

New Zealand

BUDGET REPORT



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The Treasurer and Minister of Finance, the Hon Dr Michael Cullen, presented the 2008 Budget Statement to Parliament on 22 May 2008. This CCH Budget Report has been prepared with the assistance of specialist practitioners from Ernst & Young and Bell Gully. It covers announcements of interest to tax practitioners and the business community.

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Overview

The taxation changes announced in Budget 2008 are undoubtedly dominated by the scheduled changes to the rates of personal income tax. The changes are adjustments to the steps at which an increased rate of tax commences, and they will be implemented in three steps over the period from 1 October 2008 to 1 April 2011.

There is no doubt that the personal tax rate changes are inspired by the pending general election. The argument against tax cuts in Budget 2007, that “a small tax cut now would be spent and then gone”, appears to have been abandoned. Now the proposed changes are part of the Government’s “tax cuts programme”.

The political nature of the adjustments is perhaps underlined by the absence of change in other tax rates. There is no adjustment to the 33% trustee rate of tax.

Similarly, the rates of resident withholding tax are unchanged so that, for example, a corporate taxpayer subject to the 30% company tax rate faces the possibility of paying 33% withholding tax on interest and dividends.

The cost to government revenue of the reduced rates of personal tax has been calculated to be \$10.6 billion over four years. Although this is a large figure, it does not quite match the scheduled contributions to the New Zealand Superannuation Fund over the same period. By 2012, further contributions, totalling \$11.1 billion, are projected to be made to the Fund to produce total Fund assets of \$29 billion.

There is to be no abatement in the approach that the taxpayers of today must contribute to the superannuation costs of tomorrow, in addition to the superannuation costs of today.

Beyond changes on the personal tax front, there are few taxation changes foreshadowed in the Budget. Some indication is given of increases to tax return thresholds, and confirmation is given of enactment of the CFC active/passive income distinction.

Taxation changes in other areas have apparently been deferred as an unnecessary distraction. The political success or otherwise of this strategy remains to be seen.

Personal tax package

Ministerial Statement

“The government’s strong fiscal management means we can deliver timely tax relief for workers who are struggling to make ends meet”.

Editorial comment

Budget 2008 contains a personal tax cut programme expected to cost \$10.6 billion over the next three and a half years. Importantly, this tax cut will apply not only to employees, but to the thousands of New Zealand businesses that operate as unincorporated entities and did not benefit from the cut to the company tax rate in last year’s budget.

The key elements of the personal tax reforms are:

- a progressive increase in the income thresholds at which the marginal tax rates apply; and
- the removal of the low income rebate and the introduction of a lower statutory rate of tax for the first \$14,000 of income, rising to the first \$20,000 from 1 April 2011.

The new rate structure is as follows:

Current effective rates	New rates		
	From 1 October 2008	From 1 April 2010	From 1 April 2011
15% to \$9,500	12.5% to \$14,000	12.5% to \$17,500	12.5% to \$20,000
21% to \$38,000	21% to \$40,000	21% to \$40,000	21% to \$42,500
33% to \$60,000	33% to \$70,000	33% to \$75,000	33% to \$80,000
39% over \$60,000	39% over \$70,000	39% over \$75,000	39% over \$80,000

For the full income year to 31 March 2010, these new rates will leave a worker earning \$70,000 before tax \$1,460 a year, or \$28.08 a week, better off than the current tax scale. Although this will be welcome relief for taxpayers, those who have sat through the last eight budgets without a tax cut may dispute Dr Cullen's description of the change as "timely"; perhaps "overdue" is nearer the point.

Although this hypothetical worker's tax burden in the 2010 year will fall from \$18,570 to \$17,110 (a reduction of almost 8% in tax paid), a worker living in Australia would pay only \$15,000 of income tax in the same year — more than 12% less than his or her New Zealand colleague. Although the reforms will help close what had been a widening trans-Tasman gap, there is still room to move.

From 1 April 2011, the maximum tax saving, accruing to those earning \$80,000 or more a year, will be \$55.19 per week. Given the forecast fiscal position, and the Labour Government's past performance on tax cuts, the current package is probably around the level that most had expected.

The tax cuts will be complemented by further increases in the Working for Families regime, bringing forward the inflation indexation adjustment in the thresholds from the scheduled 1 April 2009 to the earlier date of 1 October 2008 and increasing the size of the credit.

Low income rebate

Under the current regime, the low income rebate (which dropped the effective tax rate on the first \$9,500 of income from the statutory rate of 19.5% to the effective rate of 15%) is not available in respect of passive income (such as interest and dividends). The new regime, with its lower statutory rate, will provide a windfall benefit for low income earners with passive income, such as retirees and school-aged children with substantial bank accounts. These people are probably not the "working poor" the reform was really aimed at.

The removal of the low income rebate regime does, however, lead to a simplification of the tax system as there will no longer be a difference between statutory and effective rates or the need to calculate an abatement of the rebate as income rises.

Impact of changing the personal rates

The change in personal rates once again creates a gap, for many investors, between direct investment in shares and investing through a collective vehicle under the PIE regime. At this point there will be no changes to the portfolio investor rates used by PIEs to calculate tax payable (which will stay at 19.5% and 30%), or to the resident withholding tax (RWT) rates, which will remain at 19.5%, 33% and 39%. The Government will undertake a more substantive review of these regimes in consultation with the finance sector.

Since the change in tax rates comes into effect part-way through an income year, employers will have to apply different PAYE rates to pay made before and after 1 October. The new rates will need to be applied to payments made after 1 October (even if the payment covers periods prior to 1 October), although the employer will need to apportion the income if the PAYE period covers more than one month.

For employers, there will be changes to the rates and thresholds for calculating employer superannuation contributions withholding tax (formerly SSCWT) and fringe benefit tax liabilities. Both of these changes will also come into effect from 1 October 2008, and new rates are included in the Bill (the Taxation (Personal Tax Cuts, Annual Rates, and Remedial Matters) Bill) introduced on Budget night.

Calculating provisional tax obligations

For individuals subject to the provisional tax regime, the current safe harbour “standard uplift” calculation method will remain the same, but the amount will be reduced by a flat \$730 to reflect the impact of the rate reduction.

Business tax threshold changes

Ministerial statement

“Budget 2008 provides a funding boost for initiatives to better protect investors, address barriers to economic growth and improve Government services to business.

The Government will spend \$9 million for the implementation of new laws to improve the supervision of financial advisers and institutions. Additional costs will be paid for by industry.

Together, the funding will allow financial service providers to be registered and set up dispute resolution schemes, and will enable the Securities Commission to undertake a role in the licensing of financial advisers.

Funding has also been allocated to a joint public/private sector initiative on how to remove impediments to the development of strong capital markets.

\$1 million is set aside for scoping the concept of a Trade Single Window which will enable parties involved in trade and transport to lodge standardised information and documents with a single entry point to fulfil all import, export, and transit-related regulatory requirements.

The largest changes with respect to simplification are in the business tax area.

Budget 2008 provides for substantial increases to a range of business tax thresholds.

These threshold changes include:

- increasing the PAYE once a month filing and payment threshold from \$100,000 to \$250,000
- increasing the Fringe Benefit Tax annual return filing threshold from \$100,000 to \$250,000

- increasing the provisional tax use-of-money interest safe harbour threshold from \$35,000 to \$50,000
- increasing the low value trading stock threshold from \$5000 to \$10,000
- increasing the GST registration threshold from \$40,000 to \$50,000
- increasing the GST six-monthly return filing threshold from \$250,000 to \$500,000
- allowing non-individuals, subject to certain thresholds, to return income tax for financial arrangements on a cash accounting basis, and
- increasing the threshold for allowing financial arrangements to be accounted for on a straight line basis from \$1.5 million to \$1.85 million (based on the total level of financial arrangements).”

Editorial comment

The budget papers indicate that the changes to the thresholds will be incorporated in a tax amendment Bill to be introduced in June.

Beyond that indication, no additional comment was made concerning anticipated enactment and the commencement date of the proposed changes.

It may be speculated that it is unlikely that the proposed changes could commence before 1 April 2009 at the earliest. The proposed changes probably require a reasonable “lead in” time before they actually commence.

At least one of these proposals is likely to be welcomed — the intention to permit non-individuals to adopt a cash accounting basis when returning financial arrangements income, subject to certain thresholds. Presumably the intention is to allow a trustee to become a cash basis person in relation to financial arrangements income, subject to some thresholds.

Some may regard this as a sensible measure. Others may wonder why it was not a principle incorporated in the accrual rules when they first commenced in 1986.

Other business tax initiatives

Ministerial statement

“In addition, work is underway on a second phase of initiatives that represent more significant departures from normal tax rules.

These include simplified rules for deducting legal and entertainment expenditure; introducing a single category of restricted private-use motor vehicles for small and medium-sized enterprises; simplifying record-keeping requirements for private use of motor vehicles by businesses; simplifying GST invoice disclosure requirements; allowing the correction of minor errors in subsequent returns; and other measures.”

Editorial comment

The Budget papers contain no further detail on the “second phase of initiatives”. Accordingly, it is not possible to sensibly speculate what might be meant by simplified rules for the deduction of legal and entertainment expenditure or the proposed single category of restricted private-use motor vehicles for small and medium-sized enterprises. However, the tenor of the Minister’s statement is one of endeavouring to reduce compliance burdens rather than to create exemptions or reliefs.

Controlled foreign company proposals

Ministerial statement

“Today, the Government is announcing its final proposals in this area following on from the release of a discussion document in December 2006 and an update in May 2007.

These announcements confirm the introduction of an active income exemption for tax on earnings by New Zealand-based companies operating off shore.

The package will remove tax-based impediments to offshore investments while minimising compliance costs and maintaining a level of protection for the domestic tax base.

The final decisions respond to the concerns raised about certain issues.

It has been decided, in effect, to retain a grey list of one, Australia. That is consistent with the offshore tax regime for individuals. It will largely answer concerns about complexity for SMEs.

A much more limited set of base company rules will be introduced, applying only to services performed in New Zealand.

Finally, offshore controlled foreign companies in the insurance business will be able to apply for a determination from the Commissioner of Inland Revenue qualifying them for the active income exemption.

This new international tax regime will be a major support encouraging New Zealand firms to internationalise while retaining control, ownership, design and head office functions within New Zealand.”

Editorial comment

The Minister’s comments confirm previous indications from officials that the grey list will effectively be abandoned for CFC active income. If the income meets the tests for classification as being from an active business, the income will not be taxed by New Zealand on an unrealised basis when still in the hands of the CFC.

As the Minister’s statement notes, special provision will be made for Australia. The notion of a “grey list of one” for Australia presumably means that no Australian CFC income will be subject to New Zealand income tax, irrespective of its passive or active nature. It remains to be seen how New Zealand’s other trading partners will view this unique arrangement in the context of, say, the negotiation of tax treaties.

The Budget papers contain no indications of the intended outcomes for associated regimes. No mention is made, for example, of the implications

for the foreign dividend withholding payment and conduit taxation regimes. Previous government indications on those topics had foreshadowed the termination of foreign dividend withholding payment and conduit taxation.

The Budget papers also provide no detail on the comment that the revised CFC regime will continue to maintain “a level of protection for the domestic tax base”. This might be interpreted as a reference to persevering with the “fat cap” proposal, ie, reducing the New Zealand income tax deduction for the interest cost on head office borrowings to finance the CFC. If that is the proposal, it may be that New Zealand companies continuing to invest in the grey list of one will be worse off. The absence of change to the taxation of Australian CFC income will be accompanied by the reduced deductibility of financing costs.

The Taxation (Personal Tax Cuts, Annual Rates, and Remedial Matters) Bill 2008

The Bill containing the reduction in tax rates, along with confirmation of the current tax rates, was introduced to Parliament at the conclusion of the Budget speech and is expected to be passed under urgency. In addition to the Budget matters, the Bill contains the amendments announced on 14 May confirming the ongoing charitable treatment of certain entities.

The proposed amendments provide that:

- tertiary education institutions and certain non-resident charities will not be subject to income tax
- gifts to state and state integrated schools, tertiary education institutions and certain non-resident charities will be exempt from gift duty
- those making cash donations to state and state integrated schools or tertiary education institutions can claim a charitable rebate on the donation

- the Inland Revenue Department, in limited circumstances, may continue to treat an entity as being tax-exempt as a charity if it has not completed the registration process by 1 July 2008.

The proposed amendments mean that tertiary education institutions, and state and state integrated schools, will not need to register with the Charities Commission to retain their current tax-exempt treatment.

The Bill also contains minor remedial amendments to address drafting issues arising out of previous changes, particularly concerning the PIE regime.

Economic outlook

The proposed tax cut programme comes against a backdrop of declining growth and a tough international environment. The Treasury acknowledge in the Budget that the declining level of fiscal surplus (through both tax cuts and increased spending) is likely to support economic activity somewhat.

Real GDP growth (which the Minister pointed out in his speech has been higher than that of many of our trading partners in recent years) is expected to remain strong. There is, to no one's surprise, a dip in the 2008/09 forecast to 1.5%, but it will soon be back up to over 3% again. Given the global economic environment, to come through this period maintaining growth is a good outcome.

Domestic economic activity is forecast to remain weak until 2012 as consumers batten down the hatches in the face of high mortgage servicing costs, falling house values and an expected falling exchange rate that will make imports more expensive. Ironically, the falling exchange rate is also the good news story of the forecasts. Despite very weak (or even negative) export growth in the short-term, the forecast is bullish from 2010 as the primary sector rebounds from the current drought and makes the most of a falling Kiwi dollar.

Inflation is also expected to improve. This is contrary to what is normally expected with a falling exchange rate (and consequently rising import prices), but the impact of the weaker domestic economy on the non-tradeables sector is expected to outweigh this effect. Inflation is expected to be back within the desired 1–3% band by 2010. This will give the Reserve Bank room to ease interest rates.

The labour market is expected to remain robust throughout the forecast period (up to 2012), with skill shortages remaining a problem for employers and a potential constraint on New Zealand achieving the economic growth it otherwise might have had. This is likely to lead to continued wage pressure, with real wages (ie, adjusted for inflation) forecast to grow at an average of 1.5%.

Net migration flows (inflows of permanent and long-term migrants less outflows), which peaked at over 40,000 people in 2003, are forecast to remain subdued. Net migration inflows were less than 6,000 people last year and are forecast to rise slowly to only 10,000 people by 2012. This will lead to residential investment (and continued house price weakness) and labour market pressures as New Zealand struggles to find skilled workers.

Even without the tax cuts package, tax revenues are expected to decline relative to the forecasts contained in the Treasury's half year update issued in June 2007. This is because of a number of factors, including the drought's impact on farm profits, falling excise duties and road user charges as high fuel prices take more cars off the road, and falling GST as domestic consumption and residential investment fall.

Despite all of this, the Crown's fiscal position remains strong. The total Crown operating balance (which includes operating surpluses of Crown entities and SOEs) remains above \$2.5 billion throughout the forecast period. Even total Crown OBEGAL (which basically measures the difference between operating revenues and operating expenses) is expected to remain firmly in the black.



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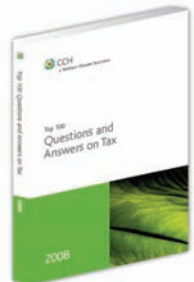


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