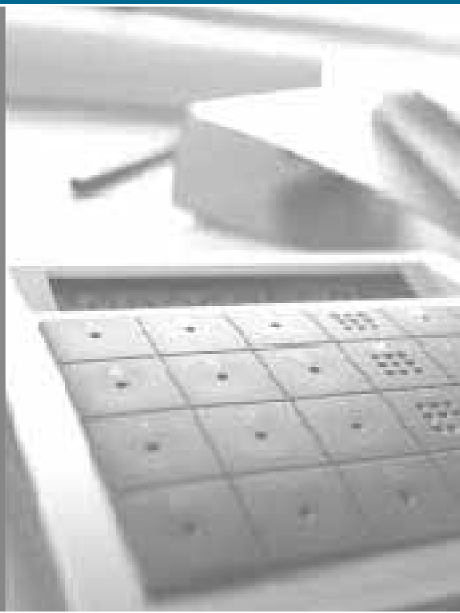
Bell Gully

NEW ZEALAND

BUDGET REPORT



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The Treasurer and Minister of Finance, the Hon Dr Michael Cullen, presented the 2005 Budget Statement to Parliament on 19 May 2005. This CCH Budget Report has been prepared with the assistance of specialist practitioners from Ernst & Young and Bell Gully. It covers announcements of interest to tax practitioners and the business community.

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2005 Budget overview

2005 is an election year. That event has cast a long shadow over the shape of this year's Budget.

The relationship between the two events can perhaps be seen most clearly in the proposal to modestly tinker with the tax rates beginning on 1 April 2008. Many will see this measure as designed to remove from the political arena the issue of the level of personal taxation.

The Minister of Finance has been on record a number of times as opposing personal tax cuts. It can be speculated that the explanation for the limited dilution of the Minister's well-known stance is a desire to diffuse the issue as one that could sensibly be put before the electorate. The debate immediately following the Budget can be expected to reveal whether the new tack will meet with political success.

Developments on the personal tax front should not be allowed to overshadow announcements in other areas. Important proposals include the intention to introduce work-based superannuation arrangements and the substantial revamp of the taxation of equity investments. The proposed exemption for the capital gains of pooled investment funds and moving a step forward to tax the unrealised gains on foreign equities can be regarded as significant developments.

The tax practitioner should also be aware that the Budget speech was followed by the introduction of a taxation bill implementing many proposals in addition to addressing the topic of corporate migrations.

Tax rate tinkering

Ministerial statement

".. it has been decided to adjust each three years by using the mid-point of the Reserve Bank's Policy Targets Agreement inflation band. This equates to a 6.12 per cent movement in the thresholds every three years.

This means that at the time of the first triennial adjustment, 1 April 2008, the $9,500 threshold will move to $10,081, the $38,000 threshold to $40,324 and the $60,000 threshold to $63,672."

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Editorial comment

The effects of these changes are summarised in the Budget papers. In the first year ending 31 March 2009 income of more than:

- $10,081 will attract less tax of $35;
- $40,324 will attract less tax of $314;
- $63,672 will attract less tax of $534.

A first reaction to this announcement is disappointment about the timing of its introduction. For many taxpayers, the introduction of changes to the tax rates beginning in some 34 months' time will seem like no reduction at all. No explanation was incorporated in the Budget papers of the justification for such a long delay.

A second reaction is surprise at the absence of full indexing. The announcement states that the adjustment to the tax scales will be based upon the mid-point of the Reserve Bank's inflation band. The implication is that the tax scales will not be adjusted if inflation, in fact, exceeds the mid-point of the band. For example, with an inflation band of 1% to 3% the tax rates will be adjusted to reflect inflation of 1.5%. However, if inflation actually exceeds that threshold, there will be no further compensatory adjustment to the tax scales.

A third area of scrutiny may well be the lack of integration with other measures. For example, the announcement on the KiwiSaver scheme indicates an employee contribution of at least 4% of employment income commencing from 1 April 2007. While not strictly speaking a tax, the employee's contribution will achieve the same outcome of a reduction to take-home pay. That reduction to take-home pay can be expected to be even greater when businesses subject to the carbon tax due to take effect from 1 April 2007 seek to pass on the cost to consumers. It will not be lost on many observers that these imposts will commence well before the small changes in the tax scales.

Viewed from this perspective, the proposed adjustment to the tax scales may be considered by some taxpayers as a "Clayton's" tax reduction.

A final observation on the Government's proposal is that there can be no doubt that it probably has more to do with politics than other factors. On several occasions in recent times the Minister of Finance has argued that

there is no capacity to reduce the burden of personal income tax. The policy based on this view has become vulnerable to attack by critics who argue that the New Zealand workforce continues to be unjustifiably overtaxed.

It remains to be seen whether the modest tinkering with tax scales until shortly before the 2008 general election will do anything to appease the critics of this policy.

KiwiSaver scheme

Ministerial statement

"With respect to retirement and first home deposit savings, the government has decided to begin with a broadly based work-based savings scheme akin to that proposed by the group chaired by Peter Harris, which reported last year. While many of the recommendations of the Harris committee have been amended in some detail, the essential features of the proposal have survived intact.

The new KiwiSaver scheme is intended to begin operation on 1 April 2007.

KiwiSaver's basic features are:

- automatic enrolment in a savings scheme at the workplace for new employees aged 18-65, with the ability to opt out
- an upfront contribution by the government on joining, plus low management fees
- a basic contribution rate of 4 per cent of income deducted through the tax system and
- minimum compliance costs for employee and employer.

Apart from automatic enrolment, employees may become KiwiSavers at any time.

The new employee can opt out by notifying IRD between weeks two and four after starting a new job. In this case IRD notifies the employer, otherwise deductions begin the next pay day after eight weeks with a new employer.

Contributions will be at one of two levels. The standard rate will be set at 4 per cent of income, but the employee can opt for a higher deduction rate of 8 per cent.

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The self-employed will be able to become KiwiSavers, selecting their own contribution rate and frequency of contributions."

Editorial comment

The essence of this proposal is that all employers will need to establish a protocol for dealing with the KiwiSaver scheme. Upon employing a new employee, the employer will be required to enrol the employee in the scheme and make deductions of 4% or 8% (at the employee's election) from salary or wages. Existing employees will need to be given the opportunity to join the scheme if they so wish. To enhance the attraction of the scheme a Government contribution of $1,000 per member will be made.

The position of existing employee superannuation schemes is addressed by the granting of an option to convert to the KiwiSaver scheme. If advantage is taken of that option, the Government contribution of $1,000 together with other assistance will become available.

The Budget papers indicate that contributions received by Inland Revenue from both scheme members and the Government will be passed to "providers" for investment and management. Presumably these are the entities that currently make up the wholesale and retail funds management sector. The investment returns they achieve will presumably be credited to the account of each KiwiSaver contributor. To ameliorate the cost of their services the Government proposes to pay fee subsidies to the providers. That subsidy together with the initial $1,000 contribution is projected to cost $384 million over the first four years of the scheme.

At this stage it is far too early to predict whether the proposal will meet with success in its implementation. Its success depends upon many factors. Prominent among those will be the reaction of employers. If a pattern emerges that employers do not offer significant employer contributions to the scheme, the continued membership by employees can be expected to be at low levels. The 4% employee contribution might be regarded as simply another form of tax that the employee could utilise more effectively. There may, for example, be disenchantment with the notion that retirement savings should be placed with institutions that, after deduction of taxes and fees, are sometimes reported to be achieving returns below bank deposit rates. The traditional New Zealand affinity for the familiar investment in real estate may be perceived to be more attractive.

It may also be the case that there are entrenched attitudes to overcome. Some observers will recall the 1998 rejection of the referendum proposal for a compulsory superannuation system. The proposal failed by an overwhelming margin of 9 to 1 opposed. It remains to be seen whether attitudes have changed in the ensuing eight years.

Removal of capital gains tax on pooled investments

Ministerial statement

"With respect to the taxation of domestic investment two major changes will be legislated for. Under the first, New Zealand-based collective investment vehicles will no longer be required to be taxed as entities. Rather they will be able to elect to have the income earned by a fund regularly attributed to the individuals investing in it and taxed at their marginal statutory rates.

As with the current regime for taxation on interest-bearing accounts, the investor will advise the fund of their marginal rate. When income is earned, it will be credited to the account of the individual and the fund will withhold tax from it at that marginal rate. This will be a final withholding tax so no tax return will be required. Equivalence to the tax regime on interest and direct investment of shares will be achieved. And, as it is a final withholding tax, the investment income will have no impact on family assistance, child support or student loan repayments.

For those collective investment vehicles which elect into the new rules the overtaxation on those earning under $38,000 a year is removed.

Editorial comment

A first thought is that it is a dramatic step to remove 33% income tax from the gains made from the sale of shares by collective investment vehicles. The proposal appears to involve the proposition that no tax is to be paid in relation to the share sale gains achieved by a pooled investment vehicle even if the scale of activities is significant enough to classify the entity as a "share trader".

Such a notion would be regarded by many as a significant departure from existing tax norms.

Two further comments are warranted. The first one is that the proposed exemption is directed at gains/losses from realisation. Interest and dividends will continue to attract tax in the usual way.

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The second comment would ask the question whether any benefit on this front is counterbalanced by the proposal to impose a "wealth tax" on offshore equities. The small size of the New Zealand market can naturally be expected to lead pooled investment vehicles to concentrate assets in foreign capital markets. As a consequence the New Zealand equities enjoying an exemption from income tax may be insignificant in comparison with the foreign equities attracting the wealth tax.

The proposals in this area are at least consistent with the traditional Government practice of "giving with one hand and taking with the other".

The reactions of the market to this proposal remain to be seen. One area that can be expected to come under scrutiny is the continued viability of passive investment funds. The principal rationale of these vehicles has been to preserve the capital gain status of share sale profits. With that concept extended across the board, at least in relation to New Zealand equities, the attractiveness of passive funds can be expected to diminish significantly.

Taxation of foreign equities

Ministerial statement

"... it is proposed to issue a discussion document within the next few weeks proposing to apply an income calculation method based on actual changes in value for investment funds, companies and individual investors.

Under the proposal, the grey list will be abolished for portfolio share investment. Collective investment vehicles will be taxed on the basis of the change in their accrued value. This would make for clearer rules, but in practical terms the results should be similar to the law as it currently applies for funds that are in the business of actively trading shares."

Editorial comment

There are several dimensions to this significant proposal.

The first aspect to scrutinise may be the impact on investment patterns. The investment choices available to a person wishing to provide for retirement comprise the traditional debt, equity and property investment classes.

Under the proposed system:

- New Zealand equities can generate tax-free capital gains.

- New Zealand real property can also generate tax-free capital gains.
- Foreign equities will attract a tax cost on an unrealised basis.

An investment regime of this kind can be expected to achieve little in loosening the traditional New Zealand affinity for investment in property. Tax reduces investment returns and investment funds can therefore be expected to flow to sectors without this tax cost.

This proposal may simply foster investment in the New Zealand market. There may be some nervousness as to whether the thin New Zealand market is truly robust enough for significant concentrations of investment funds.

One aspect that receives no comment is the relationship with Australia. Much government activity is devoted to harmonising regulatory rules with those of Australia. Prospectus requirements, for example, are creeping closer to alignment. It remains to be seen whether investment in Australia will be treated similarly to investment in New Zealand for tax purposes. If that alignment does not occur, Australia can be expected to be bemused by a New Zealand tax regime that treats Australia, as an investment destination, the same way that it would treat the world's most notorious tax haven.

The essence of this proposal will be apparent in the tax burden that it creates.

Budget papers give no indication of the taxable income that will be imputed on the changes in value subject to measurement as taxable income. The answer to this question is a matter of conjecture but the track record is not encouraging.

Many investors will vividly recall the significant declines for three years in the world's stock markets following the bursting of the stock market bubble in March 2000. Despite those unfortunate times the Government felt able to impute returns under the deemed rate of return system of 10.29% in 2001, 10.46% in 2002 and 9.9% in 2003. Imputing a return that has no relationship to market reality would be a most unfortunate outcome.

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A working tax holiday

Ministerial statement

"A temporary tax exemption of five years on foreign income will be made available to people who come to work here, whether they are foreigners or New Zealanders who have been non-resident for tax purposes for ten years. People who are not in employment will receive the same exemption for three years.

Tax on offshore income is an important issue for highly skilled people who are in demand internationally and for the businesses that recruit them from overseas. The new exemption will thus remove a tax barrier to New Zealand gaining the skilled people it needs."

Editorial comment

The Budget papers indicate that this proposal will cost $12 million per annum commencing in the 2007 financial year. Although the point is not addressed, it can be expected that the proposed exemption will commence for persons who come to New Zealand some time during the 2007 income year. It will not extend to persons who come beforehand and who still have a residue of the three- or five-year tax holiday period to go.

Another aspect that is not addressed is the treatment of investment vehicles associated with people who come to New Zealand. Particularly at the wealthy end of the spectrum, a typical profile is for investment assets to be housed in a trust or a limited liability company.

Under New Zealand's current rules relating to trusts, the new resident has a 12-month opportunity to "domesticate" the trust by exposing it to full New Zealand taxation on prospective income. If that election is not made, there is the prospect of 45% taxation on distributions received from what is classified as a non-qualifying trust.

It can be expected that this aspect will be addressed in the development of the new regime. It would be anomalous to exempt only personal foreign-sourced income but expose to full New Zealand tax the foreign income of a trust investment vehicle.

Share options

Ministerial statement

"Proposals are also being developed to change the tax treatment of employee share options."

Editorial comment

This possibly refers to practical issues including those arising over the timing of tax liabilities on the exercise of share options and international movements of employees. Care will be needed to ensure double taxation risks are not accentuated.

A paper setting out proposals will be released for discussion later this year.

Realignment of depreciation rates

Ministerial statement

"Tax depreciation rates will be changed to reflect better how assets decline in value. … [D]epreciation rates for short-lived plant and equipment will increase and depreciation rates on buildings will reduce."

Editorial comment

Current depreciation rates arguably disadvantage investment in short-lived assets while favouring buildings.

For plant and equipment the double declining balance depreciation method will apply. This means an asset with a 10-year economic life can be written off at 20% diminishing value. For example, the annual depreciation for new laptop computers will increase from 48% to 60% (including loading).

For buildings the straight-line depreciation method will be applied over their economic lives (together with an equivalent diminishing value method). For example, the annual depreciation for buildings will decrease from 4% to 3%.

The depreciation rate changes will apply to buildings acquired from today and to other assets acquired from 1 April 2005.

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Low-value asset write-offs

Ministerial statement

"… the low-value asset threshold will rise from $200 to $500"

Editorial comment

Compliance savings from this low-value asset write-off at the time of purchase include not needing to maintain and depreciate the particular asset item each year in the fixed asset register. Raising the threshold will also eliminate the adjustments needed when such an asset is ultimately disposed of.

This long overdue threshold adjustment is arguably still too low, particularly for larger businesses.

Fringe benefit tax

Ministerial statement

"I have already announced other major changes with respect to taxation. These related in particular to tax simplification and reforms to Fringe Benefit Tax."

Editorial comment

Motor vehicles

On 29 April 2005 the Minister announced that taxpayers could, from 1 April 2006, calculate FBT based on a motor vehicle's tax book value rather than cost.

However, the FBT valuation rate in these cases will be set at 36% (compared with 20% when based on cost).

In addition, leased vehicles will be treated on the same basis as owned vehicles.

Unclassified fringe benefits

Compliance costs will be slightly eased by raising the employee minimum value threshold from $75 to $200 per quarter and the employer threshold from $450 per quarter to $15,000 per year.

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Employer owned or leased business tools

Tools provided primarily for business purposes and costing less than $5,000 will be exempted from FBT.

Obvious examples include cell phones and laptop computers.

Other matters

The Government appears to have shelved the proposed changes to FBT on car parks but the issue of the business–private use boundary for vehicles remains a work in progress with officials.

Research and development expenditure

Ministerial statement

"As I announced last week, Budget 2005 will also give companies that bring in new equity investors better access to tax deductions for R&D expenditure."

Editorial comment

This measure will permit taxpaying entities to elect to carry forward R and D expenditure tax losses which may otherwise be lost because of changes in shareholding continuity.

The utilisation of these losses is restricted to the income subsequently arising from the R and D expenditure.

Foreign super schemes

Ministerial statement

"Other changes include resolving problems with foreign superannuation schemes."

Editorial comment

On 29 April 2005 the Minister announced changes designed to improve the position of inbound expatriates with foreign super scheme interests.

Certain specified Australian employment-related schemes will be exempted from New Zealand's Foreign Investment Fund rules.

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In addition, the existing exemption for new migrants will be extended to the end of the fifth year and opened up to returning New Zealanders.

The new changes will apply to persons becoming New Zealand residents from 1 April 2006.

Carbon tax

Ministerial statement

"Estimates are that the carbon tax will generate around $720 million over the forecast period ending 30 June 2009."

Editorial comment

The carbon tax will come into effect on 1 April 2007 and will be set at $15 per tonne of CO_2 equivalent. In the first full year (2007/08) the gross tax cost will be $526 million with rebates of $206 million, leaving a net annual overall tax cost of $322 million.

The net costings of the carbon tax are spread as follows:

2006/07 $80 million

2007/08 $322 million

2008/09 $319 million

Securities lending

Ministerial statement

"Qualifying transactions will now be treated on their economic substance rather than legal form."

Editorial comment

The rules will be updated to tax securities lenders on the basis of economic substance rather than legal form.

The Minister describes the updating of these rules as bringing them into line with other countries (eg, Australia), removing tax barriers and encouraging investment.

If the Minister's objective of removing tax barriers is to be achieved, care will be needed to ensure it is not swamped by the anti-avoidance measures directed at transactions transferring imputation credits.

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