



Withers Tsang & Co
Chartered Accountants



[Home](#) | [Products](#) | [Services](#) | [Contact](#)

Tax change....our take on our brave new world

Finally the budget delivering the biggest tax changes in 25 years has been read. Following are our comments and interpretations of the major changes.

There are both opportunities, risks, and decisions that will lie ahead for most clients, especially those with property assets in LAQC structures.

I will begin by bullet pointing the specific tax announcements and then offer our take on the issues in my commentary:

So what is our overall reaction?

A good budget for business and hard working Kiwis, especially those in the higher tax brackets. The tax cuts are monumental and the reduction of the corporate tax rate to 28% is a clear indication of just how serious this government is to make this country competitive.

Much of the media rhetoric has focused on the elimination of structuring opportunities for the rich. The reality though is that the change is more akin to a "if we can't beat them, let's join them" realisation. Those already structuring incomes to avoid the 39-cent tax rate will see little change, but those on PAYE salaries are better

we can't beat them, let's join them" realisation. Those already structuring incomes to avoid the 38 cent tax rate will see little change but those on PAYE salaries are better off by 5 cents in the dollar on incomes above \$70,000.

Paul Reynolds, the Telecom CEO, is probably one of the country's biggest winners with his tax saving worth in the vicinity of \$3,500 per week!

Property investors can breathe a collective sigh of relief. Whilst the removal of depreciation on buildings is a blow, it could have been oh so much worse.

There will be no:

- Capital gains tax
- Ring fencing of tax losses
- Deemed rate of return tax
- Land tax

I believe property investors will now return to the market given they can now calculate their outcomes. It's fair to say that their focus will be on the economic reality of the investment with a reduced focus on the tax savings that were previously bolstered by depreciation claims.

The specific changes are:

Tax rates

Personal tax rates will change from 1 October 2010

	New Rate	Old Rate
0 - \$14,000	10.5	12.5
\$14,000 - \$48,000	17.5	21
\$48,000 - \$70,000	30	33
\$70,000 +	33	38

Company tax rate to reduce from 30% to 28% from 1 April 2011

Trust tax rate remains unchanged at 33%

Investment tax rates including PIE tax rates to be largely aligned to the company tax rate of 28%

GST

To rise from 12.5 to 15% from 1 October 2010

Working for families eligibility

Eligibility criteria will be altered to prevent rental and investment losses being offset against taxable income when determining benefit eligibility.

Base broadening measures

Plant and machinery depreciation

The 20% loading on depreciation for new assets to be removed effective to assets acquired after 20 May 2010

Buildings

The depreciation rate for buildings with expected lives of 50 years or more to be set at zero from 1 April 2011.

Buildings with useful lives less than 50 years unaffected.

The depreciation treatment of Commercial building fit out to be reviewed and the law clarified and potentially changed from 1 April 2011.

The depreciation of residential rental property chattels is unchanged.

LAQC's

Legislation to be introduced after a consultation process that will require LAQC's to be taxed as if they are limited partnerships from 1 April 2011. More on this later.

Thin capitalisation rules

The "safe harbour" limit for gearing on foreign owned investments will be reduced from 75% to 60% from 1 April 2011.

WT commentary on the tax changes

The most significant win for our clients will be the reduction in the personal tax rate of 5% for those earning in excess of \$70,000. Remarkably 73% of all Kiwis will now pay income tax rates of no more than 17.5% given that their incomes will not exceed \$48,000.

Many clients with investment properties are currently in the top personal tax bracket. In many instances the extra tax payable as a result of the removal of depreciation allowances on buildings will be more than compensated for by the tax cut. Property investors should remember that their depreciation allowances were only ever a timing advantage, subject to recovery on disposal of the property.

The permanent savings from a tax cut are therefore far more valuable than the loss of a timing advantage from depreciation.

Interestingly, the government's removal of depreciation has been achieved by reducing the depreciation rate to zero. This means that buildings still remain within the definition of depreciable property. It is this continued inclusion in the basic framework of the depreciation rules that will require the existing accumulated depreciation on buildings to be carried forward as normal. There is nothing in the depreciation changes to trigger the recovery of depreciation at this point. This recovery of depreciation to date will still only be triggered by either a sale or deemed disposal of the building in the future.

A planning opportunity exists for those clients holding buildings with large accumulated depreciations. If these buildings are now restructured or sold the taxable income from the depreciation recovery will be taxed at the new low rates. If, for example, the decision to transfer a property to a trust has been put off because of the magnitude of the tax on the depreciation recovery, after 1 October 2010 may well be the time to act.

The fall in the company tax rate was probably the budget's biggest surprise.

Many business client's company's will be owned by family trusts. There will now be a 5% difference between the 28% corporate tax rate and the 33% trust tax rate. This difference will encourage directors to retain and reinvest profits within company structures rather than distribute profits as dividends that will then be taxed at 33% in the shareholder's hands. Clients should remember that if profits are drawn from their companies, dividends will ultimately need to be declared to cover these drawings.

So to take advantage of the lower company tax rate profits need to remain in companies.

For most business clients conventionally structured with their companies owned by trusts, it will be business as usual. There are many non tax reasons to structure business in this way that are unaffected by the budget. These include the fundamental limited liability protection offered by a company and the asset protection for the wealth flowing out of the company offered by a trust.

Transitional rules dealing with the attachment of 30% imputation credits to dividends are also being introduced. If the imputation credits that a company holds at 30% are

to be fully utilised they will need to be attached to dividends declared before 1 April 2013.

The increase of GST to 15% makes New Zealand's GST rate one of the highest in the world. The best thing about GST is that it drags the black economy into the tax base and is arguably more difficult to avoid.

Brace yourself, when calculating the GST component of a purchase, you will now be dividing by 7.6666666666 rather than 9!

Retailers will be grappling with the extent to which they will actually lift price points. For example, if you are a cafe that currently sells a coffee for \$3.95, will you want to see this price point lift to \$4.05 after the GST increase?

The government predicts that prices will only rise by 2% on average, despite the GST increase being 2.5%.

The introduction date for the GST rate change of 1 October will allow transitional rules to apply. Section 78 of the GST act contains provisions dealing with rate changes that essentially deem contracts to alter to take up the rate change. There is a raft of transitional legislation associated with this budget dealing with the practicalities of rate changes both with the GST and income tax rates. We will be able to advise clients on these specific matters on a case by case basis.

In the past, eligibility criteria for Working for Families allowed rental and investment losses. This increased the likelihood of entitlement. This has been viewed as a wroutght by the government. I believe the tightening of this eligibility criteria will only have a minor impact in our client base as it has not been our experience that tax structuring has been aggressively targeted to achieve inappropriate access to these low income benefits.

With respect to depreciation, many clients may be wondering if there is "wiggle room" to depreciate buildings that may have useful lives less than 50 years. Before you get too excited, the 50 year useful life criteria is set down in the depreciation rate schedules. The typical residential dwellings and commercial buildings that our clients invest in will all be considered to have useful lives in excess of 50 years. Examples of buildings with useful lives of less than 50 years may include car parks and milking sheds, i.e. not much scope for your typical property investor.

The door is theoretically open for investors to apply to IRD for a ruling on the useful life of a particular class of building but it would seem unlikely that any great wins will be gained with this process.

For those clients with a substantial taxable income being derived from rental of commercial or residential buildings, the first impact of the changes will be felt with

provisional tax planning. Because the change in rate takes effect from 1 April 2011 for the 2012 year, we will have the opportunity to estimate incomes that are materially altered by these changes through the 2011 year. Each client's affairs will be reviewed as we complete financial statements with this in mind.

As previously mentioned, the opportunity to depreciate residential chattels remains but there is more to come following the review of depreciation entitlements on commercial building fit outs.

The significance of decisions on whether money spent on buildings is maintenance or capital improvements will become all the more important. Expenditure of a capital nature on buildings will essentially become "black hole" expenditure for tax purposes, not deductible and not depreciable. The importance of keeping evidence that expenditure is maintenance will be critical.

I have already mentioned the fact that depreciation recovery will now be dealt with under our new lower tax rate regime and clients are encouraged to consider whether sale or restructure once the tax rates have actually fallen maybe appropriate. Call us to discuss.

LAQC tax changes

The announcement that LAQC's are to be treated as flow through entities taxed under a similar regime to limited partnerships was a wild card in the budget. No doubt many clients were left wondering just what the heck this really meant.

Treasury has already released an officials' issues paper entitled "Qualifying companies: implementation of flow through tax treatment". Submissions are now being called on these changes.

There is no doubt that these changes are going to have a significant impact on all LAQC's whether they are used for property investment or not.

So, why are they being changed?

Currently losses from an LAQC flow directly back to shareholders who take advantage of these losses at their personal tax rates which will now be a maximum of 33% but when an LAQC produces profits these profits can be retained in the company and taxed at only 28%. The government is concerned that this will lead to tax avoidance.

A flow through entity like a general or limited partnership requires both profits and losses to flow out. This means that profits from LAQC's will essentially be taxed in the shareholder's own hands at their own personal tax rate.

On the face of it, this move to tax LAQC's in the same way as limited partnerships doesn't appear too problematic however it is our opinion that there is significant danger in the detail.

The limited partnership regime contains provisions that limit the ability of partners to claim losses in excess of the partners investment in the partnership. There are complex formulas in the act that must be applied to determine whether losses are in fact less than the partner's economic exposure in the partnership. Essentially, losses are limited to the capital that a partner has at risk. The proposal will extend these same loss limitation laws to LAQC's. This will effectively cap the amount of losses that can be flowed back to shareholders. So whilst the budget didn't contain any specific ring fencing provisions, it could be argued that this change to the LAQC's is limited ring fencing by stealth. Interestingly, these loss limitation rules don't apply to normal general partnerships. This may mean a return to partnership structures as the preferred option for structuring loss making property investments.

There are further potential problems for LAQC's triggered when shareholders dispose of their shares or cease to meet the qualifying criteria for LAQC's. If a shareholder disposes of their interest in a qualifying company they would, under the new rules, be treated as disposing of their share of the underlying company property and would bear the tax consequences associated with this disposal. This is a direct consequence of flow through treatment applying.

Currently the sale of shares in an LAQC does not trigger the disposal of the assets within the company for tax purposes and this has given LAQC owners wonderful flexibility to alter the effective ownership of their assets by altering shareholding without triggering tax issues like depreciation recovery.

These flow through issues will significantly add to the compliance cost of LAQC's. The new proposals do contain provisions to reduce compliance costs by exempting the flow through tax treatment being applied if the value of the proceeds from the disposal exceeds the book value of their share of company property by less than \$50,000. If a company revokes its qualifying company status, flow through treatment would cease to apply and the company would be subject to normal company taxation rules.

We will be closely monitoring the impact of these proposed changes and will be able to advise clients on what options they have as details of the changes are worked through. At this stage I do not believe there is the need for clients with properties structured in LAQC's to panic, given that there will still generally be the opportunity to flow losses out of companies and back to shareholders. The extent to which this is possible though will be on a case by case basis depending on the shareholders capital invested in the LAQC. It does seem that the complexities and added administration costs of operating an LAQC may mean that the use of LAQC's will fall out of favour to some extent, given that ordinary partnerships will be less

administrative.

It would seem unlikely though that a wholesale restructuring of properties already held in LAQC's will be appropriate or necessary. The sheer cost of doing this and the fact that depreciation recovery would be triggered on disposal of any property assets sold out of an LAQC will make this option unappealing.

I encourage clients with LAQC's to read the officials' issues paper on these changes, I attach the following link:

www.taxpolicy.ird.govt.nz/sites/default/files/2010-ip-budget2010-laqcs.pdf

At this stage, this is the best information available on the proposed changes.

The government announced changes to the thin capitalisation rules. These rules only apply to foreign companies investing in New Zealand. Previously there was a limitation on deductibility where these investments were funded by more than 75% debt. This threshold is now to be reduced to 60%.

A couple of smaller points that didn't make it into Bill English's speech that we consider worthy of mention to you include the removal of the redundancy pay rebate from 1 October 2010.

The government have also confirmed that for now the attribution rules will remain in place despite the fact that the alignment of the top personal tax rate with the trust tax rate has removed the reason why the attribution rules were introduced in the first place. It would seem that this decision to retain the attribution rules may well be reviewed in the near future.

Ominously, the budget has also allocated a further \$120 million to the Inland Revenue to undertake more tax auditing.

In the previous budget IRD was given \$14 million to do more auditing of the property sector. These funds were used to resource the new property compliance division and we have seen focus on LAQC's being used inappropriately where shareholders live in the properties and we have also seen initiatives around apartments sold off the plans for profit. Much of the compliance work by IRD has resulted from more sophisticated data matching to tax records. There has been only a minor increase in the actual amount of tax auditing. This looks set to change.

For every dollar the government spent on these tax compliance measures, they collected \$5 in return.

It's not hard to see why Bill English has been willing to increase this budget by \$120 million.

That money will buy an awful lot of tax auditing and IRD have already signaled much of it will be focused on the property sector and the black economy.

This email has been authorised by:

Withers Tsang & Co Ltd
24-26 Pollen Street
PO Box 47-145
Ponsonby
Auckland

phone: 64 9 376 8860
fax: 64 9 376 8861
email: reception@wt.co.nz
web: www.wt.co.nz

We respect your privacy and will not sell, give or exchange your contact details with other parties.
Copyright (C) 2010 BMail by ByteMe Internet