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WEEKLY COMMENT: WEDNESDAY 30 MAY 2012

1. The Minister of Finance, Bill English, delivered the government's 2012/13 Budget last Thursday afternoon. Tax-wise, the "zero budget" followed the now familiar theme of tightening up on tax credits and deductions:

   - **Removal of three tax credits**: The income under $9,880 tax credit, the housekeepers tax credit and the children's active income tax credit, have been repealed. The children's tax credit has been replaced by a limited exemption for some types of income from which no PAYE tax has been deducted - the examples given in the Minister of Revenue's press release are income from babysitting and mowing the neighbour's lawn. These reforms come hard on the heels of the release of the recent Officials' Issues Paper on *Salary-trade-offs* which targeted tightening up on tax credits by including discounted goods and services and vouchers, fringe benefits, and currently untaxed on-premises benefits, such as car parks and childcare facilities, in Family Scheme Income (refer to my Weekly Comment 2 May for details on these).
   - **Limiting deductions for mixed-use assets**: Tightening the rules around the deductibility of costs relating to assets that are privately used by their owners as well as rented out for income. No implementation date was given. In this edition of *Weekly Comment* I discuss the likely income tax and GST implications based on the Officials' Issues Paper on *Mixed-use assets* released last August.
   - **Prohibiting certain livestock valuation changes**: Abolishing the ability of farmers to change the valuation method for a type of specified livestock from the herd scheme to another livestock valuation method, effective from 18 August 2011 (the date on which the Officials Issues Paper *Herd Scheme Elections* was released).
   - **Funding increased IRD audits**: Inland Revenue will receive an extra $78.4 million to further improve its tax auditing and compliance functions.

Mixed-use assets

2. The examples given in the Budget are holiday homes, boats and aircraft. However, these are just examples: the rules will not necessarily be limited to these assets only – the Budget referred to "… (mixed-use assets) *such as* holiday homes, boats, and aircraft". The Minister of Revenue's media statement ("the press release") states that:

   "The new rules will require mixed-use asset owners to apportion their deductions based on the actual income earned and private use of the asset.

   For example, owners who rent out their holiday home for 30 days in a year and use it themselves for 30 days in a year will be able to claim a deduction for 50 per cent of their general costs, rather than the 90 per cent they can claim now."

3. An Officials Issues Paper on *Mixed-use assets* ("the Paper") was released in August 2011. I have reviewed the contents of the Paper in paragraphs 133 to 167 of the **Larger Companies section**. In view of the statement in the Budget, I thought that it is worth briefly reviewing the suggestions in the Paper relating to:
   - The basis on which the deductions would be limited;
   - Affected assets;
   - Affected entities;
   - The implications for interest deductions; and
   - The GST implications.

The basis for limiting deductions

4. The Paper suggested that deductions for mixed-use asset be prescribed based on tests used to distinguish between a *private-focused group*, an *income-focused group*, and a *genuine mixed-use group*.

5. Two tests were suggested: a test that differentiated between all 3 groups and a test that differentiated between only a private-focused group and an income-focused group. In both tests, the private-focused group would be allowed no deductions for expenditure during the period the asset was unused, but the income-focused group would be allowed to deduct all expenditure for the period of non-use.

6. The test that differentiated between 3 groups included the *genuine mixed-use group*. The suggestion in the Paper was that this group would be allowed deductions for unused time expenditure based on the proportion of income-earning use to total use.

7. The information in the press release suggests that *the government is in favour of the mixed-use group approach*. Under this approach, an owner who uses a holiday home for 30 days in a year and rents it out for 30 days will be able to claim a deduction for 50% of their unused time expenditure. However, the reference in the press release is to "general costs" rather than "unused time expenditure". This could potentially include costs relating to the time the asset is used. While this gives the same answer in the case of a 50/50 split, the answer could be different in other cases.

8. This approach disadvantages the income-focused group. They will have to apportion deductions for any level of private use. The paper suggested distinguishing this group on the following basis:

   (a) The asset is used for actual income earning for 62 days or more in the income year; and

   (b) Personal use is less than:
      (i) 10% of income earning use in the case of the three-group test; and
      (ii) 15% of income-earning use in the two-group test; and

   (c) There is evidence to support genuine efforts having been made to earn income for all non-use periods.

Affected assets

9. The Budget clearly implied that the rules would not be limited to holiday homes, boats and aircraft. The Paper contained a discussion regarding how the rules could be made to apply to other assets. The options discussed were:
    - The rules could apply to all assets.
    - A list of specified assets that the rules would apply to.
    - The rules would apply only to assets above a minimum value threshold.
    - The use of a conceptual definition of assets that the rules would apply to.
10. Officials' recommendation was that a conceptual definition of assets be used to determine the assets that the rules would apply to. The proposed conceptual definition would include assets:
    (a) That are rented on a short-term basis only; and
    (b) That are unused for a reasonable proportion of the year - officials suggested that a total of 2 months non-use in any 12-month period ending in a tax year is a reasonable threshold.
11. The Paper suggested that the conceptual test be bolstered with a minimum value threshold for assets other than land. Officials proposed a threshold of $50,000 comprising the cost of the asset plus the cost of any improvements that are required to be added for tax depreciation purposes. The threshold value would not take any tax depreciation into account.
12. It was suggested that the following assets be excluded from the new rules:
    (a) Motor vehicles, due to the established practice of using logbooks; and
    (b) Home office expenses, also due to accepted practice derived from the decision in *CIR v Banks* (1978) 3 NZTC 61,236.

Affected entities

13. The paper proposed that the new rules should apply to partnerships, trusts and companies.
14. In the case of a partnership, there would be private use of a partnership asset if the asset is used by any partner (or an associate of a partner). If a threshold test is to be used the threshold would be applied to the aggregate of all partners' interests.
15. The Paper was indecisive regarding whether the new rules should apply to private use of trust assets by beneficiaries and/or settlors of all kinds of trusts, or apply only to family trusts. Charitable trusts, superannuation funds and trusts where settlors and the members of the settlors family are not entitled to benefit were possible exclusions.
16. In relation to companies, the Paper suggested that the rules should apply only to look-through companies ("LTCs"), qualifying companies ("QCs") and close companies.
17. For LTCs, the rules would apply to private use of an asset by a shareholder or a person associated with a shareholder.
18. The suggested approach for QCs and close companies was to leave the existing dividend, FBT and income rules in place and, in addition, apply the new deduction rules for mixed-

use assets. This would mean tax deductions would be limited, while at the same time benefits received by shareholders (or associates) would be taxed. The argument in the Paper was that this is consistent with the treatment of other dividends, the costs of which are non-deductible.

Interest deduction implications

19. The suggestion in the Paper was that the ability of companies to deduct interest should be over-ridden by the mixed-use asset rules, which act to limit deductions.

20. In addition, a look-through rule was suggested, similar to the existing rule that limits interest deductions in QCs when shareholders receive non-cash dividends, to limit interest deductions claimed by someone who purchases equity or debt in a company or company group which holds a mixed-use asset.

GST treatment of "available for use" periods

21. The suggestion in the paper was that the GST apportionment rules should be modified in relation to input tax deductions relating to the period during which mixed-use assets remain unused.

22. Officials considered that the decision as to whether non-use of an asset should be treated as taxable use should be based on the dominant use of the asset during a relevant adjustment period.

23. Assets to which the new GST rules would apply would be based on the conceptual definition, just as for income tax, and would be assets that satisfy the following criteria:

    (a) Rented out on a short-term basis; and

    (b) Unused for a reasonable proportion of the year; and

    (c) Cost more than a minimum threshold (possibly $50,000), if they are not land.

24. The current rules in relation to logbooks for motor vehicles and established practice around the use of the part of a home for income earning would continue to apply.

25. If the GST approach mirrors the income tax approach implied in the Budget, an apportionment formula would be used and an input tax deduction would be based on the proportion of use for making taxable supplies to total supplies during an adjustment period.

Overall implications

26. The rules are likely to be complicated and could have quite serious implications.

27. The Budget did not specify an application date for the new rules. I suggest that ownership of assets that would obviously be affected be reviewed now, and any changes be made if warranted, to reduce compliance costs while retaining maximum tax-effectiveness without falling foul of the general anti-avoidance rule.

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