CARTER & ASSOCIATES
CHARTERED ACCOUNTANTS LTD

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XERO GOLD PARTNER

Technology and R&M

The condition of New Zealand's housing stock was hotly debated during the lead up to the election. Houses that were acceptable in the 1970's are now considered outdated and low quality for 21st century living. With the introduction of a new Government we are waiting to see what changes will be implemented for landlords, for example, will a housing Warrant of Fitness be introduced?

Landlords may need to incur significant improvement costs to bring properties up to the required standard, so the inevitable question will arise - are the costs tax deductible, or capital in nature. Because buildings are not depreciable, if expenses are considered to be capital, no tax deduction will be available at all.

The process of determining whether expenditure comprises tax deductible repairs and maintenance work (R&M) has been established by the Courts, but it is inherently a judgement call and is open to interpretation. As a result, it is a common area of review by Inland Revenue during the investigation process.

Generally, where new building materials are used extensively, and perform different functions, then this may be considered a change in the character of the asset and therefore more likely to be capital in nature. However, one accepted means of treating expenditure as deductible R&M is on the basis of technological improvement. The rationale is based on the Privy Council decision in Auckland Gas Co. Limited v CIR in which Lord Nichols stated:

It often happens that, with improvements in technology, a replacement part is better than the original and will last longer or function better. That does not, of itself, change the character of the larger object or, hence, the appropriate description of the work.

Some objects do not lend themselves so readily to this exercise in characterisation…A house is a simple example of this. Demolition and rebuilding of a dangerous flank wall of a house would normally be regarded as repairing the house. The answer might not be so obvious if an entire derelict wing of a large house were demolished and rebuilt, especially if the new construction were substantially different from the original. Questions of degree may arise in such cases.

Inland Revenue's Interpretation Statement on R&M issued in 2012 briefly commented on the issue. Inland Revenue referred to the Auckland Gas example. In that case, a significant portion of the asset, being the gas network, was replaced with new pipes that performed differently. It was considered that the character of the gas distribution system had changed, hence the conclusion by the courts that the expenditure was capital in nature.

Let's take another common example. A landlord may choose to replace all of the windows of a rental property with double glazing. Double glazed windows can make a substantial improvement to a home's heat retention, as it is often the windows and frames that are most susceptible to heat loss. However, there is a strong argument for concluding that the character of the house is unchanged. It is visually unchanged and the windows perform the same function. While not explicitly dictated as the only choice of window, they can be considered the new technical 'standard'. In principle, the cost of making this type of improvement should be tax deductible. The tax benefit promotes the creation of healthier, greener homes. However, if in this example the landlord had chosen to replace the windows with a better product to improve the character of the house, then arguably a capital improvement has been made. Single glazed windows are available and common sense suggests the landlord would not have paid for the improvement if no advantage was gained.

Instead of replacing all of the windows, replacing the odd broken window from a stray cricket ball might help the landlord dodge Inland Revenue's capital improvement firing line.

Team development

Business owners and managers are often focused on a company's financial performance, return on investment and other monetary indicators of business success. Intangible investment in human capital can commonly be overlooked as it can be difficult to measure improvements, or any direct increase in outputs. However, employee effectiveness is critical to the performance of all business processes.

There are numerous approaches that can be used to increase the effectiveness of employees, of these the athlete-centred and employee-centred approaches are summarised below.

Using the sports field as an example, an athlete-centred approach has been proven to develop exceptional gamesmanship and understanding. Although you might not view your colleagues as a sports team, significant improvements can be made by investing time in staff development. Managers have a great opportunity to lead from the front and pave the way for a more effective organisation by creating a learning, rather than telling, work environment. To achieve this, managers need to view themselves more as teachers than autocrats. This allows employees the freedom to make errors and gives managers points to correct and teach from, developing a greater understanding of the problems at hand.

Graham Henry has an active focus on empowering the rugby players he coaches, giving them more responsibility, rather than using a dictatorial decision making style. An important aspect of this is having a senior leadership team available to help set the tone of the group for situations both on and off the field.

By allowing the senior leadership team control of almost all aspects of the team, the athletes have greater buy in and acceptance of team decisions.

Business owners could take a similar approach and create high performing teams to adopt an athlete-centred approach in business decision making processes.

The employee-centred approach relies on managers to empower their staff to take responsibility for their own work outputs, and make their own decisions

A nurturing environment must be created for this 'employee-centred' approach to be successful. A 'teach, don't tell' coaching style is a core principle. Managers who avoid telling employees what to do, and instead test their understanding of topics through the use of leading questions, enable employees to develop their decision making ability and technical skills and still think through the problem themselves.

The managers still 'teach' the employee in areas where there is a lack of knowledge, but the questioning style helps the employees broaden their knowledge and retain responsibility for their outputs.

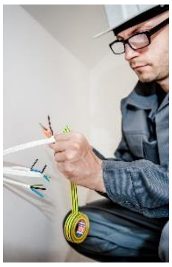
Good managers will move between this 'teach don't tell' style of coaching, to a more prescriptive style as required by the situation on managers to empower their staff to take responsibility for their own work outputs, and make their own decisions.

Voluntary Disclosures

Tradies have been under the watchful eye of Inland Revenue (IRD) for the last few years since being identified as a cash-dominated industry in 2012. A media campaign has recently been launched to warn tradespeople that doing 'cash jobs' may comprise tax evasion, and that every cash job leaves a trail (or lack of a trail) that can be tracked by IRD.

Tradespeople risk substantial financial consequences if they are caught understating taxable income in their tax returns. Fines, penalties, use of money interest, and potential prosecution are all within the IRD's power.

This begs the question, if a business identifies an error and the correct amount of tax has not been paid, what should be done? Contrary to some views, it does not comprise a windfall gain. If a business has underpaid its tax by more than $1,000 it must be disclosed to IRD. No business owner will take joy in having to pro-actively contact IRD, so here are a few points to keep in mind which will help smooth the process.



The best way to proceed is by making a written voluntary disclosure. With any re-assessment to increase a person's tax liability, IRD will consider whether shortfall penalties should be charged. If charged, the amount is based on a percentage of the tax shortfall and the percentage varies depending on the nature of the error and the taxpayer's culpability.

The taxpayer should therefore use their written disclosure to clearly set out what the error is, how it arose and what actions have been taken to ensure it will not happen again.

The disclosure provides an opportunity to explain the facts in the most favourable way possible. It reassures IRD of the taxpayer's willingness to comply with the tax rules and demonstrates that the matter is being taken seriously.

The disclosure should also set out how the relevant tax return should be amended, with reference to the actual box numbers in the tax return. Broad statements regarding how the mistake should be fixed run the risk of IRD amending the return incorrectly, which will only give rise to more contact with IRD – the taxpayer should make it extremely easy for the person processing the change to get it right.

In most cases, if a voluntary disclosure is made no shortfall penalty should be charged. In a small number of cases, the IRD may receive the disclosure and commence an investigation. IRD could potentially take the view that if one error was made, something else might be wrong.

This reinforces the need to word the initial disclosure carefully to ensure there is an appearance of 'there is nothing to see here, move along'.

If a voluntary disclosure is not made, and IRD find the error themselves the situation could be much worse. Shortfall penalties, that may not otherwise have been applied, could be charged and the IRD may undertake a more comprehensive investigation. So full disclosure at the earliest opportunity is always recommended. Being able to sleep at night is worth some temporary discomfort.

Snippets

Holding gold

Can an investment in gold bullion create a tax liability? Inland Revenue (IRD) has recently released a statement on this specific point.

IRD consider that gold bullion purchased as an investment has been acquired with the purpose of eventual disposal, i.e. a purpose or intention of resale exists. Consequently, any gain that arises on its future sale is income and taxable. In IRD's view, a commodity such as gold does not provide any annual return or income for the period of ownership, so it is hard to argue that the investment was for any purposes other than eventual disposal.

The IRD considers the 'reason' for acquiring gold is irrelevant. Whether it has been purchased as an investment, or a hedge, this does not counter the underlying purpose of a future disposal. In comparison with other investments such as shares in a company, which may be held on capital account for the purpose of a deriving a dividend stream, gold has none of these features.

If you have any questions regarding this Newsletter, please don't hesitate to contact the office - 09 5799157

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