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Budget - May 2010

The national government's budget announced in May 2010 (the budget) is far reaching. The government strived for more of a "reallocation model" rather than overall tax increases which have been the flavour of past budgets. Following are details of the significant areas that have altered together with examples of practical application:

GST

From 1 October 2010 the GST rate will rise to 15%. This had previously been referred to in many government announcements and was not unexpected. GST is a broad based consumption tax and thus is hard to avoid. There are transitional provisions effective 1 October 2010 to account for this change. The government have amended benefits and superannuation by 2.02% in an endeavour to ensure that, on average, no parties are materially disadvantaged.

The New Calculations – 15%	The Current Calculations – 12.5%
$\text{GST} = \text{Gross Total} \times 3 \div 23$ $\text{GST} = \$115.00 \times 3 \div 23 = \15.00	$\text{GST} = \text{gross total} \div 9$ $\text{GST} = \$112.50 \div 9 = \%12.50$
$\text{gross total} = \text{net amount} \times 1.15$	$\text{gross total} = \text{net amount} \times 1.125$
$\text{net amount} = \text{gross total} \div 1.15$	$\text{net amount} = \text{gross total} \div 1.125$

Payments basis adjustment

All businesses GST registered on a payments (cash) basis must make an adjustment in their GST return covering 30 September 2010. The adjustment requires you to account for payments made and received from 1 October 2010 using the new GST 3/23rd fraction. This adjustment is made irrespective of the GST rate originally applied to the supply.

The adjustment calculation has three steps;

- 1) Calculate the amount of taxable supplies received and remaining payable to creditors at 30 September 2010.
- 2) Subtract the amount of taxable supplies receivable from debtors at 30 September 2010.
- 3) Multiply the balance by the old GST fraction (i.e. 1/9th) subtracted from the new GST fraction (i.e. 3/23rd), or more simply stated multiply the balance by 4/207ths.



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Example:

Tax Weary Limited is filing a six-monthly GST return and accounts for GST on a payments basis. A return is due to be filed for the period ending 30 September 2010.

At 30 September, Tax Weary Limited has the following debtors and creditors:

Debtors (GST incl.) \$32,850

Creditors (GST incl.) \$16,250

Adjustment calculated as

- 1) Creditors – debtors = \$(19,600)
- 2) $\$(19,600) \times 4/207 = \(378.74)

As the debtors exceeded the creditors the result is treated as a credit in box 13. Don't hesitate to contact us should you need help with this calculation.

Other Issues to consider

- i) Depending on your customer type will you be passing on or absorbing the GST rise?
- ii) What will be the impact of your decision in i) on your sales?
- iii) Prices lists, websites, marketing material, stationery may need to be updated.
- iv) Do you take deposits for work you undertake? You may need to increase them to cover for the higher GST.
- v) If you are an importer there are issues with the Deferred Payments Scheme account.
- vi) You should review all your contracts to confirm the GST adjustments/impact that may result.
- vii) Perpetual invoices e.g. rent, need to be re issued at the new amount.
- viii) Can your current accounting system cope with two rates at the same time?
- ix) Any property settlements bridging or close to the 1 October need to be carefully considered.



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Personal income tax rates

Taxable Income	Rate(until 30.09.10)	Rate(from 01.10.10)
\$0-\$14000	12.5%	10.05%
\$14,001 to \$48,000	21%	17.5%
\$48,001 to \$70,000	33%	30%
\$70,0001+	38%	33%

The personal income tax rates have been significantly reduced and the government estimates that someone on \$44k per annum will be \$11 per wk after tax better off.

Tax rates alignment

The top personal tax rate has been brought into alignment with the trust tax rate of 33% and the company tax rate reduced to 28% from the 2011 /2012 income year

This will remove many of the previous incentives for income splitting between different legal entities.

Reduction in personal tax rates: consequential changes

The rates at which tax is deducted from personal incomes come into effect on 1 October 2010. The changes affect a number of calculations undertaken by employers and provisional taxpayers.

PAYE

Employers need to ensure that they deduct the correct PAYE from employees' salaries and wages. The mid-year change in rates heightens the risk of incorrect PAYE deductions. Inland Revenue has indicated that the new PAYE tables and PAYE calculators will be available in early September.

Lump sum payments

Lump sum payments such as bonuses will be subject to the new deduction rates (10.5%, 17.5%, 30% and 33%) from 1 October 2010. For payments made between 1 October 2010 and 31 March 2011 the mid-year change may mean that additional tax will be payable at year end given that income tax is calculated on an annual basis. Inland Revenue is aware of the issue. A legislative fix to give employers flexibility with PAYE rates for such extra pays would be welcome.



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Example

An employee earns \$35,000 in the first six months of the 2010-2011 income tax year with tax withheld of \$8,075 (excluding ACC). The employee then receives a promotion and earns \$45,000 in the second six months with tax withheld of \$10,310 (excluding ACC). For the 2010-2011 income year, the employee has total income of \$80,000 with total tax payable of \$18,635 using the composite rates. However, the total tax withheld is only \$18,385 leaving a shortfall of \$250.

One question on employers' minds is whether to defer the payment of bonuses until after 1 October 2010 or after 1 April 2011 and the benefits and risks involved in doing so.

Deferral until after 1 October 2010

There will be no change in the recipient's ultimate tax liability if an employer defers a bonus until after the lower tax rates come into effect on 1 October 2010. This is because composite rates apply for the whole of the current (2010-2011) income year.

However, the PAYE deducted is likely to be different from the ultimate tax liability. Employees who receive bonuses on or after 1 October 2010 may have tax to pay at year end, whereas employees who receive bonuses before 30 September may be entitled to refunds.

Deferral until after 1 April 2011

Deferral until after 1 April 2011 will benefit employees, as the bonuses will be taxed at the lower tax rates. However, ACC rates are likely to rise reducing the benefit of deferral. Deferral also raises a number of issues, such as whether an employee is entitled to the bonus before it is paid out, whether the employer can contractually defer the payment of the bonus and whether the bonus is deductible if it is not paid out within 63 days of balance date.

Employees who exercise employee stock options after 1 April 2011 will also benefit from the lower personal tax rates. However, employees should consider the non-tax risks of any deferral exercise.

Fringe benefit tax

The flat rate for fringe benefit tax (FBT) will reduce from 61% to 49.25% from 1 October 2010. The multi rates have also changed in line with the changes to the personal tax rates. Composite rates apply for the 2010 - 2011 income year with the new rates applying fully from the 2011-2012 income year.



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Employer Superannuation Contribution Tax

From 1 October 2010 the rates and thresholds for employer superannuation contribution tax (ESCT), formerly known as SSCWT, will change. From the first pay period that ends on or after 1 October, employers will need to apply the new rates and thresholds to determine the tax they need to withhold on employer superannuation contributions.

Redundancy payment tax credit

The Taxation (Budget Measures) Act 2010 removes the redundancy payment tax credit for redundancy payments received on or after 1 October 2010. The credit provided a rebate of 6 cents for each dollar of redundancy payment, capped at \$3,600 (equating to a \$60,000 redundancy payment).

Tax rates on savings and investment

The resident withholding tax (RWT) rates on interest reduce from 1 October 2010 to align with the new personal tax rates. The top rate and the rate for non-declaration will reduce from 38% to 33%.

The tax rates on portfolio investment entities (PIEs) that pay tax based on investors' marginal tax rates will reduce to align with the new personal tax rates from 1 October 2010. However, tax will be capped at a maximum of 28%.

The fact that RWT and PIE rates change on 1 October 2010 means that investors will be able to access the full benefit of the new rates six months before the rates are available for other forms of income.

Provisional taxpayers

From 1 October 2010, the percentages used to calculate provisional tax under the uplift method will decrease to 95% for the 2011 and 2012 income years. This will allow individuals to reduce their amount of provisional tax payable due to the reduction in the personal tax rates.

Corporate tax rate change: issues and opportunities

From the beginning of the 2011-2012 income year, companies and certain other entities will be taxed at 28%.

Early balance date companies will have an advantage over standard and late balance date companies. For example, a 31 October balance date company will be subject to the new 28% rate from 1 November 2010 whereas a 30 September balance date company will not be taxed at the new 28% rate until 1 October 2011.



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The new rate is likely to encourage some business owners who currently operate their business as sole traders, partnerships or trading trusts to consider changing to a corporate model.

There may be some legitimate opportunities for businesses to defer income until after the 28% rate is introduced or incur expenditure earlier than they might otherwise have done in order to deduct it at the 30% rate.

Provisional tax

Special rules apply to corporate provisional taxpayers who use the uplift method. The standard uplifts of 105% (of the previous year's residual income tax (RIT)) and 110% (of the year before the previous year's RIT) are reduced to 100% and 105% respectively.

Imputation

The imputation ratio will change to 28/72 from 1 April 2011. However, the current ratio of 30/70 will be available until 31 March 2013 for the distribution of profits taxed at 30%. This will ensure that shareholders are not adversely affected when dividends are paid out in arrears. At the end of the transition period companies will be able to distribute any 30% tax credits but only at the new imputation ratio of 28/72.

Other consequential changes to be aware of include:

- From the beginning of the 2011-2012 income year, corporate shareholders will receive only a 28% tax credit for imputation credits attached to dividends received when the dividends are imputed at 30/70. However, they will still receive a full 30/70 credit to their imputation credit account.
- The resident withholding tax (RWT) rate will remain at 33%. For dividends imputed at 28/72, an additional 5% will have to be deducted as RWT.
- A new foreign investor tax credit (FITC) formula will apply when dividends paid to overseas-resident shareholders are imputed at 28/72. This will still result in a FITC equal to the supplementary dividend. The 30/70 FITC formula continues for dividends imputed at 30/70.



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Depreciation rates

The rate of depreciation for buildings with an estimated useful life of 50 years or more (as set out in Commissioner's depreciation determinations) - such as rental housing and office buildings - will reduce to 0%. This change comes into effect from the 2011-12 income year.

Buildings that were previously considered to be structures, and were purchased on or before 20 May 2010 will continue to be treated as structures for tax depreciation purposes. Any improvements to these buildings made after 20 May 2010 will have 0% depreciation rate.

Depreciation loading for assets

The 20% depreciation loading (a tax concession in the form of accelerated depreciation) will be removed for assets purchased after 20 May 2010. The economic rate of depreciation will apply.

Qualifying assets purchased, or with binding contracts for purchase, entered into on or before 20 May 2010 can continue to use the economic rate with loading.

The Building Depreciation Rate Reduces To 0% - What About Buildings Eventually Sold At A Loss?

Will any loss be income tax deductible, because of depreciation factors; where a building is sold for less than its book value?

IRD have not indicated that losses on the sale of buildings that have not been depreciated will be deductible. The legislation introduced to give effect to the 0% budget announcement for depreciation of buildings, did not amend the Tax Act which prohibits a deduction for a loss on the disposal of a building.

Continuing to deny a deduction for a loss on the sale of a building is in line with the stated reasons for denying a depreciation deduction - namely, that, on average, NZ buildings do not drop in value over time. Continuing to disallow a deduction for a capital loss on a building is also consistent with the treatment of losses on other capital investments.

The impact of nil depreciation rates on deferred tax

Many taxpayers that own buildings will have to recognise a deferred tax liability now that the Government has reduced the depreciation rate on buildings with a life of 50 years or more to 0%. The liability arises because from the 2011-2012 income year future tax deductions for depreciation will no longer be available. This is a transitional issue that applies to buildings held for use (rather than sale) on 20 May 2010.



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Companies need to consider the impact of this change on, for example, their net equity position, banking covenants, thin capitalisation position and NZX continuous disclosure requirements. Taxpayers will also need to determine which 'buildings' will be subject to the new depreciation rate of 0%.

Qualifying/Loss Attributing Qualifying Companies (QC's/LAQC'S)

The government had previously advised there would be significant changes made in this area. The indicative changes were announced with the budget and will come into effect 1 April 2011.

The proposals will significantly align QC's/LAQC's with the limited liability partnership regime already in place. Losses will be limited to the shareholders' "at risk amount", and profits will flow through to individual shareholders and not be taxed at the corporate level.

Transfer of shares in a QC will also give rise to a "deemed sale" of the proportionate share of the underlying assets which, in the cases of trading or property companies, could give rise to taxable income/ depreciation recovered.

From 1 April 2011:

1. LAQC's and QC's as we know them will go.
2. Existing LAQC's and QC's will become a flow-through entity called a QC.
3. All income of the QC will be taxable to the shareholders in proportion to their interest in the QC.
4. Losses of the QC will be deductible to the shareholders in proportion to their interest in the QC; but,
5. The loss deduction will be limited to the shareholders' economic interest in the QC ("the loss limitation rule").
6. QC's will be defined and treated as a partnership for tax purposes rather than a company, meaning:
 - Profits, capital gains, interest received, dividends received, expenses etc. will have to be distributed proportionately to all shareholders.
 - Private use adjustments will apply.
 - Working shareholders will have to have an employment contract and be in the PAYE system for "shareholders-employee salaries" to be deductible.
 - Shareholders will be personally liable for tax on remitted debts.
 - If a company ceases to be a QC there will be deemed disposals of assets at market value with the shareholders facing depreciation recovery, tax on gains from trading stock and possibly land.
 - The ceased QC will be deemed to acquire the assets at market value.
 - If a QC is liquidated there will be a disposal with tax consequences to the shareholders and if the assets are taken over *in specie* there will be a deemed acquisition at market value.



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- No imputation credit accounts will be required as all dividends will be tax-exempt.
- No limitation on foreign sourced income.
- All QC's will be only allowed to have one class of share.
- The QC will file an IR7 Partnership tax return.
- It appears (although the detail is unclear on this point) that trustees will be required to return QC income (taxed at 33%) rather than the current requirement to pass dividends through to beneficiaries.

Losses

The use of QC losses by shareholders will be subject to a loss limitation rule.

Shareholders will only be permitted a deduction for losses to the extent of their investment in the QC.

This is similar to the rule applying to limited partnerships. What is unclear is whether or not the value of personal guarantees will be able to be taken into account in calculating the extent of a shareholder's investment (the value of guarantees are taken into account when calculation the level of investment in a limited partnership). A shareholder in a QC will usually have made loans to the QC and guaranteed debt. The consultation document is silent on this point. We would expect however that the value of guarantees will be taken into account.

Unutilised losses will be carried forward by the shareholder.

So, what does this mean?

For property investors (or those that remain) the QC has probably had its day. We would be inclined to look at individual / partnership ownership of property investments or if the long term view is taken – trust ownership.

For small business, it is likely great news! The new QC is simpler to establish than a limited partnership, has all the advantages of partnership and has all the advantages of limited liability (except for income tax debt).

If you have any question regarding this, please give us a call on 968-4440.