



BUDGET 2010

May 20



MAKING THE MOST OF A CRISIS

They say you should never waste a good crisis and in tax terms the Hon Bill English has chosen the current global financial crisis as the perfect opportunity to introduce tax changes he describes as "the most thorough and beneficial overhaul of the tax system in 25 years".

The highlights include:

- Personal tax cuts across the board from 1 October 2010 with the top rate dropping from 38% to 33%.
- An increase in GST from 12.5% to 15% from 1 October 2010.
- A cut in the company tax rate from 30% to 28% from the start of the 2011/2012 income year.
- A suite of measures against property investment including removal of depreciation on all buildings and tightening of QC and LAQC rules.
- Removal of the 20% depreciation loading on all new depreciable assets required from budget day.
- Reducing taxes on savings vehicles (e.g., KiwiSaver, PIEs and unit trusts) to 28%.
- Capping interest deductions for foreign owned companies by reducing the debt to asset ratio to 60% from 75%
- Measures to compensate the vulnerable to offset the GST rate increase.
- Measures to reduce abuse of entitlements and improve integrity of the tax system.

Key Outcomes

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The personal tax cuts are expected to result in 73% of income earners having a top marginal tax rate of 17.5% or less. Two thirds of the cost of the personal tax cuts relate to income in the bottom two income tax brackets of less than \$14,000 and less than \$48,000.

As the tax cuts are expected to be fiscally neutral the people bearing the burden of the base broadening measures will be property investors and non-residents.

The tax cut package is estimated to cost \$2.92 billion in 2010/11; \$4.65 billion in 2011/12; \$5.05 billion in 2012/13 and \$5.24 billion in 2013/14 - costing an estimated \$17.86 billion over the 4 year period.

The tax cuts are largely funded by the GST rate increase and together with the other revenue generating measures are estimated to collect \$2.45 billion in 2010/11; \$4.53 billion in 2011/12; \$4.8 billion in 2012/13 and \$4.98 billion in 2013/14 - collecting an estimated \$16.77 billion over the 4 year period.

After adjusting for the macroeconomic effect of the package - that is, increased tax collection through additional economic activity - the Government expects the total impact to be a decrease of \$460 million on the operating balance in 2010/11, changing to a positive impact of \$175 million on the operating balance in 2013/14.

Conclusion

This is a bold but not overly bold budget. It is a necessary budget as it seeks to move the New Zealand economy from a 'borrow and spend' model to more of an investment model.

As generally expected those bearing the cost of some of the tax cuts are: property investors who will be unable to claim depreciation on buildings; foreign investors who largely debt fund their New Zealand business; and wealthy families who have previously structured their affairs to qualify for Working for Families tax credits.

It is unlikely that the drop in company tax rate from 30 percent to 28 percent will compensate foreign investors for the changes that affect them. The tax rate decreases are designed to encourage productive effort and the GST increase will dampen the spending instinct.

Those not affected by the specific targeted measures are likely to embrace the Budget positively and with across the board personal tax cuts all income earners appear to be better off. This should encourage skilled people to stay in New Zealand.

Sincerely

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www.taxguide.co.nz
www.treasury.govt.nz
www.taxpolicy.ird.govt.nz

PERSONAL INCOME TAX

The most significant tax change in the Budget is the reduction on personal income tax rates. The Government notes that personal taxes "affect incentives to work and to up-skill.

They also affect people's decisions to stay and work in New Zealand or to work abroad, and the incentives for skilled foreigners to come to New Zealand." It goes on to say that "Given our highly mobile and skilled labour force, reducing personal tax rates is important for growth." The aim is to help families get ahead through reductions in personal tax rates and effective marginal tax rates, and to keep Kiwis in New Zealand.

The personal income tax changes that will apply from 1 October 2010 are:

Income	Current Rate	New Rate
\$0 - \$14,000	12.5%	10.5%
\$14,001 - \$48,000	21 %	17.5%
\$48,000 - \$70,000	33%	30%
Over \$70,000	38%	33%

Secondary tax and resident withholding tax rates will also be reduced from 1 October 2010, to align with the new personal tax rates.

The impact of the tax cuts for a low income earner, a middle income earner and a high income earner (based on a single person with no children) are as follows:

Income	Weekly tax cut before GST rise	Weekly tax cut after estimated extra GST	Annual tax cut before GST rise	Annual saving after estimated extra GST
\$26,000	\$13.46	\$4.82	\$700.00	\$250.55
\$50,000	\$29.42	\$13.71	\$1,530.00	\$712.91
\$120,000	\$89.04	\$56.08	\$4,630.00	\$2,916.03

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COMPANY TAX RATE

The drop in the company tax rate to 28% and the timing of the cut was unexpected. By introducing the tax cut from the start of the 2011/12 income year New Zealand beats Australia to the jump.

It is a smart move as it may help take the sting out of the depreciation changes and it is always good to beat Australia at anything!

In a move similar to the previous cut in the company tax rate there will be a transitional period of two years during which companies can attach imputation credits arising from tax paid at 30% at an imputation ratio of 30/70.

As with the cut in personal tax rates, any company provisional taxpayer that pays provisional tax based on the standard uplift basis -

that is, based on a prior year tax liability - will have its standard uplift automatically adjusted to take into account the personal tax cuts.

GOODS AND SERVICES TAX

The rate of Goods and Services Tax ("GST") will be increased from 12.5% to 15% from 1 October 2010. This is consistent with the Government's plan to move away from personal and company tax rates that it considers harmful to economic growth.

As David Lange reputedly said "Even drug dealers pay GST".

Immediate compensation for the increase in the GST rate will be provided from 1 October 2010 by increasing by 2.02 percent payments to persons receiving the main working-age benefits, student allowances, New Zealand Superannuation and Veterans Pension. Annual indexation of these benefits will resume on 1 April 2011.

Also Working for Families, along with most of the important forms of supplementary assistance, and the Government Superannuation Fund and National Provident Fund annuities that are subject to CPI adjustments will be increased by 2.02 percent from 1 October 2010.

The 2.02 percent compensation package has been calculated based on Statistics New Zealand's calculation of the overall increase in prices - as reflected in the CPI - to rise by about 2 percent as a result of the GST rate hike to 15%.

The last GST rate hike was in 1989 - from 10% to 12.5% - more than 20 years ago. The public's reaction to the latest proposal has been mixed at best - many polls apparently finding that the majority are against a GST increase.

For businesses - especially those that fall into the small and medium enterprise group - there has been plenty of concern about the implications. A recent MYOB survey of SMEs indicated that about half of those surveyed were against a GST rate hike.

Preparation for a rate hike is key.

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PROPERTY CHANGES

Measures are to be introduced from 1 April 2011 to try and redress the Kiwi love affair with investing in property. However the measures are rational and have not gone as far as many feared.

The good news for landlords is that they have not quarantined losses from rental properties; they have not limited deductions for interest on negatively geared properties or introduced a bright line test for property bought and sold within a period such as 24 months.

Instead the measures have been limited to removing depreciation on most buildings and treating a qualifying company as a look-through

entity.

From the start of the 2011/12 income year taxpayers will no longer be able to claim depreciation on the cost of a building which has an estimated useful life of 50 years or more, on the premise that evidence suggests that buildings do not decline in value.

This measure is not restricted to residential rental properties. It applies to all buildings. A taxpayer who can show that a building has an estimated useful life of less than 50 years - perhaps because it is used in a particularly corrosive industry or is of a temporary nature - can apply for a provisional depreciation rate from Inland Revenue.

Those companies with significant investments in buildings may get at least some comfort from the reduction in company tax rate but foreign owners of properties such as hotels, office buildings and apartment blocks suffer a double whammy from the reduction in the thin capitalisation percentage and the depreciation removal.

Building owners will need to ensure that the "fit-out" within the building is separately costed and depreciated as fit out rather than as the fabric of the building. Inland Revenue is to produce an Issues Paper on what constitutes a "fit-out".

The tax profile of the QC/ LAQC regime will change from the current position where losses are attributed but profits are retained in the company. This produced a marginal tax rate discrepancy where the losses were offset at the top marginal rate but profits were taxed at the lower company tax rate.

From the start of the 2011/12 income year LAQCs will be treated as a look-through entity meaning that where the LAQC has a loss, the loss will still be able to be deducted from the shareholder's other income.

Where it makes a profit, the profit will be taxed at the shareholder's marginal rate. Rental property investors using a LAQC will still be able to access the rental loss but the loss itself will be lower because of the lack of a depreciation claim on the cost of the building.

The Budget forecasts assume that the tax package will reduce house prices by around 2% than would have otherwise been the case. This could cause some concern for small and medium sized business owners who use equity in their homes - and/or other investment property - to obtain bank debt to fund their business.

DEPRECIATION LOADING REMOVED

The 20% depreciation loading will be removed from assets purchased after 20 May. Previously, a purchase of a new asset - other than buildings - entitled the taxpayer to an uplift in the standard depreciation rates by 20%.

This was particularly cumbersome when a business was acquired under an asset acquisition as opposed to a share acquisition and the fixed asset register had to be recast to remove the loadings as the assets effectively became secondhand.

The impact on future investment in capital items such as new plant and equipment will be difficult to gauge as the lower company tax

rate of 28% may compensate for this removal.

WORKING FOR FAMILIES (WFF)

The WFF regime has been highly criticised as being open to abuse by high income earners who are able to structure their affairs - perhaps by having income derived through a trust - so that their family income is reduced to a level where they are entitled to WFF benefits.

The Budget takes a first step at preventing this from happening.

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THIN CAPITALISATION

For foreign investors into New Zealand who debt-fund their New Zealand business, the reduction in the acceptable percentage for thin capitalisation purposes to 60% from 75% is significant.

In many cases the balance sheets of overseas owned companies will need to be recapitalised to ensure the level of interest bearing debt in proportion to the total value of assets does not exceed 60%. Where the level of debt is higher than 60% the interest expense attributable to portion of the debt in excess of the threshold is non-deductible.

OTHER CHANGES

Other changes broadly include:

- § Tax benefits relating to capital contributions made to fund the acquisition of capital assets will end. A capital contribution is a payment made to a supplier for the construction of an asset, for example, a payment to an electricity lines company to construct a line to a building. Either the tax cost of a depreciable asset will exclude capital contributions, or the capital contributions must be amortised as income over 10 years. This change will apply to contributions made after 20 May 2010.
- § GST changes including measures to address risks such as phoenix scheme fraud will be introduced from 1 April 2011.
- § The redundancy tax credit will be removed from 1 October 2010.
- § An additional \$119.3 million over four years will be provided to Inland Revenue for compliance and enforcement.

COMPARISONS WITH AUSTRALIA

While a proper comparison with Australian taxes is often complicated by the fact that Australia has a comprehensive capital gains tax, stamp duty and other taxes and levies that New Zealand does not levy, it is interesting to consider the head-line income tax rates between the two countries.

The Tax Working Group report noted that individuals in New Zealand earning less than \$240,000 per year will pay on average more income tax than those on equivalent salaries in Australia. The changes to the New Zealand personal tax rates alters this considerably.

The Australian tax rates applying from 1 July are as follows:

Income	Tax rates
\$0 - \$6,000	0
\$6,001 - \$37,000	15%
\$37,001 - \$80,000	30%
\$80,001 - \$180,000	37%
\$180,001 +	45%

The Government has indicated that they want to encourage Kiwis to remain in New Zealand. The reductions in personal tax rates means that the comparison with Australia - using headline rates and including ACC levies (NZ) and Medicare levies (Australia) only - is: (ignoring exchange rate differences)

Income	NZ Tax (NZD)	Australian Tax (AUD)
\$50,000	\$9,020	\$8,550
\$85,000	\$20,670	\$20,675
\$200,000	\$59,120	\$66,550

The reduction in New Zealand personal tax rates means that individuals in New Zealand earning less than \$50,000 per year will pay on average more head-line income tax than those on equivalent salaries in Australia.

The break-even point is obtained at around \$85,000. Individuals earning more than \$85,000 per year will generally pay on average less head-line income tax in New Zealand than those on equivalent salaries in Australia.

TAXATION OF INVESTMENTS

Changes will be made to the taxation of certain investments and investment vehicles. This is consistent with the personal tax cuts and the cut in the company tax rate and ensures that the tax system retains some coherency.

The key changes are:

- § From 1 October 2010 the top rate for most portfolio investment entities ("PIEs") including Kiwisaver accounts will be reduced from 30 percent to 28 percent. The other PIE tax rates will drop to align with the new personal tax rates. Note that with

the top personal tax rate changing to 33%, and with the trustee rate remaining at 33%, there will still be an incentive to invest via a PIE to cap the tax rate on investment income at 28%.

- § The tax rate for other savings vehicles - e.g., unit trusts and widely-held superannuation funds - will also be reduced from 30 percent to 28 percent from the 2011/12 year.
- § Resident withholding tax ("RWT") rates applying to interest earned through a bank account will be reduced so they align with the new personal tax rates from 1 October 2010.
- § Reducing the top tax rate applying to PIEs and savings vehicles will cost \$15 million in 2010/11 rising to \$60 million a year by 2013/14.

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