

Deductions and valuation issues

The financial arrangements rules

Specific timing rules apply to the recognition for income tax purposes of income and expenditure in relation to financial arrangements. The effect of the rules is to eliminate the capital/revenue distinction for financial arrangements. The financial arrangements rules apply only to New Zealand residents or entities carrying on business in New Zealand.

The financial arrangements rules were amended with effect from 20 May 1999. The rules were divided into two divisions. Division 1 contains the rules that continue to apply to financial arrangements entered into before 20 May 1999 (the old financial arrangements rules). Division 2 contains the amended rules that apply to financial arrangements entered into on or after 20 May 1999 (the new financial arrangements rules).

Financial arrangements

Financial arrangements are broadly defined to include any arrangements whereby a person obtains money or money's worth in consideration for a promise to provide money or money's worth at some future time. Common examples of financial arrangements are loans, government stock, mortgages, swaps and options.

Exceptions to the definition of 'financial arrangement' include life insurance policies, superannuation schemes and hire purchase agreements. Hire purchase agreements are treated as two separate transactions, being a sale of goods accompanied by a loan, with income and expenditure under the loan being recognised under the financial arrangements rules. From 20 May 1999, the exceptions to the definition of 'financial arrangement' in both Divisions include interests in group investment funds, partnerships and joint ventures, certain private or domestic agreements, warranties and employment contracts.

The general rule is that income or expenditure from financial arrangements will be returned for tax purposes using the yield-to-maturity method. However, where the total value of all financial arrangements held at any time in the year does not exceed \$1.5 million, the straight line method is acceptable. In certain circumstances the market valuation method can be used. Where it is not possible to use any of these methods, income or expenditure from the financial arrangement may be returned on the basis of a determination made by the Commissioner. An alternative method may be adopted if it meets certain criteria.

Base price adjustment

Upon maturity or disposal of a financial arrangement, a base price adjustment is performed to 'wash up' final amounts of income and expenditure. Discounts realised on redemption are taxable. The base price adjustment applies regardless of the calculation method used in prior periods and applies also to cash basis holders.

The old financial arrangements rules [Division 1] - Cash basis holder

Where an individual lender derives not more than \$70,000 from financial arrangements in an income year or the total value of financial arrangements held by that person at any time in the year does not exceed \$600,000, and the difference between the income which would be deemed to be derived on an accruals basis and the income derived on a cash basis does not exceed \$20,000, the income from financial arrangements held by that person may be returned on a cash basis.

The borrower under an old financial arrangement cannot return expenditure on a cash basis.

The financial arrangements rules [Division 2] - Cash basis person

Either party to a Division 2 financial arrangement can be a cash basis person.

Where the total value of the person's income and expenditure from the financial arrangement does not exceed \$100,000 in an income year or the total value of financial arrangements at any time in the year does not exceed \$1 million, financial arrangements held by that person may be returned on a cash basis. A person will not be a cash basis person if the difference between the income which would be deemed to be derived on an accruals basis and the income derived on a cash basis exceeds \$40,000.

Foreign exchange

Under the financial arrangements rules, foreign exchange gains arising from financial arrangements denominated in a foreign currency (whether realised or unrealised, capital or revenue) are included as gross income. Foreign exchange losses (realised and unrealised) are deemed to be interest and, provided the losses meet the interest deductibility criteria, a tax deduction should be available. In some circumstances foreign exchange income or expenditure will be taxed based on the expected value of the financial arrangement. Any unexpected portion will be taxed upon realisation of the gain or loss.

Deferred settlements

Deferred settlements of real and other property can give rise to deemed interest in the sale price, resulting in gross income for the vendor and a potential interest deduction for the purchaser. However, private or domestic agreements with deferred settlements are an exception to the definition of financial arrangement, subject to certain conditions. Agreements must be entered into for a private or domestic purpose, and the monetary value of the settlement must be less than \$1 million if it relates to real property, or \$400,000 if it relates to any other property or services. Settlement must take place within 365 days of the agreement.

International Financial Reporting Standards (IFRS)

Legislation enacted in 2007 introduces a number of changes to the financial arrangements rules to ensure that taxpayers who adopt International Financial Reporting Standards (IFRS) can continue to use tax rules that rely on accounting practice. For other taxpayers, the existing tax spreading methodologies will continue to apply but without the option of using the financial reporting method.

The new rules include a combination of compulsory methods and elective methods that are available subject to the taxpayer meeting certain qualification criteria.

Two new methods (the expected value method and the equity-free fair value method) have been introduced to assist in reducing exposure to volatility that might otherwise arise under IFRS fair value accounting.

For most taxpayers that use IFRS for financial reporting purposes the new rules apply from the 2007/2008 income year.

Interest deductibility for companies

Interest incurred by companies (other than qualifying companies or those that derive certain exempt income) is deductible subject to the thin capitalisation rules (refer Thin capitalisation, page 38).

Depreciation

Taxpayers have the choice of using the diminishing value (DV) or straight line (SL) method of depreciation with a pooling option for assets with a cost or book value below \$2,000. Generally, annual deductions are calculated in accordance with the formula:

$$a \times b \times c / 12$$

where a = the depreciation rate applying for the asset;

b = the cost price (SL) or book value (DV) of the asset;

c = the number of months (or part months) during the year in which the property was owned and used or available for use by the taxpayer.

Depreciation rates (DV and SL equivalents) are determined by the Commissioner pursuant to a statutory formula which takes account of the expected economic life and residual value of assets. In special circumstances taxpayers may ask the Commissioner to prescribe a special depreciation rate.

Legislation enacted in 2006 introduced the double declining balance (accelerated) method for depreciating plant and equipment. Under the double declining balance method equipment with an estimated useful life of 10 years results in DV depreciation deductions of 20% per annum ie double the straight line rate of 10% over the equipment's 10 year life. Buildings, certain motor vehicles, high residual value property, fixed life intangible property and property acquired prior to the introduction of the new rules cannot be depreciated under the double declining balance method.

The actual depreciation rate to be applied is dependent upon the date of acquisition of the relevant asset by the taxpayer:

- assets acquired prior to 1 April 1993 - apply 'old' rates previously allowed by the Commissioner, plus a 25% loading for qualifying assets acquired on or after 16 December 1991;
- assets acquired between 1 April 1993 and 31 March 1995 (or equivalent balance date) - choose between applying 'old' rates, inclusive of any loading, and 'new' economic rates;
- assets acquired between 1 April 1995 and the end of the 2004/2005 income year - apply 'new' economic rates plus a 20% loading for qualifying assets;
- assets acquired in the 2005/2006 income year – choose between applying 'new' economic rates plus a 20% loading for qualifying assets and, in the case of plant and equipment, double declining balance rates plus a 20% loading for qualifying assets;
- buildings acquired on or after 19 May 2005 - must apply a 2% SL rate or equivalent 3% DV rate, with application to the 2005/2006 and subsequent income years; and
- assets acquired in the 2006/2007 and subsequent income years – apply double declining balance rates to plant and equipment (where applicable) plus a 20% loading for qualifying assets.

Assets acquired on or after 19 May 2005 costing up to \$500 may be expensed on acquisition rather than capitalised and depreciated provided certain criteria are met. The low-value asset threshold for assets acquired before 19 May 2005 was \$200.

The classes of depreciable property include certain land improvements and some types of intangible property. Computer software must be depreciated.

All depreciation recovered is taxable in the year of sale. Taxpayers are not able to offset depreciation recovered against the cost of replacement assets.

Entertainment expenditure

In recognition of the personal benefits that often arise as a consequence of business entertainment, generally 50% of entertainment expenditure is non-deductible for tax purposes.

The entertainment tax regime applies to specified types of entertainment, namely:

- corporate boxes;
- holiday accommodation;
- yachts and pleasure craft; and

- food or beverages:
 - provided as part of the above; or
 - provided or consumed off the taxpayer's business premises; or
 - provided or consumed on the taxpayer's business premises, at a party or social function, or in an exclusive area of the premises reserved for employees of a certain level of seniority.

Exclusions from the entertainment regime include:

- food or beverages consumed while travelling on business, except where entertaining business contacts;
- food or beverages consumed at a conference which lasts over four hours;
- certain overtime meal allowances;
- 'light meals' provided to employees while working;
- entertainment at trade displays and other promotional activities; and
- entertainment enjoyed or consumed outside of New Zealand.

Farming, agriculture and forestry expenditure

Provisions exist for the deduction of specified development expenditure against income derived from such ventures.

Farming and agriculture

Taxpayers engaging in farming or agriculture may take an immediate deduction for the following classes of development expenditure (ordinarily classified as capital and accordingly non-deductible):

- destruction of weeds, plants or animal pests detrimental to the land;
- clearing, destruction and removal of scrub, stumps and undergrowth;
- repair of flood or erosion damage;
- planting and maintaining trees for the purpose of preventing or combating erosion or for the purpose of providing shelter; and
- construction of fences for agricultural purposes, including rabbit-proofing of new or existing fences.

Development expenditure not eligible for immediate write-off is capitalised and 'depreciated' together with similar development expenditure from earlier income years on a diminishing value basis. Depreciation rates range from 5% to 10% plus a 20% loading on the specified rate.

In addition to detailed records of direct capital expenditure, farmers are required to keep details of indirect costs incurred in relation to farm development, such as labour and motor vehicle expenses.

Forestry

Taxpayers engaging in forestry may take an immediate deduction for expenditure incurred in:

- planting and maintaining forests;
- construction of temporary access tracks; and
- administration of the forestry business (ie interest, rates, insurance premiums and administrative overheads).

Forest land development expenditure not eligible for immediate write-off is capitalised and 'depreciated', together with similar development expenditure from earlier income years, on a diminishing value basis.

Depreciation rates range from 5% to 20%, plus a 20% loading on the specified rate. Expenditure incurred in relation to the purchase of an existing forest must be capitalised to a 'cost of timber' account and is only deductible in the year the relevant timber is sold.

Livestock valuation options

Provisions exist for the valuation of 'specified livestock' (sheep, beef cattle, dairy cattle, deer, goats and pigs) whereby the specified livestock may be valued using one of four methods of valuation:

- national standard cost scheme; or
- the herd scheme; or
- cost, market value or replacement price; or
- self assessed cost scheme.

Special valuation rules apply for bailed or leased livestock, non-specified livestock and bloodstock.

Motor vehicle deductions

Self-employed taxpayers using a motor vehicle partially for business and partially for other purposes are required to maintain either:

- complete and accurate records of the reasons for and distance of journeys undertaken for business purposes; or
- a motor vehicle logbook for a three month test period every three years to establish a business mileage pattern. Where no records or logbook are maintained, the tax deduction will be limited to the lesser of the percentage of actual business use or 25% of the total operating expenditure and depreciation.

Research and development expenditure

Research expenditure is always deductible. Development expenditure is deductible until the product or process is clearly defined and the costs attributable to the product or process can be separately identified and measured. Development expenditure not immediately deductible must be analysed to determine whether a depreciable asset is created. Where annual development expenditure is less than \$10,000 it is automatically deductible. For tax purposes the definitions of research and development expenditure mirror those in the relevant accounting standards. Special rules govern the deductibility of software development expenditure.

In certain circumstances companies are able to defer deductions for research and development expenditure which would otherwise be forfeited on the introduction of new equity investors. This rule removes a barrier to investment in research and development by allowing deductions for research and development expenditure (including depreciation) to be matched against income arising from that expenditure.

From the beginning of the 2008/2009 income year (1 April 2008 for most taxpayers) businesses that meet certain criteria are eligible for a new 15% tax credit for qualifying research and development expenditure (refer New developments – Research and development tax credit, page 53)

Trading stock

Trading stock may be valued at either cost or market selling value, if this is lower. Cost will be determined by reference to generally accepted accounting principles. Market selling value must be demonstrated generally based on actual sales. Replacement price or discounted selling price may be used to approximate cost if these methods are used for financial reporting purposes. Shares which are trading stock must be valued at cost.

Business environmental expenditure

Taxpayers can deduct certain expenditure incurred in avoiding the discharge of contaminants and in remedying or mitigating the effect of such discharges. An 'environmental restoration account' is used to match site restoration expenditure against prior business income.