after the completion of substantial repair work, then IR could argue that the costs resulted in an improvement and a non-taxable capital gain on the sale of the property. If there has been a non-taxable capital gain then the costs should not be deductible.

The timing of the work compared with the purchase date and price or the subsequent sale price should be considered on a case by case basis.

In a case where a tenant moves out and the property is tidied up or renovated for sale and sold some months later, then it is likely that the costs would not be deductible.

However the costs of regular maintenance work, particularly if spread across several years should all be tax deductible.

Chattels would consist of those items that may be taken out when a building is sold eg oven, dishwasher, curtains, carpets etc. The cost of chattels continue to be capitalised and depreciated at rates determined by IR and available on their website.

Some commentators believe IR interpretations such as this have no force – they merely reflect IR’s approach to interpreting the legislation. However the onus of proof is on the taxpayer and once IR has taken a stand on whether your costs are deductible or not it can be very costly for you to argue the case in court.

The building fit-out depreciation rates apply to commercial buildings where tenants may have built their own partitions, added in bathroom facilities etc but can dismantle these and remove them at the end of the tenancy. Some taxpayers have applied these rates to their residential rental properties but IR’s interpretation makes it clear that it does not accept this approach.

We believe there is more to be gained by maintaining residential rental buildings and claiming those maintenance costs than claiming depreciation on the capitalised cost.

Holidays

Many of you have asked Baubre how her London marathon went. Well she completed it – it took her 4 hours and 32 minutes. So now she’s looking at completing the Auckland one in October.

If anyone else is planning on doing it please let us know.