



WEEKLY COMMENT: FRIDAY 21 SEPTEMBER 2012

1. This week I look at the new expenditure apportionment rules for mixed-use assets contained in the *Taxation (Livestock Valuation, Assets Expenditure, and Remedial Matters) Bill* ("the Bill") introduced on 13 September. The Bill includes new rules for both income tax and GST purposes. The income tax rules will apply from the 2013-14 income year. The GST rules will apply to taxable periods starting from 1 April 2013.
2. I look at:
 - The scope of the rules: assets included, 'private use' and application to companies;
 - The expenditure limitation rule;
 - Interest expenditure limitation for close companies;
 - Quarantined expenditure; and
 - The GST rules.

The scope of the rules: assets included, 'private use' and application to companies

3. Only assets that are not used for part of the year will be subject to the rules. The rules will not apply to assets that are actively used throughout the year for either income-earning or private purposes. More specifically the rules will apply to land (including improvements) whatever the cost, and assets other than land that cost the taxpayer \$50,000 or more, that are not used for at least 62 days in the income year (or 62 working days if warranted by the pattern of typical use). If total use and non-use relates to only part of a year, the 62-day test for non-use is proportionately reduced. [s. DG 3(1) & DG 22(2)]
4. When deciding if the cost of an asset other than land is at least \$50,000, any part of the cost that is tax-deductible under general tax rules (other than by way of depreciation) is excluded. Also excluded from these rules are motor vehicles, and assets whose expenditure is apportioned for tax based on space or floor area or a similar measure. [s. DG 3(2) to DG 3(4)]
5. Private use is any use – income-earning or otherwise – by the taxpayer or an associated person. If the taxpayer is a company, any person who has a voting interest of at least 5%, or whose share in the company gives them a right to use the asset, is an associated person for the purposes of these rules. [s. DG 4(1) & DG 6]
6. As a backstop, any use of the asset where the income earned is less than the market value amount is treated as private use. [s. DG 4(2)]

7. The provision by the taxpayer, or an associated person, of expert services as part of the income-earning use – for example, piloting an aircraft – is not treated as private use if the amount earned includes payment for the services rendered. [s. DG 4(3) & (4)]
8. The rules apply only to **close companies** as defined in s. YA 1 – i.e. companies of which the majority of the shares are owned by 5 or fewer natural person shareholders - but the definition is expanded so that companies owned through other companies will be subject to the rules. The intention appears to be to limit the application of these rules to close companies, but the present wording appears to cast the net somewhat wider and may need amending to achieve the desired effect. [s. DG 2(4)]
9. For the purposes of these rules, a group of companies is treated as a wholly owned group, so that a shareholding in any company in the group will extend to all other companies in the group. This rule is relevant to the limitation of interest expenditure in company groups. [s. DG 2(5)]

The general expenditure limitation rule

10. The expenditure limitation rule applies on an asset-by-asset basis to ‘mixed’ expenditure – i.e. expenditure that is not related solely to either income-earning use or private use. Expenditure related solely to income-earning use, and therefore not subject to the limitation rule, includes expenditure to meet a regulatory requirement for using the asset to derive income. All expenditure on repairs and maintenance must be treated as ‘mixed’ expenditure subject to the limitation rule. [s. DG 7 & DG 9(3)(a)]
11. If the taxpayer is not a company, a general expenditure limitation rule applies to all ‘mixed’ expenditure including interest expenditure. If the taxpayer is a company two separate limitation rules apply: the general limitation rule for non-interest expenditure and a special limitation rule for interest expenditure. [s. DG 8(3)]
12. Under the general rule, ‘mixed’ expenditure is spread over income-earning and private days, and only the portion allocated to income-earning days is deductible. Days of non-use are ignored. All days when a market value amount is earned are treated as income-earning days. All other days when the asset is in use are treated as private days. Deductible ‘mixed’ expenditure is determined as the proportion of income earning days to the sum of income-earning and private days. [s. DG 9(2)]
13. An alternative unit of measurement – such as hours or nights – could be used if it achieves a more appropriate apportionment. [s. DG 9(3)]
14. The Bill includes useful examples. Here is a modified combination of 2 of the examples relating to the general expenditure limitation rule:

Facts: Mike operates a charter boat that he also uses privately. He rents out the charter boat at market value of 100 days in an income year, and uses it for his personal enjoyment for 50 days. He incurs expenditure that includes advertising costs of \$3,000, costs in meeting Maritime New Zealand survey requirements of \$2,000, and general maintenance costs of \$10,000.

Treatment of expenditure: The advertising costs of \$3,000 are fully deductible because they deliver no private benefit. The survey costs of \$2,000 are fully deductible as a regulatory requirement cost if they are incurred only for charter purposes. The maintenance expenditure must be treated as ‘mixed’ expenditure subject to the limitation rule. The asset is used for 150

days. Income-earning days are 100, and the remaining 50 days of use are private days. Mike may deduct 2/3 of the maintenance expenditure under the general limitation rule: the formula is $\$10,000 \times (100/(100 + 50)) = \$6,666.67$.

Interest expenditure limitation for close companies

15. When a close company holds a mixed-use asset, expenditure other than interest is dealt with under the general expenditure limitation rule. Interest expenditure is dealt with separately.
16. An expanded definition of 'interest' includes not only ordinarily tax-deductible payments on financial arrangements that provide funds to the taxpayer company, but also payments on fixed rate foreign equity, fixed rate shares and stapled debt securities that are issued by the taxpayer and held by a New Zealand resident. Excluded from 'interest' are changes in the liabilities that arise purely from foreign exchange movements. The liabilities that give rise to payments of 'interest' under the expanded definition are treated as the taxpayer entity's 'debt'.
[s. DG 10 & DG 5]
17. Interest on all debt up to the value of the mixed-use asset is subject to the interest limitation rule, which is wide-ranging and extends, in the following order up to the value of the mixed use asset, to:
 - (a) Interest payable by the mixed-use asset owning company on its own debt up to the value of the mixed-use asset;
 - (b) Interest payable on their debt by other companies in the same group as the mixed-use asset owning company, to the extent that the mixed-use asset owning company's own debt was less than the value of the mixed-use asset;
 - (c) Interest payable on their debt by non-group corporate shareholders of any company in the mixed-use asset-owning company's group, to the extent that the company group's total debt was less than the value of the mixed-use asset; and
 - (d) Interest payable on their debt by non-company shareholders in the mixed-use asset owning company, to the extent that the combined company group's and non-group corporate shareholders' debt was less than the value of the mixed-use asset. (Natural persons are only subject to this rule to the extent of money borrowed to acquire shares in the mixed-use asset owning company or in corporate shareholders in the company group.)
[s. DG 11 to DG 14]
18. For the company that owns the mixed-use asset, the interest limitation rule is based on a comparison of the company's **debt value** – the average of the opening and closing values of the total liabilities giving rise to interest payable – and the company's **asset value** – the value of the particular mixed-use asset in relation to which expenditure is being limited:
 - (a) If the asset value exceeds the debt value, the entire debt is treated as having financed the mixed-use asset, and all of the company's interest is subject to the limitation rule.
 - (b) If the debt value exceeds the asset value, only the portion of debt corresponding to the asset value is treated as having financed the mixed-use asset. Only the interest on the proportion of the debt value corresponding to the asset value will be subject to the limitation rule. General tax rules apply to the deductibility of the remainder of the interest.

[s. DG 11]

19. For each company in the same group as the company that owns the mixed-use asset, the interest limitation rule is based on comparing the **net asset value** – the remaining mixed-asset value after deducting the debt of the asset-owning company – to each group company's debt. The net asset value is reduced each time a group company's interest payable on debt becomes subject to the limitation rule. [s. DG 12]
20. The rule is then applied in the same way to non-group corporate shareholders in the company group and to non-corporate shareholders in the mixed-use asset owning company, until the mixed-use asset value has been completely extinguished, or the interest payable on all of the debt has been made subject to the limitation rule. Corporate and non-corporate shareholders, however, will only have interest deductions limited based on their percentage shareholding applied to the net asset value of the mixed-use asset. [s. DG 13 & DG 14]

Quarantined expenditure

21. The deduction allowed to a person in an income year for expenditure that is limited under the general expenditure limitation rule and/or the interest expenditure limitation rule can be less than the limited amount if the income derived (from persons other than associated persons) for the income year from the use of the mixed-use asset is less than 2% of:
- (a) For land and improvements to land, the later of the most recent rating valuation or the acquisition cost (or market value if acquired from an associated person).
 - (b) For other property, the cost of the mixed-use asset to the person.
- [s. DG 16]
22. The quarantining rule does not apply if the person uses the asset themselves for business purposes and income cannot be separately attributed, provided that 80% or more of the total use of the mixed-use asset is not for some other use from which the income can be separately attributed. [s. DG 20]
23. Where income from the mixed-use asset is less than the 2% threshold, the limited expenditure is only deductible to the extent of the total income derived from the use of the asset in the income year. The remainder of the limited expenditure is quarantined and carried forward, and may become deductible in a following income year if sufficient income in excess of limited expenditure is derived in the subsequent income year. [s. DG 16 & DG 17]
24. There are essentially 2 rules:
- (a) Rule 1 applies to current year limited expenditure in the year that the income threshold is not reached; and
 - (b) Rule 2 applies to brought forward limited expenditure that was quarantined in an earlier income year.
25. In the case of Rule 1, the current year limited expenditure plus any brought forward quarantined expenditure of the person that owns the mixed-use asset is compared to the income from the asset:
- (a) If the total limited expenditure (current year limited expenditure + brought forward quarantined limited expenditure) exceeds the current year income from the asset, the excess is quarantined and carried forward. In this case, all of the limited interest expenditure of other group companies, non-group corporate shareholders and non-

corporate shareholders is similarly quarantined – i.e. there is insufficient income to allow deductions by any of these persons.

- (b) If the total limited expenditure is less than the current year income from the asset, the excess income is referred to as an **outstanding profit balance**, and may be used by group companies and their non-group corporate shareholders or non-corporate shareholders in the asset owning company to deduct limited interest expenditure that would otherwise be quarantined. The outstanding profit balance is applied first to group companies, then to non-group corporate shareholders and finally, if there is still profit left, to non-corporate shareholders, to determine the extent to which their limited interest expenditure and brought forward quarantined expenditure can be deducted in the current income year. Any profit balance available to corporate or non-corporate shareholders may be used only to the extent of their percentage shareholding in the relevant company.

[s. DG 16 & DG 18]

26. Rule 2 applies when the person who owns the mixed use asset has quarantined expenditure from an earlier year, and the current year income exceeds the person's current year limited expenditure:

- (a) The brought forward quarantined expenditure of the person that owns the mixed-use asset is deductible to the extent of the excess current year income.
- (b) If the brought forward quarantined expenditure of the person that owns the mixed-use asset is less than the excess current year income, the remaining income is an **outstanding profit balance** that can be used by group companies and their non-group corporate shareholders or non-corporate shareholders to deduct their brought forward quarantined limited expenditure from an earlier year. The sequential application of the outstanding profit balance is the same as for Rule 1.

[s. DG 17 & DG 19]

Information requirements

27. The interest limitation rules and the quarantining rules require information to be provided on the net asset values and the outstanding profit balances. Under s. 30D of the Tax Administration Act 1994 the company that owns the mixed-use asset must provide each shareholder with their share of the net asset balance and any outstanding profit balance for the income year.

GST rules

28. The new GST rules are based on a combination of the income tax rules described above and the GST apportionment rules that have applied since 1 April 2011.

29. Input tax for expenditure on a mixed-use asset is allowed only to the extent that the asset is used for income-earning days (or some other measurement unit that provides a fair and reasonable result). Input tax on expenditure is apportioned based on the proportion of income-earning days to total active use days (income-earning plus private use days). Income-earning days and private use days are defined as they are for income tax – see paragraph 12 above. [S. 20G of the GST Act]

30. The usual GST apportionment rules apply – i.e. the percentage intended use is determined on acquisition, and then adjusted for actual use at the end of each subsequent adjustment period.

As with other GST adjustments, no adjustment is required if the percentage adjustment is less than 10% and the adjustment does not exceed \$1,000.

31. The rule in section 10(3) that deems the consideration for an associated supply to be the open market value will not apply to mixed-use assets. [s. 10(3DB) of the GST Act]



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