

BUDGET 2010 SPECIAL REPORT – FRIDAY MAY 21, 2010

The tax package introduced yesterday proposes:

A cut to the personal income tax rates, with effect from 1 October 2010:

Income	Current Rates	From 1 October 2010
\$0–\$14,000	12.5%	10.5%
\$14,001–\$48,000	21.0%	17.5%
\$48,001–\$70,000	33.0%	30.0%
Over \$70,000	38.0%	33.0%

- An increase to the GST rate to 15%, with effect from 1 October 2010 (currently, 12.5%);
- A cut to the company tax rate to 28%, with effect from the 2011–12 income year (currently, 30%);
- A cut to the top tax rate for most portfolio investment entities (PIEs) to 28%, and a cut to other PIE rates to align with the new personal income tax rates, with effect from 1 October 2010;
- A cut to the tax rate for life insurance policy holders and widely-held savings vehicles to 28%, with effect from the 2011–12 income year (currently, 30%);
- That no depreciation deductions be allowed for buildings with an estimated useful life of 50 years or more from the 2011–12 income year. Mr English says that the treatment of commercial building fitout will be reviewed after the Budget and, if necessary, amended prior to 1 April 2011 to clarify the law on the split between buildings which will not be depreciable and separate assets which will continue to be depreciable;
- The removal of the 20% depreciation loading on new plant and equipment, for assets purchased from 21 May 2010;
- Changes to the tax rules applying to Loss Attributing Qualifying Companies (LAQCs) and Qualifying Companies (QCs) from 1 April 2011; and
- Changes to the GST rules to stop the use of “phoenix” GST fraud schemes.

The tax rate applying to trusts will remain at 33%.

[See comprehensive summary of the tax changes below, under the heading “Tax Reform: Centrepiece of Budget 2010 ”.]

Better Public Services

In his Executive Summary of the Budget, Mr English states that the Government is determined to focus on the high priority areas. Therefore, 75% of the \$1.1 billion operating allowance (or around \$800 million) has been allocated to improving health and education services and lifting science and innovation. Mr English states that most government agencies will see no additional funding for several years.

Budget 2010 allocates:

- An additional \$2.1 billion to Health over the next 4 years, including \$60 million to boost elective surgery and \$93 million for disability support;
- An additional \$1.6 billion to Education over the next 4 years, including funding for a 4% increase in operating expenditure for schools, \$349 million for school property, \$92 million for Early Childhood Education, and \$48 million for Youth Guarantee; and
- \$321 million to a range of science and R&D initiatives over the next 4 years.

Controlling the Government's Finances

Mr English says that the fiscal outlook has improved from last year. The projected operating deficit for the next financial year is \$8.6 billion, or 4.2% of GDP. And it is projected to improve steadily in each subsequent year, and to reach surplus in 2015–16.

Mr English says that the Government's long-term fiscal objective is to ensure that net debt is brought back to no more than 20% of GDP by the mid-2020s.

Tax Reform: Centerpiece of Budget 2010

The Government states that tax reform is a "centrepiece" of Budget 2010. The Government's objectives are to encourage savings and productive investment, to ensure the tax system rewards effort, to make the tax system fairer and to attract and retain skilled people in New Zealand.

The Budget is based around a shift towards lower and more uniform rates of income tax, more indirect taxation and broadening of existing tax bases. According to the Government, this represents the most thorough and beneficial overhaul of the tax system in 25 years.

The Government's two criteria for tax reform were:

- The need to be fair and to be seen to be fair. The package addresses some of the more obvious anomalies in the current system. It is also broadly neutral in terms of its impact on the income distribution. While higher income earners pay more tax and therefore receive larger personal income tax reductions, these groups also bear the impact of most of the tax base broadening. All household income groups will receive on average around a 0.5% to 1% increase in their real disposable income.
- Fiscal neutrality: Given the Government's commitment to strong finances and delivering public services, the package is also broadly fiscally neutral.

The key tax reforms included in Budget 2010 are:

- From 1 October 2010, personal taxes will be cut.
- GST will rise to 15%.
- NZ Superannuation, Working for Families and benefit payments will increase.
- From 1 October 2010, the tax rates for most PIEs and bank interest will fall. The tax rate for other savings vehicles will fall to 28% from 1 April 2011.
- From 1 April 2011, stricter rules governing the taxation of investment property will take effect.
- From the 2011–12 income year, the company tax rate will fall to 28%.

The following table shows the impact of the tax package as a percentage of average disposable income, by bands of household incomes:

	Less than \$40,000	\$40,000 to \$85,000	Over \$85,000
Personal income tax	0.9%	2.8%	4.2%
GST	-2.5%	-2.5%	-2.6%
Compensation via income support	2.6%	0.6%	0.1%
Other measures in the package	-0.3%	-0.5%	-1.0%
Net impact	0.7%	0.4%	0.7%

The tax reforms announced in Budget 2010 are each discussed in detail below.

Personal Tax Cuts

The Government's aims in introducing the personal tax cuts in Budget 2010 are to reward effort, help families get ahead and encourage savings.

- All personal income tax rates will be cut from 1 October 2010, as shown in the following table:

Income	Current rates	From 1 October 2010
\$0 - \$14,000	12.5%	10.5%
\$14,001-\$48,000	21.0%	17.5%
\$48,001-\$70,000	33.0%	30.0%
Over \$70,000	38.0%	33.0%

The Government states that lower personal tax rates reward effort and give people an increased incentive to up-skill, develop new products and services, and get ahead under their own steam, which has strong benefits for the economy. Further, lower personal tax rates provide an increased reason for skilled people to stay in, or move to, New Zealand, and will encourage saving, as people have higher after-tax incomes and pay less tax on their investment income. The top tax rate will now be the same as the trustee rate, which the Government believes is the most important thing it can do to improve the coherence and integrity of the tax system. The Government also stated that the new income tax rates more than compensate wage and salary earners for the increase in GST (see below).

The Government also states that:

- A person on the average annual wage of about \$50,000 will get a weekly income tax cut of about \$29 a week. Even after the increase in GST is taken

into account they are more than \$15 a week better off if they are paying an average rent or mortgage.

- Low and middle income earners have been the "big winners" when the collective impact of all tax cuts since 1996 - including Budget 2010 and excluding Working for Families – is considered. The Government states that after the Budget 2010 changes, workers earning between \$15,000 and \$50,000 a year are now paying between 40 and 50% less tax than they were in 1996.
- Aligning the top tax rate with the trust tax rate at 33% ensures wage earners in the top tax bracket - like many high-school teachers, nurses and police - no longer pay a higher rate of tax than wealthy individuals, who have been able to structure their affairs to effectively select the tax rate they want.
- Higher income earners get the biggest gain from these income tax cuts, but on the other hand bear the brunt of the other measures like depreciation changes (either directly or because they own shares in a company).
- The overall tax package has a broadly distributionally-neutral impact across household groups as a proportion of income.
- The cost of the personal tax cuts (excluding those on NZ Superannuation payments, which are included in the compensation package) is \$2.46 billion in 2010–11 rising to \$4.26 billion in 2013–14. These form part of a package of changes that overall are broadly fiscally neutral.

GST Increase and Associated Compensation Package

Budget 2010 announces that GST will be increased from 12.5% to 15%, from 1 October 2010.

Income support and other payments will be increased by 2.02% from 1 October 2010, to compensate for this increase. This will apply to all those receiving:

- All main benefits, such as the Unemployment Benefit, the Sickness Benefit, the Invalid's Benefit and the Domestic Purposes Benefit.
- The maximum rates of the Disability Allowance, Child Disability Allowance and Childcare subsidies paid through Work and Income.
- The Family Tax Credit and Minimum Family Tax Credit, which are part of the Working for Families scheme.
- Student Allowances.
- NZ Superannuation, Veterans Pension (see below) and CPI-adjusted payments from the Government Superannuation Fund or National Provident Fund.

According to the Government, personal tax cuts, plus compensation for GST, mean the vast bulk of people, are better off, even if they spend all of their income. GST does not tax savings, therefore an across the board reduction in personal income taxes, together with an increase in GST, encourages people to save, or pay off their mortgage, rather than consume. Further, New Zealand relies heavily on personal income and corporate taxes, which are harmful for economic growth. The Government believes that shifting the tax mix away from these taxes, and on to GST, is less distorting and better for the economy.

The Government also states that:

- The increase in GST will raise \$1.59 billion additional revenue in 2010–11, rising to \$2.46 billion by 2013–14.
- The compensation measures will cost about \$420 million in 2010–11, rising to about \$620 million a year by 2013–14. These figures include the impact of tax cuts on NZ Superannuation.

NZ Superannuation and Veterans Pension

From 1 October 2010, New Zealand Superannuation and Veterans Pension payments will rise, by the amounts shown in the table below.

People receiving NZ Superannuation or the Veterans Pension will get an increase in income for two reasons - across the board personal income tax cuts and a special 2.02% increase in NZ Superannuation payments to compensate for the rise in GST.

	Current rate	New rate	Increase
Single living alone	\$636.24	\$667.50	\$31.26
Single sharing	\$587.30	\$615.34	\$28.04
Married couple (each)	\$489.42	\$511.06	\$21.64

Company Tax

The company tax rate will fall from 30% to 28% from the 2011–12 income year. For most companies, this will apply from 1 April 2011.

Dividends issued after the new company rate takes effect will be allowed to be imputed at the existing 30% rate for 2 years if company tax has been paid at the 30% rate.

According to the Government, a lower company tax rate encourages productive investment in New Zealand, thereby increasing productivity, raising wages and creating jobs. New Zealand's company tax rate is high compared to most other developed countries, thus affecting international competitiveness. A lower rate will help companies which retain and reinvest earnings.

The Government notes that:

- The average company tax rate in the OECD in 2009 was 26.3%.
- Australia has just announced plans to lower its company tax rate to 28%, phased in over 3 years from 2012–13.
- About 360,000 companies registered in New Zealand filed tax returns in the last income year.
- The company rate reduction is part of a package of measures to widen the business tax base while lowering overall rates.
- Company tax is not a final tax for New Zealand shareholders. New Zealand shareholders are ultimately taxed at personal income tax rates, which have all been reduced as part of the tax package.

- The company tax cut will cost \$20 million in 2010–11, rising to \$340 million in 2011–12, and then falling to \$305 million in 2013–14. (These costs are affected by timing issues relating to the transitional imputation measure).

Portfolio Investment Entities, Life Insurance and Other Investment Vehicles

- The top tax rate for most portfolio investment entities (PIEs), including KiwiSaver accounts, will fall from 30% to 28%, while the other PIE rates drop to align with the new personal tax rates, from 1 October 2010.
- The tax rate for life insurance policy holders and widely-held savings vehicles like unit trusts and superannuation funds will fall from 30% to 28% from the 2011–12 income year.

The changes to the top rate for PIEs and savings vehicles will cost \$15 million in 2010–11, rising to \$60 million a year by 2013–14.

Resident Withholding Tax

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.

Banks and other financial institutions will automatically reduce the current RWT rate or PIE rate to the new rate when the changes take effect.

Depreciation

Depreciation Loading

Businesses will no longer be able to claim 20% accelerated depreciation on new plant and equipment. This change will apply to assets purchased after Budget day, 20 May 2010. The old rules will continue to apply for assets purchased before this date.

The Government considers that the 20% loading distorts people's decisions about what capital assets to invest in, at a real cost to the economy. For example, if a business buys a new car or computer, it gets the advantage of the depreciation loading but not if it buys a second-hand piece of machinery. The 20% loading also means some projects which do not "stack up" on their own merits are taking place, because they are effectively being subsidised by taxpayers.

Further, because of the 20% loading, New Zealand's overall depreciation allowances are more generous than in most other developed countries.

The Government expects that these changes will raise \$135 million in 2010–11, rising to \$345 million in 2013–14.

Building Depreciation

Depreciation deductions will no longer be allowed for buildings with an estimated useful life of 50 years or more, such as rental houses and offices.

These rules will change for all such buildings from the 2011–12 income year. For most businesses they will be effective from 1 April 2011.

The Government states that:

- Data indicates that, on average, New Zealand buildings do not drop in value over time. The current depreciation allowances therefore give a tax preference to owning property.
- The new rules will better reflect how buildings actually change in value and make the tax treatment of property fairer compared to other forms of investments. This will encourage productive investment in the economy.
- These changes will affect landlords, property investors, property investment companies and some business owners, who can currently claim depreciation at 3% (by the diminishing value method) or 2% (by the straight line method) of the purchase price of their building.
- Building owners will still be able to claim deductions for repairs and maintenance, to maintain the condition and value of their properties. They will also still be able to claim depreciation deductions for "fit outs" not considered part of the building. The Government intends to review the treatment of commercial "fit out" and, if necessary, amend the rules prior to 1 April 2011 to address any uncertainty in this area.
- Building owners will be able to apply to Inland Revenue for a provisional depreciation rate if they consider a class of buildings, has an estimated useful life of less than 50 years.
- These changes will raise \$685 million in 2011–12, rising to \$690 million in 2013–14.

Loss Attributing Qualifying Company and Qualifying Company Rules

The Loss Attributing Qualifying Company (LAQC) and Qualifying Company (QC) rules will be tightened from income years starting on or after 1 April 2011.

LAQCs and QCs will therefore become flow-through entities for tax purposes - similar to limited partnerships.

The rationale for this change is to prevent people choosing to have losses deducted at their marginal personal tax rate, but profits taxed at the lower company tax rate.

Inland Revenue and Treasury are releasing an issues paper on 20 May 2010 on the implementation of the new rules. Changes will take effect from income years starting on or after 1 April 2011, and legislation implementing these changes will be enacted later this year. The changes will affect only shareholders of QCs and LAQCs.

The changes are expected to generate additional revenue of \$70 million in 2011–12, falling to \$55 million a year by 2013–14.

Thin Capitalisation

The safe harbour in the inbound thin capitalisation rules ("thin cap") will be reduced from 75% to 60%.

This means foreign-owned companies will be able to claim only tax deductions for interest payments on debt up to 60% of their local asset value. The change therefore

limits the extent to which foreign multinationals can allocate debt to their New Zealand subsidiaries, claim tax deductions for the interest they pay on this debt, and therefore reduce the amount of tax they have to pay in New Zealand. There will only be an exception if the total multinational group's debt ratio is higher than this threshold.

This change will take place from the 2011–12 income year. For many businesses, this will be from 1 April 2011.

The Government also states:

- Debt is commonly used as a tax planning tool by multinationals operating in more than one tax jurisdiction. Like many other developed countries, New Zealand has rules to limit the scope for excessive amounts of debt to be loaded against the domestic tax base.
- The United States also has a 60% safe harbour in its interest allocation rules.
- This change will generate \$200 million a year in additional revenue from the 2011–12 income year.

Working For Families

- From 1 April 2011, people will no longer be able to use investment losses, including from rental properties, to reduce their income and become eligible for Working for Families (WFF).
- The Government states that WFF was designed to help low and middle-income families, not people with sufficient means to artificially inflate their eligibility. These changes are intended to make the system fairer.
- Changes to the treatment of income for Working for Families eligibility will affect property investors, higher-income recipients of WFF and people who structure their affairs to claim higher than intended levels of WFF. Inland Revenue estimates about 9,700 people getting WFF currently also claim rental property losses.
- One part of the formula that adjusts Working for Families payments for inflation will be amended because it currently gives higher-income families a greater proportional increase than lower-income families.
- Amending the formula moderates this over-adjustment for higher-income families, while leaving most lower income families unaffected.
- The Government also states that it 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 and will become a policy decision for the Government. The abatement threshold will remain at the current level of \$36,827, but the Government has kept the flexibility to increase the threshold in the future.
- The Government expects that the removal of automatic adjustment of the abatement threshold will save \$15 million in 2011–12, rising to \$40 million a

year by 2013–14, unless the Government elects to raise the threshold during that period.

- An issues paper will be released later in 2010. It will also look at whether other forms of income including income from some PIE and superannuation schemes and fringe benefits should be counted.
- It is expected that stopping investment losses being counted, and counting some other forms of income such as trust distributions, will generate \$5 million in 2010–11 rising to \$25 million a year by 2013–14.

Tax Avoidance and Tax Integrity

- Budget 2010 provides that Inland Revenue will get a \$119.3 million funding boost over four years, starting in 2010–11, to increase its audit and compliance activity around debt collection, the hidden economy and property transactions.
- The Government considers that increased audit and compliance activity is highly effective for tracking down people who are avoiding tax, including property speculators who are not paying tax on their property trading gains, and people who are operating outside the tax system altogether.
- GST rules will be changed to stop the use of so-called "phoenix" arrangements. Transactions between registered persons involving the transfer of land will be zero rated for GST. This change will take effect from 1 April 2011.
- This measure is intended to address transactions - particularly in the property sector - which have been occurring between associated parties, whereby one party claims a GST refund and the other party is wound up before it has to pay GST.

ACC

Budget 2010 provides \$2 million in new funding in 2010–11 for the provision of policy advice by the Department of Labour.

The extra funding allows an exploration of funding options and models including further analysis of the benefits of competition and choice in the Work Account. This is in line with National's 2008 election policy which stated it would investigate opening up the Work Account to competition and choice.

It also recognises that the Stocktake Steering Group's final report into ACC's accounts will be completed by 30 June this year.

Summary report provided by Brookers.