



CCH New Zealand Budget Report 2010

prepared with the assistance of specialist practitioners from



ERNST & YOUNG

About Ernst & Young's Tax services: Your business will only achieve its true potential if you build it on strong foundations and grow it in a sustainable way. At **Ernst & Young**, we believe that managing your tax obligations responsibly and proactively can make a critical difference. Combining our local knowledge with that of our 25,000 talented tax professionals in over 135 countries gives you technical knowledge, business experience, consistent methodologies and an unwavering commitment to quality service — wherever you are and whatever tax services you need. It's how **Ernst & Young** makes a difference.

BELL GULLY

Bell Gully is a leading New Zealand corporate law firm with extensive commercial, corporate, finance, banking, taxation, litigation and commercial property experience. Bell Gully has one of the largest legal taxation divisions in New Zealand, including a substantial tax litigation and indirect tax practice, and advises on all aspects of New Zealand taxation.

In this Budget Report

- [2010 Budget tax highlights](#)
 - [Budget overview](#)
 - [Tax rates for individuals](#)
 - [GST rate](#)
 - [Company tax rate cut](#)
 - [Tax rates for savings vehicles](#)
 - [Working for Families adjustments](#)
 - [Property tax changes](#)
 - [Loss attributing qualifying companies \(LAQCs\)](#)
 - [Thin capitalisation](#)
 - [Other issues](#)
-

2010 Budget tax highlights

" ... the TWG [Tax Working Group] believes that for New Zealand to have a world-class tax system and to ensure that the system is sustainable in the medium-term, significant changes are required to the current tax mix and base. Small changes at the margin are unlikely to achieve this."

[*A Tax System for New Zealand's Future: Report of the Victoria University of Wellington Tax Working Group*, January 2010, p 19]

The Minister of Finance, the Hon Bill English, read the 2010 Budget Statement to Parliament on 20 May 2010. This year, taxation reform has a major role — a matter the Minister signalled in pre-Budget speeches on several occasions. Opinions will vary on whether the Government has responded sufficiently to the Tax Working Group's conclusion that the tax system is in need of serious structural reform. Mr English has consistently stated that, in view of the current economic situation, tax neutrality is a fundamental Budget requirement.

What is certain is that:

- for New Zealand families, the reforms announced today are the most significant to occur for several years, and
- equity and fairness issues have also been considered.

The Budget tax changes are described briefly below.

GST rate hike

The rate of the goods and services tax (GST) will be increased from 12.5% to 15%, beginning on 1 October 2010. The Government considers that this increase is more than offset by the reductions to the rates of personal income tax set out below. However, the Minister also referred to additional measures to compensate vulnerable individuals for the effects of the GST increase. In particular, he referred to people receiving New Zealand superannuation, veterans' pensions, student allowances, main working age benefits, certain Working for Families tax credits and some Government Superannuation and National Provident Fund payments.

Personal income tax rates reduced

The following cuts have been made to personal income tax rates, also beginning on 1 October 2010.

Income Band	Current Rates	New Rates
\$0 - \$14,000	12.5%	10.5%
\$14,001 - \$48,000	21%	17.5%
\$48,001 - \$70,000	33%	30%
\$70,001 and more	38%	33%

Company tax rate

The rate of company tax will decrease from 30% to 28% from the 2011/12 income year. Savings vehicles such as portfolio investment entities (PIEs), superannuation funds, unit trusts, group investment funds and life insurance policyholder income will be subject to the same rate. The Government objective is to provide further incentives for New Zealanders to save.

Trustee tax rate

The current 33% tax rate for trustees is unchanged.

Qualifying companies

For income years commencing on or after 1 April 2011, qualifying companies and loss attributing qualifying companies will be treated for income tax purposes as "flow through" entities, in a manner similar to limited partnerships. The objective is to address the mismatch between an individual's top personal tax rate (currently 38%) and the lower company tax rate. Loss offsets obtained by taxpayers active in the residential

rental property sector are one target of this reform.

Depreciation

Changes to depreciation tax treatment include the removal of the 20% depreciation loading for new assets purchased after the 2010 Budget.

There will also be a zero depreciation rate for buildings with expected lives of 50 years or more. Repairs and maintenance expenditure by building owners will remain deductible for income tax purposes, while depreciation deductions will remain for "fit out" items not considered to be a part of the taxpayer's building.

A review of the tax treatment of commercial building "fit outs" is to come.

Tightening of Working for Families tax credit scheme

The Government has recognised that some families are unfairly obtaining the Working for Families (WFF) tax credit by structuring their financial position. From 1 April 2011, investment losses will need to be added back to a person's taxable income for the purpose of determining eligibility for WFF.

The Minister described this restriction as an initial step. Other reforms in the areas of trust distributions and income cash PIEs will be the subject of further study in a discussion paper. Reforms in those two areas are scheduled to commence from 1 April 2011.

International taxation

The Minister noted a reduction to the thin capitalisation "safe harbour" threshold for inward investment (down to 60% from 75%).

Increased IRD audit activity

To better ensure the integrity of the tax system, Inland Revenue will receive a funding boost of \$119.3 million over four years, starting in 2010/11. This funding will "increase [the Department's] audit and compliance activity around debt collection, the hidden economy and property transactions".

GST and land transactions

Legislative changes will prevent "phoenix arrangements" involving GST refunds based on transactions where one party is wound up without paying GST. From 1 April 2011, transactions between registered persons involving the transfer of land will be zero rated for GST purposes.

[Back to Top](#)



Budget overview

A major theme of Budget 2010 is a significant adjustment to the Government's sources of taxation revenues. Excessive reliance on income tax and its taxation of labour is being eschewed in favour of increased taxation of consumption in the form of raised GST. Accordingly, personal income tax rates and the company tax rate are to be reduced, along with the tax rates on savings.

The income tax rate adjustments proceed from the assumption that taxation has a powerful influence on citizens' savings and investment decisions. If income tax on earnings from labour and investment can be reduced, the expectation is that increased economic growth will follow in due course.

At the same time Budget 2010 takes the opportunity to reduce the attractiveness of some kinds of economic activity, particularly investment in property. For property, that is to be achieved by restricting access to depreciation deductions.

A third prong of Budget 2010 is to endeavour to make the tax base as robust as possible. One approach adopted is to seek to control the cost of some forms of State assistance. There is to be a tightening of the eligibility criteria for some forms of social assistance, such as the Working for Families tax credit. A second

approach is to seek to raise the tax contribution of the non-portfolio foreign investor through reduction of the safe harbour thin capitalisation threshold.

Implementation of these themes commenced on Budget day with the introduction into Parliament of the Taxation (Budget Measures) Bill. For its part Inland Revenue released an issues paper, "Qualifying Companies: Implementation of Flow-through Tax Treatment", to start the consultative process for one aspect of the Budget announcements.

[Back to Top](#)



Tax rates for individuals

Ministerial statement

"From 1 October 2010, all personal income tax rates will decrease. The new tax rates will be:

- 10.5% on income to \$14,000 (down from 12.5%)
- 17.5% on income between \$14,001 and \$48,000 (down from 21%)
- 30% on income between \$48,001 and \$70,000 (down from 33%), and
- 33% on income over \$70,000 (down from 38%)."

Editorial comment

The Budget Statement announces that a cornerstone of the tax reforms incorporated in Budget 2010 is a \$4.5 billion per annum reduction in income tax rates. This reduction in the Government's tax take is to be funded through an increase in goods and services tax (GST) and other measures designed to boost taxable incomes.

The justification for this rebalancing of taxation revenues is ascribed to the December 2009 report of the Tax Working Group. The Tax Working Group had concluded that the New Zealand tax base had become vulnerable as personal and corporate rates had gradually risen compared with the tax rates of other countries. Reductions in tax rates needed to be contemplated.

Evidently the Government has accepted this perspective. The Budget Statement observes that personal taxes affect incentives to work and to up-skill. Personal taxes also affect choices about whether to stay in New Zealand or to work abroad; they similarly affect non-residents contemplating migration to New Zealand. The Budget Statement observed that some 17% of skilled New Zealanders currently live abroad. This is the third highest percentage among OECD members.

Against this background, the Government regards reducing personal income tax rates as an important contributor to economic growth. Reduced tax rates can be expected to channel resources to saving and productive investment and away from current applications that favour consumption. A tax rate structure which is internationally more competitive should also help to bolster the tax base.

No doubt different views are possible on the Government's contention that a reduced income tax take should foster economic growth. Some commentators may argue that an outcome of that kind is more apparent than real, pointing to the commendable growth rates achieved by some countries with nominally high tax rates.

At least in the present context, any debate along these lines may not adequately capture the rationale of the reduction of personal income tax rates. Since the overall tax package is said to be revenue neutral from the Government's point of view, the changes are more about adjusting the sources of taxation revenue for the Government. Evidently the Government has a preference for increased GST receipts because of the comparatively lower collection costs, reduced boundary issues and minimal scope for avoidance. The Government is not alone in this view, since GST and VAT-type taxes now account for some 25% of all taxes collected worldwide.

One unspoken feature of the tax reform package concerns its durability. Under the package as it stands today, it may appear reasonable to, say, accept an increase in the rate of GST when that measure is

balanced by a reduction in income tax.

However, that consensus would be undermined if, subsequently, income tax was increased. Unfortunately there is an historical precedent for developments of that kind. The original adoption of a top tax rate of 33% was part of a package that included base-broadening measures such as the abolition of the deductibility of employee expenses. That equilibrium was disturbed when the 33% rate was increased to 39%.

A final aspect which perhaps should not be lost sight of is that New Zealand appears to be in the fortunate position of being able to implement the philosophy of reducing income tax to stimulate growth. A number of nations are faced with the unenviable prospect of having to adopt the opposite approach. These are countries whose balance sheet has become stretched through the global financial crisis of 2008/09, leading to stimulatory expenditures at a time when tax revenues were receding. New Zealand appears to have been fortunate, so far at least, to have escaped a squeeze of that kind.

[Back to Top](#)



GST rate

Ministerial statement

"From 1 October 2010 we will lower personal income tax rates, and increase the rate of GST to 15 per cent.

The increase in GST has been estimated by Statistics New Zealand to raise the level of prices by about 2 per cent."

Editorial comment

The increase in the GST rate from 12.5% to 15% is the balancing mechanism for the reductions to income tax rates. To illustrate the operation of the whole package, the Budget Statement gives the following examples:

A married couple both work. They jointly earn around the average household wage of \$76,000 — one earning \$50,000 a year and the other earning \$26,000. They have two children under the age of 13 and also receive Working for Families. The family pays \$300 a week in mortgage repayments which do not incur GST. Under Budget 2010 changes, they get a household tax cut of \$45.85 a week and pay an extra \$21.14 in GST to buy the same goods and services as before. Overall they are \$24.71 a week, or \$1,284.92 a year, better off.

A retired couple receive New Zealand Superannuation. They own their own home. Under Budget 2010 changes, they get a tax cut of \$11.52 a week, plus an additional \$10.12 increase in their NZ Super and pay \$10.87 extra in GST to buy the same goods and services as before. Overall they are \$10.77 a week, or \$560.04 a year, better off.

A single person earns \$50,000 a year — about the average full-time wage. He pays \$120 a week rent towards the flat he lives in and is saving \$50 a week towards a deposit on his first home. Under Budget 2010 changes, he gets a tax cut of \$29.42 and pays \$13.51 more in GST to buy the same goods and services as before. Overall he is \$15.91 a week, or \$827.32 a year, better off.

There will be administrative issues to address in the course of implementing the increased GST rate. For example, suppliers who have a continuous supply agreement/contract and who issue a single tax invoice at the 12.5% rate may be asked for another tax invoice for deemed supplies after 30 September 2010. Similarly, care may need to be exercised in relation to the issue of credit notes and debit notes around the 1 October 2010 changeover date.

The Budget papers make one further mention of GST changes. From 1 April 2011 there will be "measures to address risks such as phoenix scheme fraud (where input tax credits are paid to a buyer of an asset but no GST output tax is collected due to insolvency or liquidation of the seller)".

[Back to Top](#)

Company tax rate cut

Ministerial statement

"When New Zealand's company tax rate was set at 33 per cent more than 20 years ago that rate was competitive by world standards.

Since then company tax rates show strong downward momentum around the globe.

The tax rate applying to New Zealand companies will reduce from 30 per cent to 28 per cent. This will apply from the start of the 2011/12 income year."

Editorial comment

Although cuts in personal taxes were well signalled before the Budget, the cut in the company rate will have taken many by surprise.

For most companies the new rate will take effect from 1 April 2011, but it could be earlier for companies with non-standard balance dates. This change trumps the Australian company tax cuts, which will progressively reduce the Australian company tax rate, but with the 28% rate not available for many Australian companies until the 2014/15 fiscal year.

Viewed in isolation, the New Zealand company tax rate cuts are forecast to cost the Crown \$1,115 million over the next four years. However, the Government points out that, on average, firms will pay more in tax going forward because of changes to depreciation and the thin-capitalisation rules. Given that the total tax burden on companies will not be reduced, the overall impact on investment is likely to be small, and even the Government points out that most of the expected boost to the real economy is likely to come from the effect on the labour market.

Cuts in the company rate have flow-on effects for the imputation regime, with the maximum imputation rate falling from 30/70 to 28/72. As with the last reduction in the company rate, the Government is providing a two-year window during which dividends can continue to be imputed at the current 30/70 rate.

[Back to Top](#)

Tax rates for savings vehicles

Ministerial statement

"28 per cent will also become the standard tax rate applying to most savings vehicles. It will apply to vehicles taxed as companies, including Group Investment Funds, unit trusts, life insurance and superannuation funds. It will also be the maximum tax rate applicable to Portfolio Investment Entities, known as PIEs.

Lower income taxpayers will still have access to lower rates via imputation credits from companies and electing lower PIE rates."

Editorial comment

The reduction in the tax rate for these kinds of entity is evidently intended to encourage savings. No doubt that is a reasonable expectation. It would be attractive for a taxpayer on the 33% marginal tax rate to endeavour to channel investment earnings to a savings vehicle taxed at a maximum of 28%.

The Budget Statement does not precisely specify the group investment funds, unit trusts and superannuation

funds which will be subject to the maximum 28% tax rate. At present, there is alignment between the top tax rate of a PIE, on the one hand, and approved unit trusts, widely held Group Investment Funds (GIFs) and widely held superannuation funds, on the other hand. All such entities face a maximum 30% tax rate. Presumably the intention is that this 30% rate will reduce to 28%.

The Budget Statement does not explore how PIEs and other entities are to implement the reduced maximum rate of tax. PIEs have had to devote resources to obtaining revised portfolio investor rates effective from 1 April 2010. A similar exercise may need to be undertaken for the latest tax rate reduction.

The Budget Statement makes no reference to the rates for employer's superannuation contribution tax. Presumably there is intended to be a continuation of the existing rates of 12.5%, 21% and 33% (possibly with an adjustment to the income bands for which the rates apply).

[Back to Top](#)



Working for Families adjustment

Ministerial statement

"The Tax Working Group also reported that anomalies arise through the use of taxable income as a means of determining eligibility for certain Government assistance. Taxable income may not always be a good measure of true economic circumstances.

As an initial step, from 1 April 2011 investment losses will be added back to taxable income for the purpose of determining a family's eligibility for Working for Families assistance.

Further changes of eligibility for Government assistance, including student allowances, covering areas such as distributions from trusts and income from cash PIEs, will follow after the Budget. Officials will release a paper setting out the issues and proposed solutions later this year for implementation from 1 April 2011."

Editorial comment

The change to the rules on eligibility for Working for Families assistance is likely to be uncontroversial. Eliminating the impact of investment losses may rightly be regarded as conferring a more accurate entitlement to the assistance.

As part of the revisions to Working for Families, the Budget papers also announce that indexation of the Working for Families tax credit abatement threshold will be removed. No further details were supplied.

The second aspect of the Budget Statement announcement is perhaps not so clear-cut. There is plenty of room to speculate on the meaning of reviewing the use of trusts and cash PIEs in the context of eligibility for "certain" social assistance programmes. Vague language of that kind readily leads to speculation about the social assistance programmes that will be affected by the proposals.

Speculation is also likely about the meaning of trust distributions and their impact on entitlements. A benign view of the Budget announcement is that a distribution of trust capital, along with a distribution of trust income, may be taken into account in determining entitlement to the relevant social assistance programme.

The Budget papers go on to indicate that additional forms of financial benefit may be taken into account for the purpose of measuring entitlements. Along with trust distributions and income from cash PIEs, eligibility may also be based on "income from non-resident spouses and certain fringe benefits".

[Back to Top](#)



Property tax changes

Ministerial statement

"... the Government is not convinced that all buildings actually depreciate.

Allowing tax deductions for depreciation provides an unfair tax advantage for these assets.

Accordingly, the depreciation rate for most buildings with an expected life of 50 years or more will be set to zero from the start of the 2011/12 income year."

Editorial comment

Where a building does not depreciate, clearly no depreciation allowance should be available. However, it is likely that many buildings with an expected life of more than 50 years (the default life for most buildings other than those made of "temporary" materials such as portable buildings and hothouses) do in fact depreciate. The Government has left open the opportunity for building owners to apply for a depreciation rate of other than 0% for such classes of buildings. We can be confident, however, that one class of building that will not get a higher rate is residential dwellings — the unstated but obvious target of the reforms.

The changes come into effect from the start of the 2011/12 income year and, unlike most previous changes to the depreciation regime, apply to existing assets, not just those acquired after the new rules came into effect.

Building owners will still be able to claim deductions for repairs and maintenance, to maintain the condition and value of their properties. They will also still be able to claim depreciation deductions for "fit outs" not considered part of the building. According to the Inland Revenue Policy Advice Division, the Government "intends to review the treatment of commercial 'fit out' and, if necessary, amend the rules prior to 1 April 2011 to address any uncertainty in this area." Given recent interpretation statements issued by the Commissioner of Inland Revenue in respect of fit out of residential properties, it is likely that any legislative resolving of "uncertainty" will be a mechanism to reduce the types of assets that can be separately depreciated and to increase those that need to be treated as part of the building (and, under the new rules, not depreciable).

The other big change on the depreciation front is for assets other than buildings. The 20% depreciation loading will no longer be available for any asset purchased after 20 May 2010. The loading was introduced in 1992 (originally at a rate of 25%) to encourage investment in new assets. The current Government has decided that such a subsidy is no longer warranted and that the \$3,120 million of revenue expected to be saved from the combined depreciation changes can be better spent elsewhere.

[Back to Top](#)



Loss attributing qualifying companies (LAQCs)

Ministerial statement

"Many investors hold property through Loss Attributing Qualifying Companies, or LAQCs. After a short period of consultation, legislation will be proposed so that from 1 April 2011 all LAQCs will be taxed as limited partnerships.

The main impact of this change will be to ensure both profits and losses are assessed at the marginal tax rate of the investor."

Editorial comment

In the lead-up to the Budget, there was some speculation that the days of LAQCs were numbered and that property losses would be ring-fenced in the vehicle making the investment. Although the proposed loss ring-fencing rules are not comprehensive, the new regime will limit the amount of the loss that can be passed through from an LAQC to the shareholder, to the amount the shareholder has invested in the LAQC (in much the same way as losses of limited partners are restricted). The shareholder's investment (or "membership base") would include the initial equity invested, along with undistributed earnings of the LAQC and the share

of any debt guaranteed by the shareholder.

The new rules will also mean that where investors want to be able to access the losses at their own personal tax rate by passing through the losses in the bad years, they must also pay tax on the income in the good years at their personal rates. With the removal of depreciation on residential properties (still the major use of LAQCs), there are likely to be more income-generating years relative to loss years going forward. Investors may need to reconsider whether an LAQC is still the appropriate vehicle to hold such an investment.

[Back to Top](#)

Thin capitalisation

Ministerial statement

"The Government has also reviewed taxation of inward investment into New Zealand. International tax law generally provides that income should be taxed in the jurisdiction where it is earned.

However, it is relatively easy to transfer income between jurisdictions by use of debt, often between related parties.

New Zealand, like most countries, operates 'thin capitalisation' rules to limit this practice. The current 'safe harbour' limit for gearing on foreign owned investments, will be reduced from 75 per cent to 60 per cent from the 2011/12 income year."

Editorial comment

A cut in the thin-capitalisation safe harbour limit was suggested by the Tax Working Group, but there was no analysis to support the change outlined in their report and no compelling reason is set out in the Minister's speech. It appears from the material released that, although the safe harbour is coming down to 60%, interest deductions will only be restricted (as now) where the debt to asset ratio of the New Zealand subsidiary exceeds 110% of the debt-to-asset ratio of the worldwide group. Some companies that exceed the 60% limit may, therefore, still be able to deduct all of their interest. Clearly the expectation is that at least some interest deductions will be restricted as the change is forecast to bring in another \$200 million each year from 2011/12.

From the current income year, the thin-capitalisation rules also apply to many New Zealand companies that have offshore investments in controlled foreign companies. The proposed changes to the thresholds will not apply to these companies, which will retain the existing 75% safe harbour threshold.

[Back to Top](#)

Other issues

Provisional tax

Changes in both the personal and company tax rates mean that provisional tax "uplift" calculations will need to be amended, just as happened following the last round of tax cuts. For the 2011/12 income year, instead of using 105% of the previous year's residual income tax ("RIT"), the amount of provisional tax payable is calculated using 95% of their RIT for an individual and 100% of the RIT for a company.

Redundancy tax credit

The current 6% tax credit for individuals on redundancy payments (designed to mitigate the impact of one-off payments potentially pushing them into a higher tax bracket), up to a maximum credit of \$3,600, will be removed from 1 October 2010.

Capital contributions to fund acquisition or construction of capital assets

The income tax treatment of capital contributions to fund the acquisition or construction of capital assets, such as those which have been common in the electricity lines sector, will change for contributions made after 20 May 2010. The taxpayer will need to elect to either reduce the tax depreciable cost base of the assets by the amount of the capital contribution or to treat the contribution as taxable income over a 10 year period.

[Back to Top](#)

