



BUDGET 2010

On 20 May 2010, Bill English delivered his second budget. This budget came on the heels of the Tax Working Group's recommendations on the overhaul of the New Zealand tax system and at a time when New Zealand was showing signs of coming out of the global financial crisis. This background presented Bill English with the opportunity to make some sweeping changes to the tax system. For the first time in many years the budget was closely watched by many commentators and business people to assess its impact on them.

The Polson Higgs team presented a budget breakfast on 21 May stepping through the tax changes announced and discussing their likely impact. For those who were unable to attend the breakfast copies of the slides are available at www.ph.co.nz. In this Tax Brief we look to explore the key tax changes outlined in the budget.

MORE TAX CUTS!!!

Budget 2010 included further tax cuts across the board. These are effective from 1 October 2010.

As the tax cuts come into effect in the middle of the 2010/11 income year, the full impact of the new rates will not be felt until the start of the 2012 year. The 2010/11 year is a composite year.

The table below shows the annual rates for the respective income years.

Income Tax Rates

Personal Income	Current	2010/11	2011/12
\$0-14,000	12.50%	11.50%	10.50%
\$14,001-48,000	21.00%	19.25%	17.50%
\$48,001-70,000	33.00%	31.50%	30.00%
70,001 +	38.00%	35.50%	33.00%

The following depicts the tax savings at various income levels.

Personal Income \$	Current Tax \$	Proposed Tax \$	Saving \$
14,000	1,750	1,470	280
48,000	8,890	7,420	1,470
70,000	16,150	14,020	2,130
100,000	27,550	23,920	3,630
150,000	46,550	40,420	6,130

The change in the personal tax rates will result in consequential changes to other taxes. These include RWT on interest, PAYE rates, PIE tax rates, Provisional tax, FBT, Superannuation contribution tax rates, Fund withdrawal tax rates and Secondary tax rates which have been changed to align with the new personal tax rates.

As the top tax rate has been reduced to 33 percent, from 1 October 2010 the redundancy tax credit has also been removed. This credit was originally put in place to ensure the receipt of redundancy payments did not cause a person to move up a tax threshold and be taxed at a significantly higher rate.

Work out how the tax changes affect you at: www.taxguide.govt.nz

Company Tax and Savings Vehicles

In a move designed to encourage savings and investment, the tax rates of companies and many savings vehicles were also dropped.

The company tax rate will fall from 30 percent to 28 percent from the 2011/12 income year.

From 1 October 2010, the top tax rate for most portfolio investment entities (PIEs) will fall from 30 percent to 28 percent, while other PIE rates will drop to align with the new personal tax rates.

GST RATE INCREASE

From 1 October 2010, the GST rate will increase from 12.5% to 15%. This will mean wide-ranging changes across all sectors and creates more than a few issues to think about. The aim was to broaden the tax base and shift the emphasis from taxing income to taxing consumption and to encourage savings.

The new rate means that there is a new way of working out the GST component on everyday items.

To calculate the GST component of an inclusive amount:

	12.5%	15%
GST component	$1/9$ (or $12.5/112.5$) x inclusive amount	$3/23$ (or $15/115$) x inclusive amount

To calculate a GST exclusive amount:

	12.5%	15%
GST exclusive price	$8/9$ x inclusive amount	$20/23$ x inclusive amount

A rise in GST rate by 2.5 points equates to an increase in GST inclusive prices of 2.22%.

A SIMPLE EXAMPLE

A vacuum cleaner that cost \$1,125 (including GST) before the price increase will now cost:

The exclusive price:

$$8/9 \times \text{inclusive amount} = 8/9 \times \$1,125 = \$1,000$$

The new GST inclusive price:

$$\$1,000 + 15\% = \$1,150$$

This is a \$25, or 2.22% increase in price.

Some suppliers may choose to maintain prices and absorb the GST rise, while others may increase prices in excess of the increased GST rate as suppliers take advantage of the opportunity to raise prices.

Issues for businesses to think about:

Compliance:

- » If your return period spans 1 October, a two-part return will be required, one at the 12.5% rate and one at the 15% rate.
- » Special adjustment rules apply to businesses who account for GST on a payments basis.

Pricing and demand:

- » Can/should you increase prices? What will this mean for your margins?
- » How will you manage inventory during any sales peak preceding the change and any drop-off that might occur after the change? Have you planned promotions etc?

Accounting Systems and Staff Training:

- » A review of your accounting systems will need to be carried out and staff will need to be trained.

Contracts:

- » Existing contracts should be reviewed to evaluate the GST consequences of the wording used.
- » New contracts should ensure that you are not disadvantaged when the new rate kicks in.

The Government has announced that a GST advisory panel is to be set up to aid the transition and monitor and report back on the change, and how businesses are dealing with the transition.

The GST rate increase results in a significant number of issues. This may be an opportunity to get your GST systems reviewed. If you would like to do this, please contact your Polson Higgs advisor.

CHANGES TO THE DEPRECIATION REGIME

The budget has brought about two well publicised changes to the depreciation regime. Combined, these represent the largest and most far-reaching shift in the treatment of depreciable assets since the overhaul of the regime in the 1993-1994 income year.

Removal of Building Depreciation

From the 2011/2012 year a zero rate of depreciation is set for all buildings with an expected life of 50 or more years. While this change was well signalled for the residential sector, the inclusion of commercial buildings was not. The justification for the change in the current rules is a perceived uneven "playing field" whereby a \$200 billion sector currently yields tax losses of approximately \$500 million per annum, allowing (at a tax rate of 33%) investors to gain a \$150 million tax benefit.

The loss of the depreciation deduction affects all building types with estimated lives of 50 years or more. Generally any loss incurred on the sale of a building is a non-deductible capital loss. This has not changed even with the removal of depreciation.

For buildings which have been depreciated under the "old" rules, the depreciation can still be recovered (income) where the building is sold for an amount greater than its written down value.

There are particular building types that the IRD has held in the past as having an estimated useful life of less than 50 years. These include dairy sheds, concrete bunkers and other agricultural buildings. A question mark remains around special purpose buildings, and those with little or no market (thus little chance of resale) which may no longer as of right be depreciated. However building owners are able to apply to the Department for a provisional depreciation rate for buildings expected to have a useful life of less than 50 years.

Treasury has forecast rents to increase by 1.4% above the expected increases over the next 3 to 5 income years, and also property prices to fall. This may incentivise individuals to move away from renting and enter the housing market.

The loss of this deduction begins in the 2011/2012 income year. For taxpayers with March balance dates this will be from 1 April 2011. For June balance dates the change will be effective from 1 July 2011.

Removal of 20% Loading

From Budget Day (21 May 2010) the ability to add a 20% loading to depreciation rates for new assets was removed. This has no impact on rates applying to assets acquired prior to the budget.

It is likely that this will have the most effect on those who use predominantly hi-tech equipment; where in the past an annual depreciation rate of 60% was available (for example for a new computer); this will now fall to 50%.

Review of commercial fit-out

Interpretation Statement IS 10/01 (“Residential rental properties - Depreciation of items of depreciable property”) released earlier this year considers the depreciation of items including fit-out in the context of a residential rental property and clears some of the greyness in interpretation of the law in this area.

Budget 2010 signalled that treatment of commercial fit-outs will be reviewed in line with the above policy, and if necessary changes will be made prior to 1 April 2011. Please watch this space for upcoming developments.

WORKING FOR FAMILIES

From 1 April 2011 ‘well-off families’ will no longer be able to use investment losses, including losses from rental properties, to reduce their income and therefore become eligible for Working for Families (WFF) payments.

The Government will urgently reform other rules relating to income for the purposes of WFF, Student Allowances and the Community Services Card. These changes include ensuring trust income is counted as part of a family’s total income for the purposes of WFF. Resulting changes will apply from 1 April 2011.

The Family Tax Credit (part of WFF) will continue to be automatically adjusted for inflation, but the level of the abatement threshold will no longer be adjusted automatically

LAQC CHANGES

It is proposed from 1 April 2011 qualifying companies (QCs) and loss attributing qualifying companies (LAQCs) will become flow-through entities for tax purposes, similar to limited partnerships. The rules have been changed to prevent people choosing to have losses deducted at their marginal personal tax rate but profits taxed at the lower company tax rate.

The Inland Revenue has released an issues paper on the implementation of the changes which is summarised below. However it is possible that there may be changes made before the implementation date.

There will no longer be a difference between LAQCs and QCs. A QC’s income and losses will both be passed on to shareholders and taxed or deducted at a shareholders marginal tax rate.

QCs will no longer pay dividends to shareholders as no income will be retained by the company. Capital gains will be treated as being earned by the shareholder and generally not subject to tax. There will no longer be a need for a QC to operate an imputation credit account.

If the shareholders revoke or do not meet the requirements to be a QC then the QC will revert to being an ordinary company. If this occurs then there will be a deemed disposal and reacquisition of the company’s assets at market value. If a shareholder disposes of their shares then they will be treated as disposing of their interest in the QC with tax consequences (some thresholds will apply). These measures have been brought in to stop people from leaving the regime and avoiding being taxed on income in their own names, e.g. in the absence of this rule a person could elect for a company to leave the QC regime and then sell a property. The depreciation recovery could then be taxed at the company tax rate rather than to the individual.

The losses that will be available to a shareholder will be limited to the extent of the shareholders investment in the company, including any debt guaranteed by the shareholder.

FBT will no longer apply to shareholder employees.

We recommend that all existing QCs and LAQCs are reviewed before 1 April 2011 to determine the implications of the changes for each company and shareholders circumstances. This will include deciding whether existing QCs and LAQCs should remain in the regime.

OTHER BUSINESS FRIENDLY MEASURES

Research & Development

The Budget allocates \$321 million over four years for a range of science and R&D incentives, lifting total spending to \$750 million per annum. This includes business R&D grants and assistance for firms to access new ideas, science and technology from Public Research Organisations, stronger commercialisation within CRIs and universities, and research infrastructure.

Aquaculture

The Government will legislate this year to support the aquaculture sector’s objective of becoming a billion dollar industry by 2025, working with industry and other stakeholders to lift regulatory barriers.

Petroleum

The Government released a plan to unlock New Zealand’s petroleum and mineral potential in November 2009 and has begun implementing it. The Budget funds implementation of that plan.

Water

Water is a key strategic resource. The Government is currently working on improving the regulatory regime, including those parts that impact storage and irrigation, as part of an efficient and sustainable water management programme.

Exporters

An important leg of the Governments growth plan is to improve access for New Zealand exporters to world markets. Given the increasing importance to New Zealand of trade with Asia and the Pacific Rim, NZ has recently signed Free Trade Agreements with Hong Kong and Malaysia, and is in negotiations with Korea and India. NZ’s Agreement with the 10 countries of ASEAN recently came into force.

The Government is working with the Trans-Pacific Partnership regional grouping, including the United States, to open further markets and opportunities for New Zealand exporters.

To ensure that these and related initiatives continue to benefit the economy, a Productivity Commission has been established. This will be a standing body with high level expertise, operating independently with a wide brief to undertake inquiries into productivity-related matters. It will be in place by April 2011.

STOP PRESS!!!

CIR vs Penny & Hooper – Change to company structure was tax avoidance

A much awaited decision of the Court of Appeal was delivered on the 4th of June 2010. This is the most recent and most authoritative NZ Court decision regarding the use of structures by small to medium size entities where those structures result in the top personal tax rate being replaced by the lower company/trust tax rate.

Penny & Hooper were both orthopaedic surgeons practising in Christchurch as sole traders. They restructured their businesses so that they were carried on by companies in 1997 and 2000 respectively. In both cases, as a result of salaries from the newly formed companies being lower than their previous self employed earnings, significant tax savings were achieved.

The Court of Appeal, by a two to one majority, concluded that the adoption of the company structure and the non payment of market salaries, without legitimate reason, amounted to tax avoidance. This issue has been uncertain since Labour introduced the 39% personal tax rate in 2000 and the Taxation Review Authority first considered the use of a structure which had the effect of avoiding the top personal rate in 2002 (Case V 20)

In reaching the above conclusions the Court of Appeal observed:

- » Both Doctors chose to incorporate after operating on their own account (ie there was a change in structure)
- » There was no valid criticism of adopting the company structure
- » Net income from personal exertion (via salary) was dramatically reduced, and it was no coincidence this drop in income coincided with the increase in the top personal tax rate to 39% on 1 April 2000
- » Salaries paid by the companies were substantially below what could have been expected on an arms length basis.
- » *“...in general terms the Act is not concerned with the level of salaries paid to employees in family-owned companies...” and “...there may be good reasons why an employee would agree with an employer to accept a salary reduction.”*, but none of those reasons applied in this case.
- » The increased company profits (because of the lower salaries) still had the effect of benefiting the Doctors and their families, ie the taxpayers still enjoyed the full benefit of the income of the companies.
- » It was not considered that the structure was necessary to protect the Doctors from negligence claims.
- » *“It could not have been within the contemplation of Parliament that a company director/employee could adopt a salary of less than one-fifth of a proper commercial salary and thereby secure significant tax advantages while still receiving, in practical terms, the benefit of the company’s entire net income..”*

- » The way the businesses were transferred to the companies also tended to emphasise the artificiality of the arrangement (goodwill was seen as very low given the income levels involved)
- » The Commissioner should not interfere in marginal circumstances.
- » The Court of Appeal was not asked to determine the fiscal effects of concluding that the payment of a non-market salary was tax avoidance.

The Court concluded

“It is important to recognise, however, that this decision should not be regarded as establishing a principle that salary levels in family companies which are below the levels which could be expected in an arms-length situation, are necessary to be regarded, without more, as evidence of a tax avoidance arrangement.”

It will be a matter of assessing all the circumstances, including the extent and nature of any element of artificiality or contrivance, in order to determine whether any particular arrangement is within or outside the contemplation of Parliament in enacting the tax legislation...

...And the Court can only determine one case at a time.”

While this decision has been much awaited, it is unlikely to be the final word in this area. There are a number of issues which have not been addressed, for example

- » What if a company structure was adopted from day one?
- » What is the market salary? While the Court of Appeal was not asked to determine this, the evidence suggests that the IRD’s view and taxpayers views are some distance apart.
- » *“..what the taxpayers here have done has not required particular “ingenuity” such that Parliament could not have contemplated the use of company structures in this way.”*
Ellen Frances J

We will not know for some time if this decision will be appealed to the Supreme Court, nor how broadly the IRD will look to use the decision to challenge structures. Accordingly this issue is likely to continue to cause frustration for taxpayers and undoubtedly further time and cost will be incurred in trying to establish where the boundaries lie. A company tax rate aligned to the top individual tax rate does of course avoid all these issues.

NEWSLETTER VIA CYBERSPACE

We are sending this newsletter out electronically to those clients for whom we have email details. If you have not received this electronically and wish to in the future, or if you are keen to only receive via email (not snail mail) please email your email address to:

info@ph.co.nz

FOR FURTHER INFORMATION PLEASE CONTACT:

DUNEDIN PO Box 5346, Moray House, 139 Moray Place, Dunedin 9058, New Zealand
T 03 477 9923 F 03 477 9795 W www.ph.co.nz

CHRISTCHURCH PO Box 4449, HSBC Tower, 62 Worcester Boulevard, Christchurch 8140, New Zealand
T 03 366 5282 F 03 366 4254 W www.ph.co.nz

If you wish to receive future editions of “Tax Brief” by email, please email us at info@ph.co.nz with your contact details.