



Welcome to the first edition of our newsletter for 2006.

It is shaping up to be a big year for us. We have just had three new graduates join our team and they will all be introduced to you soon on our website. We are also looking forward to moving to our new premises on Victoria Street towards the middle of the year.

31 March is fast approaching and you will soon receive our checklists for the 2006 financial year so now is the time to start reviewing your accounts receivable and writing off bad debts. We also remind you that if you have stock greater than \$5,000 you must do a stocktake as at 31 March.

In the meantime please contact us if you wish to discuss anything.

Best regards

Anna, Bryan, Richard & the team at Poccock Hudson.

ELECTION PROMISES ARRIVE!

To deliver on some of the promises made during the election campaign, the Government tabled new legislation in Parliament in November 2005. Entitled the Taxation (Annual Rates and Urgent Measures) Bill 2005, it makes changes to the "Working for Families" and Student Loan schemes. The legislation was passed on the 21 December 2005.

Working For Families

From 1 April 2006, the income level at which family assistance starts to drop will increase from \$27,500 to \$35,000. The level at which family assistance abates will drop from 30c to 20c.

Student Loan Scheme

Changes to the Student Loan Scheme apply from 1 April 2006.

To qualify for a full interest write off of all the borrower's interest on the student loan, the borrower must be "personally present" in New Zealand ("NZ") for 183 or more consecutive days after 31 March 2006. A borrower may be absent from NZ for a total of 31 days or less within that 183 consecutive day period and still be regarded as being present for the period in question.

Borrowers who are absent from NZ for a period of 184 or more consecutive days will not be entitled to a full interest write off. They will be treated as absent if they are back in NZ for 31 days or less within that 184-day period of absence.

The Commissioner will have discretion to allow borrowers to receive a full interest write off even if they fail the test for the 183 day presence in NZ. In brief the discretion can be exercised if borrowers are absent because they:

- Were serving the Government of New Zealand
- Were working as volunteers or for token payment for a named charitable organisation

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- Had an unexpected delay, ie circumstances beyond their control
- Had an unplanned personal absence, circumstances beyond their planning and control
- Were required to be absent due to their employment or occupation,
- Were studying overseas at a post graduate level,
- Accompanied their partner (ie spouse, de facto or civil union partner) overseas who is overseas for any one of the work or study reasons above.

Currently, when borrowers go overseas they are required to notify the IRD to calculate their repayment obligations while they are away. If those obligations are not met, those borrowers will not only incur interest, but late payment penalties as well. In some instances borrowers' residency status are updated without their knowledge, and they are assessed as non-residents for student loan purposes. When they return, their loan, including interest and late payment penalties, may have grown considerably.

Included in the legislation is an amnesty from late payment penalties for borrowers who are overseas, if they agree to meet their obligations for a two year period. In return, any late payment penalties charged will be reversed. However, the penalties will be reinstated if the amnesty conditions are breached.

The amnesty period will run from 1 April 2006 to 31 March 2007 and will only apply to borrowers who are non-resident on 31 March 2006. If borrowers have returned from overseas and regained their NZ resident status before 1 April 2006, the amnesty conditions will not apply to them.

PROVISIONAL TAX AND GST CHANGES - UPDATE

The Taxation (Depreciation, Payment Dates Alignment, FBT and Miscellaneous Provisions) Bill 2005 that received considerable attention both generally and discussed in previous newsletters was reinstated into Parliament after it lapsed due to the election. The Bill includes a number of changes that will require some preparation by accountants and the IRD alike, such as administrative changes to provisional tax and GST payment dates.

As some of the proposed changes are to come into effect from 1 April 2006 there is concern that the passing of the Bill is being left too late for these changes to be implemented smoothly and in a timely manner. As the content of the Bill may change before it is enacted, there is little point in accountants making administrative changes in anticipation of the Bill being passed.

The following changes to start dates have been proposed by the Minister of Revenue in a letter to the Finance and Expenditure Committee to enable the changes to be implemented smoothly:

1. Changing GST due dates from the last working day of the month to the 28th – delay from 1 April 2006 to 1 April 2007.
2. Aligning provisional tax payments with GST due dates – delay to 2008 – 2009 income year.
3. Option to base provisional tax on a percentage of GST turnover – delay to 2008 – 2009 income year.

Progress and updates on the Bill will be in future newsletters, as they come to hand.

GST ON CANCELLED CONTRACTS

Imagine you have recently entered into a sale and purchase agreement to sell your turnip farm in Queenstown. You have received the deposit which you included in your last GST return as you are registered on the payments basis. You issued an invoice to the purchaser and understood the purchaser to have made an input claim for the full purchase price.

This morning your lawyer phoned you to say the agreement has fallen over, but on the bright side, you get to keep the deposit. This makes you feel better, but being a good taxpayer, you are left thinking "what about the GST?"

The Inland Revenue has clarified what effect such a cancelled contract will have. In this situation, you the vendor, may make an input claim on the amount of the deposit and the purchaser must return the value of any previous input claim as an output. This effectively reverses the amounts that had been returned (by you) and claimed (by the purchaser) for GST.

GST no longer applies to the deposit that was paid as it is not for a separate supply. Once the purchaser terminates the contract the deposit represents damages for failure to complete the contract.

No supply has been made by the vendor, accordingly no GST is chargeable on the deposit. It does not matter if it is the purchaser or the vendor who terminates the contract, it is a question of whether or not the deposit has been received in return for a supply.

One further point to keep in mind is the cancellation of a contract is not recognised until the period in which it occurs. Therefore if the

contract is cancelled in a period after the GST on the contract is due for payment, you must still return the GST in the earlier period and claim it back in the period in which the cancellation occurs.

DEDUCTIBILITY OF PATENT COSTS

The IRD recently issued an interpretation statement (IS) outlining how assorted items relating to patents and patent rights should be treated. For example, a manufacturing company researches and develops a new method of manufacturing. It then makes an application for that method to be patented, and the application is approved. Different types of expenditure are incurred in this process from labour costs to legal fees, the IS clarifies how each type of cost should be treated.

The term "patent" does not include the invention to which it relates. A "patent" refers to the legal rights granted to an applicant, to exclude others from using a particular mode of manufacture. The patent costs able to be depreciated are those costs incurred by the taxpayer that are directly attributable to the patent, for example the administrative and legal fees.

A change to the legislation, effective 1 October 2005 and with application from the 2005 – 06 income year, means that where an application for a patent is refused or withdrawn, expenses that would have been part of its cost had the patent been granted, are now deductible.

The actual research or development costs of a process subject to a patent are likely to be dealt with under sections DB 26 and DB 27 of the Income Tax Act 2004 (formerly DJ 9A of the 1994 Act). Essentially these sections

require the tax treatment to follow that of accounting standards.

Legal fees in actions either defending or attacking a patent, including infringement proceedings, are revenue in nature, and will be deductible.

Where a patent is not renewed and the patent rights end, it is treated as a disposal for nil consideration and any costs not already depreciated can be deducted.

Where a patent is sold the Income Tax Act specifically states the amount is income. Upon sale any costs not previously deducted, or subject to depreciation, may be claimed.

Unfortunately the IS specifically applies to patents and patent rights applied for and granted under the New Zealand Patents Act 1953. The treatment of patents granted outside New Zealand are therefore, not covered by the IS.

GST AND RESIDENTIAL RENTALS

It is common for property developers to acquire property for their businesses on which there are residential dwellings. Generally, the developer will make a GST input claim on the entire property, including the dwelling. The dwelling is usually rented out until it is sold or otherwise disposed of. In this sort of scenario, the GST Act requires an output "change of use adjustment" to be recognised as the property is being used for a non-taxable supply, being that of residential rental.

The correct basis for this adjustment has been the source of some debate over recent years. The recent Court of Appeal decision in CIR v Lundy Family Trust (the Lundy case) addressed this issue. This case was an

appeal by the Commissioner from the High Court.

The crucial issue in the debate has always been "the extent that" the property acquired is applied for the non-taxable purpose of rental accommodation. The Commissioner's original assertion in the High Court was that the relevant cost was the property's GST inclusive acquisition price. The High Court determined that a period by period adjustment was required, and that the most suitable method of adjustment should be based on the depreciation of the dwelling.

The Court of Appeal agreed that the adjustment should be a period by period adjustment but as the supply consisted of both land and buildings, it was held the adjustment needed to be calculated on both. However, as the property had a dual use, apportionment of this amount is also required. The taxpayer had made a depreciation adjustment based on the building value and not the land, which the judge described as a "somewhat rough and ready" approach but a reasonable allocation method nonetheless.

With respect to GST claims on other costs such as rates and insurance, the Court of Appeal was also of the opinion that a reasonable apportionment was required between the taxable and exempt use.

The Court of Appeal agreed with the previous High Court decision that upon the eventual sale of the property, it was restored to a fully taxable purpose and a reversal of the earlier change of use adjustments was available. The only proviso to this is that to the extent that the goods and services have been "used up" at the time of disposal, then the market value of those goods and services would be lower than cost and, obviously, a lesser (and

in some cases nil) adjustment will be made.

The wording in the legislation relating to 'change of use' was amended after this case was first heard, so the case's application to current situations will need to have regard to that. At this point it is not known if the IRD will appeal the decision.

WHO PAYS THE RENT?

Where a sublessee fails to pay the rent, the question of who is then liable, may be disputed.

Many long term commercial leases with local authorities and charitable bodies are renewable each 21 years. Often they are valuable leases which the original lessee does not want to assign but does want to sublease at a higher rent and for a term exceeding the head lease. Subleases may also contemplate terms beyond the next expiry date of the head lease. The sublease may then be assigned to a downstream tenant who defaults after the initial term. The question is whether the original subtenant has an obligation to the first lessee for the default in rent payments by the later tenant.

Under common law, if a sublease is of the same term or longer than a head lease, it is deemed to be an assignment of the head lease. One method of avoiding this is for the sublease to be split into two lease periods, with a sufficient gap in the middle and an intention to enter the second lease period.

A recent Court of Appeal decision suggests the court is prepared to look through the terms of a lease agreement to identify the "commercial purpose" of the parties'.

The court basically required a sub lessee to be liable for the second lease period by referring to the

"commercial purpose" being to enter a lease covering the term of both the initial lease period and the later lease period.

The minority view was that regardless of the stated intention of the parties to enter into a new lease, that promise was under the first lease term and that expired at the end of that term and there was no contractual commitment beyond the expiration of the first lease term.

The issue may not yet be resolved as the Supreme Court may now consider the matter.

LITTLE SNIPPETS

No Nuts In Queenstown

In August 2000 the Overseas Investment Office granted consent to Lance Weller of Georgia (USA) to purchase a 43ha Queenstown property if he developed a 20ha chestnut orchard and a 5ha Douglas fir plantation. As Lance Weller did not take any action to meet the requirements he has been fined \$17,000 and ordered to pay \$5,000 costs in the Queenstown District Court. This is the first conviction under the Overseas Investment Act.

No Bras In Cardrona

Between Christmas and New Year's 1999, four bras appeared on a fence in the Cardrona Valley. More than 800 bras have since been put on the fence, some with names, addresses and phone numbers attached. The fence has become something of an icon, being featured by overseas media and regularly photographed by overseas tourists.

After a complaint by a local resident about the fence, a legal opinion sought by the Queenstown Lakes District Council has determined that the owner requires a resource consent for the fence.

The owner of the fence obviously disagrees and is seeking his own legal advice on the issue of the resource consent.

Bank Reconciliations

For those of you who run an accounting package such as MYOB please make sure you do a bank reconciliation as at 31 March 2006 and print the report and include it in the information you give us.

Often your bank statements will not be aligned to the end of the month (e.g. your bank statement end date is the 8th of April). If this is the case, please make sure you do a separate reconciliation up to the end of March before reconciling to your bank statement date.

Please contact us if you have any queries about this.

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