

## TAX

## “KEY” REFORMS - WHAT’S LEFT

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John Key’s opening speech to Parliament on Tuesday outlined the Government’s proposed economic reforms for 2010.

The most anticipated part of this speech was around the proposed tax reform to be revealed in this year’s Budget. The reform follows recommendations made by the Victoria University-based Tax Working Group in January. While precise details have not been offered, the Prime Minister ruled out some options put forward by the Tax Working Group and indicated what options are still on the table.

The Tax Working Group report concluded that New Zealand’s current tax system is “incoherent, unfair, lacks integrity, unduly discourages work participation and biases investment decisions” and that the current system is unsustainable in light of New Zealand’s aging population. To overcome these deficiencies the Tax Working Group recommended a number of significant changes to the New Zealand tax system, including the introduction of new property based taxes and the general alignment of income tax rates.

In this update we outline which of the Tax Working Group’s proposals have been ruled out by the Prime Minister and those that remain on the table.

### What changes is Government still considering?

- Increasing the GST rate from 12.5% to “no more” than 15% (with the proviso that this would need to be accompanied by some form of compensation package for lower income earners on account of the regressive nature of GST).
- Potential reductions to all personal marginal tax rates. John Key has rejected the notion that tax cuts would be focused only on the top tax rate and has emphasised that tax cuts will be made “across the board”. The Tax Working Group considers that relatively high personal income tax brackets are harmful to growth in creating a disincentive to work harder (particularly when combined with the abatement of Working for Families tax credits). It is expected that these changes would be made effective as of 1 October this year.
- Changes to the way property is taxed, with a focus on rental property investments. The only remaining options not ruled out by the Prime Minister are discussed below.
- Changing the way that Working for Families measures income to prevent

high net worth individuals using trust and company structures to qualify for Government assistance.

### What's off the table?

- A universal capital gains tax (CGT) on gains made from the sale of all types of assets (including property). This proposal was rejected because it was feared that a broad-based CGT would lead to administrative complexity and would encourage taxpayers to retain property.
- A land tax which would have been imposed periodically on the unrealised value of land. This was perhaps the most controversial proposal from the Tax Working Group. The Prime Minister rejected it on the basis that it would put a cash flow strain on taxpayers such as retirees who may be asset rich but cash poor.
- A risk free rate of return income calculation method for property which would have taxed the "economic income" from property annually on an unrealised basis. John Key rejected this unrealised income calculation method because some landlords would not have sufficient cash flow to satisfy the tax which could lead to an increase in rents.

### What options remain for property?

The property sector received a lot of attention in the Tax Working Group report, in particular, the \$200 billion residential property sector which in 2008 generated approximately \$150 million in tax revenue losses. At a broad level this arises by a combination of tax free capital gains on sale and the deduction for funding costs and depreciation on rental properties.

The Government has ruled out the "hard" options for taxing property while at the

same time promising that there will still be tax changes that impact on the property sector. This would appear to leave only two options.

#### *Removing depreciation on buildings*

The Tax Working Group's report criticised the ability to obtain tax benefits through depreciation claims on assets that may actually be increasing in value – particularly rental properties. Many investors have relied on depreciation expenditure to reduce their tax liability and, in many cases, utilised resulting income tax refunds to fund mortgage repayments. Because depreciation claimed by investors is generally clawed-back on the disposal of the property, the tax advantage is only one of timing. However, tax payable from the claw-back of depreciation could be satisfied from sale proceeds at that time. This timing advantage would be eliminated if depreciation was denied on rental property investments. Investor behaviour in response to these changes is difficult to predict and is the subject of continuing debate. Investors could sell-up their properties and move into other investments or increase rental to cover the effective increase in the cost of borrowing (although the ability to pass on the cost may be constrained by tenants' ability to pay).

The Tax Working Group report suggests that depreciation would only be denied in respect of those buildings that do not decrease in value over time. It is not clear how the law would distinguish between buildings which genuinely decrease in value over time (for example, commercial buildings employed in an active business) and those which do not. Extending the denial of depreciation to all buildings could increase the cost of doing business in New Zealand.



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### *Ring fencing rental property losses*

Another proposal considered by the Tax Working Group was to “ring fence” losses arising from rental property investments. Such tax losses could not be offset against other sources of income, such as salary and wages. Losses would be carried forward until the investor’s property generated a taxable profit.

This change would remove the ability of landlords who are also wage and salary earners (PAYE taxpayers) from setting off rental losses against their salary or wages, and obtaining tax refunds.

### *A bright line test for property*

Yesterday Bill English said that the Government is also considering making gains on the sale of property automatically subject to tax if the property is sold within a certain time frame – for example, within two years. Currently the law provides for a number of scenarios where the gains on the sale of property are subject to tax – for example, where property is bought with the intention of resale. The application of these tests is not always clear and a bright line test would remove any doubt about the application of these rules for sales within the bright line period. However, no comment was made about what might happen to property sales after the bright line period. It is assumed that the existing rules will continue to apply to such sales.

### **What didn’t Key comment on?**

There are a number of significant tax reform options suggested by the Tax Working Group that were not commented on by the Prime Minister:

- Although there is a mention of personal tax rate reduction, there is no reference to tax rate alignment – i.e. a reduction in tax rates for all types of taxpayers

(individual and corporate) to 30%.

The Tax Working Group viewed the current disparity of rates between different investment vehicles (e.g. trusts, companies, sole proprietorships and portfolio investment entities) as creating a distortion in the economy which leads to investment decisions being heavily influenced by the desire to achieve the optimum tax result rather than the best commercial outcome.

- There is no reference to a reduction in corporate tax rates, a particularly important issue given the recent focus on the Government’s self-appointed goal of closing the economic gap between Australia and New Zealand.
- Other tax changes such as removing the 20% depreciation loading on certain new assets and reducing the thin capitalisation threshold percentage.

### **When do we get the details?**

A detailed tax package should be announced in the 2010 Budget on 20 May.

Given that 2011 is an election year, we would not be surprised to see additional tax announcements in the 2011 Budget.

The current expectation is that GST will rise to 15% and that one of the methods of taxing property outlined above will be implemented. Since making his speech John Key has made various comments to media which suggest that not only is he intending to drop the 33% and 38% personal tax rates but that the lower rates of 21% and 12.5% will also be reduced.

### **In summary**

The glimmers of recovery in the economy may be prompting National to return to its long term plans for reductions to personal tax rates, although the changes in the

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upcoming budget will be made by “shifting” tax rather than cutting expenditure and this will result in both winners and losers. The challenge for the Government will be to minimise any political fallout that arises from the increases of taxes in some sectors (at this stage, mainly property) and to maximise the political capital to be gained from personal tax cuts.

Perhaps the most significant revelation from the Prime Minister’s statement to Parliament is the rejection of a fundamental shift in the tax base from income to property. Options such as a land tax or a capital gains tax are steeped in controversy and the Government appears to be opting for the conservative path by limiting itself to minor tax changes for the property sector.

The pressing question for many taxpayers will now be to what extent personal tax rates will move and how this will affect them. Property investors are not yet off the hook and will be waiting to see the details of any changes to the ability to claim depreciation deductions or offset losses.

We will provide you with updates on developments as they occur.

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