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# Guide to the tax changes proposed in the Taxation (Budget Measures) Bill 2010

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*A special report from the*  
Policy Advice Division of Inland Revenue

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## Personal tax cuts

Under changes proposed in the Taxation (Budget Measures) Bill 2010, all personal income tax rates will be reduced from 1 October 2010.

To ensure that the effects of the tax cuts flow through the tax system appropriately, other consequential amendments to the tax Acts will be needed. The Taxation (Budget Measures) Bill 2010 therefore proposes to amend fringe benefit tax rates, secondary employment codes, withholding tax rates for casual agricultural employees and election day workers, extra pay rates, ESCT rates, PIE rates, RWT rates, RSCT rates, withholding rates for some Māori authority distributions, ACC attendant care withholding rates, child taxpayer tax credits and transitional circumstances tax credits. Transitional provisional tax rules for individual taxpayers are also proposed.

Redundancy payment tax credits are proposed to be removed from 1 October 2010, and fund withdrawal tax also phased out from that date.

### Key features

- Under the changes proposed in the bill, the new tax rates will apply to income earned by individuals from 1 October 2010.
- The bottom tax rate will be lowered from 12.5% to 10.5%, the 21% rate to 17.5%, the 33% rate to 30%, and the highest rate lowered from 38% to 33%.

- Consequential changes to other aspects of the tax legislation – such as PAYE tax and provisional tax, resident withholding tax rates for interest income, portfolio investment entity tax rates, and fringe benefit tax – will be made to coincide with these changes.
- The bill does not amend some withholding tax rates (for example, the 19.5% tax rate for Māori authorities, and certain withholding tax rates such as payments to horticultural contractors). These rates will be reviewed as it is not clear what rates are appropriate for these payments.

## Application date

Generally these changes apply from 1 October 2010.

Fund withdrawal tax will not apply to withdrawals that relate to contributions made on or after 1 October 2010.

Redundancy tax credits will not be available for redundancy payments derived after 1 October 2010.

## Detailed analysis

### Composite income tax rates for the 2010–11 income year (clause 71(1))

Income tax is calculated based on a person’s annual income. Because the proposed tax rates will be changing part-way through the 2010–11 income year, the new tax rates that will apply for the whole of the 2010–11 income year are “composite tax rates” that reflect an average of the two income tax rates that are used during the year. The table below shows the income tax rates that will be used during the 2010–11 income year as well as the composite tax rates for the year. The new composite rates will be contained in schedule 1, part A, table 1 of the Income Tax Act 2007 and are shown below:

	<i>Old tax rates applying to PAYE for the period 1 April 2010 – 30 Sept 2010</i>	<i>New tax rates applying to PAYE for the period 1 Oct 2010 – 31 March 2011</i>	<i>Composite tax rates for 2010–11 income year</i>
\$0 – \$14,000	12.5%	10.5%	11.5%
\$14,001 – \$48,000	21%	17.5%	19.25%
\$48,001 – \$70,000	33%	30%	31.5%
\$70,001 and over	38%	33%	35.5%

**Income tax rates for the 2011–12 and future income years (clause 71(2))**

Proposed schedule 1, part A, table 1 of the Income Tax Act 2007 provides for new income tax rates for the 2011–12 and future income years. The new rates will be:

***Income tax rates for the 2010–11 and future income years***

<i>Income range</i>	<i>Tax rate</i>
\$0 – \$14,000	10.5%
\$14,001 – \$48,000	17.5%
\$48,001 – \$70,000	30%
\$70,001 and over	33%

**PAYE rates: M and ML tax codes**

The new income tax rates will apply to PAYE for the first pay period that ends on or after 1 October 2010. For pay periods that span the 1 October date and are for a month or are shorter, PAYE will be deducted at the new rates. If the pay period spanning 1 October is longer than a month, then PAYE should be deducted at the old rate for the part of the pay period before 1 October and at the new rate for the part of the pay period after 1 October. The new rates will be:

***PAYE rates from 1 October 2010***

<i>Income range</i>	<i>Tax rate</i>
\$0 – \$14,000	10.5%
\$14,001 – \$48,000	17.5%
\$48,001 – \$70,000	30%
\$70,001 and over	33%

Inland Revenue’s PAYE deduction tables will be updated to reflect the new rates, so the M and ML tax codes reflect the new rates.

**PAYE rates: secondary employment income (clause 36)**

Proposed schedule 2, part A of the Income Tax Act 2007 reduces withholding tax rates on secondary employment income to reflect the new tax rates. This will apply from the first pay period that ends on or after 1 October 2010. The new rates will be:

***PAYE rates from 1 October 2010: secondary employment income***

<i>Income range</i>	<i>Tax code</i>	<i>Tax rate</i>
\$0 – \$14,000	SB	10.5%
\$14,001 – \$48,000	S	17.5%
\$48,001 – \$70,000	SH	30%
\$70,001 and over	ST	33%

### **Extra pays (clauses 37)**

Lump sums earned in the course of employment (“extra pays”) are generally taxed at the employee’s marginal rate. Proposed schedule 2, part B, table 1 of the Income Tax Act 2007 will reduce withholding tax rates on extra pays to reflect the new marginal tax rates. These will apply from the first pay period that ends on or after 1 October 2010. The new rates will be:

#### ***Tax rates for extra pays***

<i>Income range</i>	<i>Tax rate</i>
\$0 – \$14,000	10.5%
\$14,001 – \$48,000	17.5%
\$48,001 – \$70,000	30%
\$70,001 and over	33%

### **PAYE rates: casual agricultural employees and election day workers (clause 36)**

Proposed schedule 2, part A of the Income Tax Act 2007 reduces withholding tax rates for casual agricultural employees and election day workers. The rate will drop from 21% to 17.5%, to reflect the second-to-lowest marginal tax rate and will apply from the first pay period that ends on or after 1 October 2010.

### **Resident withholding tax rates on interest income for individuals (clause 32)**

Schedule 1, part D, table 2 of the Income Tax Act 2007 provides for new resident withholding tax (RWT) rates for individuals who receive interest income. These reflect the proposed new personal tax rates of 33%, 30%, 17.5% and 10.5%.

#### ***Non-declaration rate***

Row 1 of schedule 1, part D, table 2 will replace the previous 38% RWT rate that applied if a person had not supplied their interest payer with their tax file number with a 33% rate, to align with the new highest marginal tax rate.

#### ***Default rates***

Row 2 of schedule 1, part D, table 2 introduces a new 33% default rate from 1 October 2010 for people who have opened a new account with an interest payer after 31 March 2010 but do not elect a tax rate.

Row 5 of schedule 1, part D, table 2 provides for a 17.5% default rate from 1 October 2010 for people who have not opened a new account after 31 March 2010 and have not made a tax rate election.

Additionally, table 2 sets out transitional rules so that people who elected rates before 1 October 2010 shift automatically on that date to the relevant new RWT rates.

The new rates will apply from 1 October 2010.

**Consequential change to resident withholding tax rates on interest income for companies (clause 33)**

Schedule 1, part D, table 3, rows 3 and 4 are being amended to reflect changes to personal income tax rates. This will reduce the rate of resident withholding tax from 38% to 33% for interest paid to a company when the recipient of the interest has either elected for the top personal rate to apply or has not supplied their tax file number to the payer.

This will apply from 1 October 2010.

**Portfolio investment entity (PIE) rates (clauses 5, 6, 7, 8, 9, 30 and 39)**

Proposed schedule 6, table 1 is being amended to lower the tax rates that apply to investors in portfolio investment entities (PIEs). The new rates will be:

***PIE tax rates***

<b>Taxable income</b>	<b>Taxable + PIE income</b>	<b>PIE tax rate</b>
\$0 – \$14,000	\$0 – \$48,000	10.5%
\$0 – \$14,000	\$48,001 – \$70,000	17.5%
\$14,001 – \$48,000	\$0 – \$70,000	17.5%
\$48,001 and over	Any	28%
Any	\$70,001 and over	28%

Section HM 58 ensures that people who invest in PIEs before 1 October 2010 will automatically shift to the new equivalent rate on 1 October 2010, so that they do not need to re-elect their rate with the PIE.

These changes will apply from 1 October 2010.

**Provisional tax (clauses 25, 26, 27, 28, 29 and 30)**

The bill introduces changes to sections RZ 3 to RZ 5 to amend the formulas used to calculate provisional tax and allow individuals who pay provisional tax based on the earlier year method to reduce their provisional tax payments from 1 October 2010.

To calculate provisional tax from 1 October 2010 that is paid on the basis of an earlier year’s residual income tax (RIT), transitional factors will apply.

The following table provides adjustments to the transitional factors for individuals on the standard and the GST ratio methods for calculating provisional tax for the 2010–11 or later income years.

	Years			
	2010–11	2011–12	2012–13	2013–14
Standard method adjustment				
– 110% payment decreases to:	95%	95%	100%	
– 105% payment decreases to:	95%	95%		
GST ratio method adjustment				
– Two years before preceding year RIT decreases to:	80%	80%	85%	90%
– Year before preceding year RIT decreases to:	85%	85%	90%	
– Preceding year's RIT decreases to:	90%	90%		

For the 2010–11 income year the adjustments apply to provisional tax payments made on or after 1 October 2010.

Consequently, the formulas referred to in sections RZ 5B and RZ 5C from the 2008 Budget measures are repealed.

### **New FBT rates (clauses 64 to 70 and 72)**

Proposed changes to sections RD 50 to 53 and schedule 1, part C, table 1 of the Income Tax Act 2007 provide for new fringe benefit tax (FBT) rates and thresholds for attributed fringe benefits. These reflect the new personal tax rates. The changes will apply to the 2010–11 income year and subsequent income years. For the 2010–11 income year, composite rates apply to reflect the two sets of rates being used for that year.

The new FBT rates and thresholds for attribution purposes will be:

#### ***FBT rates for the 2010–11 income year***

<i>Income range</i>	<i>Tax rate</i>
\$0 – \$12,390	0.1299
\$12,391 – \$39,845	0.2384
\$39,846 – \$54,915	0.4599
\$54,916 and over	0.5504

#### ***FBT rates for the 2011–12 and subsequent income years***

<i>Income range</i>	<i>Tax rate</i>
\$0 – \$12,530	0.1171
\$12,531 – \$40,580	0.2121
\$40,581 – \$55,980	0.4286
\$55,981 and over	0.4925

Employers will still have the option of paying FBT at a single rate if they prefer. Proposed changes to sections RD 58 to 61 reduce the single rate from 61% to 49.25%. For close companies and small businesses that are able to file FBT returns annually, the applicable rate will also be reduced to 49.25 from the 2011–12 income year – however, for the 2010–11 income year, a composite rate of 55.04% will apply.

**New employer superannuation contribution tax rates (clause 31)**

Contributions that an employer makes to an employee’s superannuation scheme are generally taxed at the employee’s marginal tax rate. Proposed schedule 1, part D, table 1 of the Income Tax Act 2007 provides for new employer superannuation contribution tax (ESCT) rates. Under the changes proposed in the bill, the 12.5% rate has been dropped to 10.5% and the 21% rate has been dropped to 17.5%. The rate has been reduced from 33% to 30% for people who earn between \$57,601 and \$84,000.

The changes will apply from the first pay period that ends on or after 1 October 2010. The new rates will be:

***ESCT rates***

<i>Income range</i>	<i>Tax rate</i>
\$0 – \$16,800	0.105
\$16,801 – \$57,600	0.175
\$57,601 – \$84,000	0.300
\$84,001 and over	0.330

It should be noted that the income ranges at which the ESCT rates apply are higher than the income ranges that apply for personal tax rates. This is to reduce the risk that employer contributions made to employees whose income is close to a threshold are not overtaxed.

**New retirement superannuation contribution tax rates (clauses 35, 40 and 42)**

Contributions made by an approved entity to a member’s superannuation scheme are generally taxed at the member’s marginal rate under the retirement superannuation contribution tax (RSCT) rules. Proposed schedule 1, part D, table 5 and schedule 6, table 2 of the Income Tax Act 2007 provides for new RSCT rates that reflect the new personal tax rates.

A consequential change has also been made to section 28C of the Tax Administration Act 1994, which deals with notification of a person’s retirement scheme prescribed rate, to reflect the new top tax rate.

The changes will apply from 1 October 2010.

### **ACC attendant carers (clauses 38 and 73)**

Payments to ACC attendant carers are currently subject to a withholding tax rate of 12.5%, which reflects the bottom tax rate. Proposed schedule 4, part I, clause 1 reduces the withholding tax rate to 10.5% from 1 October 2010. A consequential change is also being made to section 33C(c) of the Tax Administration Act 1994. This will ensure that these taxpayers do not need to file a tax return if they used 10.5% or the 12.5% rate in the 2010–11 income year.

### **Payments from Māori authorities to members who have not provided a tax file number (clause 34)**

The current rate of tax for Māori authority distributions to members who have not provided a tax file number is 38% in schedule 1, part D, table 4. It is proposed that this rate be reduced to 33% to reflect the reduction in the top personal tax rate. The changes will apply from payments made on or after 1 October 2010.

### **Fund withdrawal tax (clause 4)**

Fund withdrawal tax (FWT) is a 5% tax payable on some superannuation fund withdrawals for members whose income is above \$70,000. FWT was introduced to ensure that taxpayers who are on the highest tax rate were not undertaxed under the employer contribution superannuation tax (ESCT) rules, as the top rate for ESCT was 33%.

As a consequence of the bill's proposal to align the top ESCT rate and the top personal tax rate, fund withdrawal tax is being phased out. Section CS 1 will be amended to ensure that FWT will not apply to withdrawals that relate to contributions made on or after 1 October 2010 (which is the proposed date of the changes to personal rates).

However, FWT will continue to apply to withdrawals that relate to contributions made before 1 October 2010 (before the top ESCT rate was aligned with the top marginal tax rate).

In some cases the trustee of the superannuation fund may not be able to establish whether an employer's superannuation contribution was made before or after 1 October 2010. In these cases, the income derived by the fund in section CS 1(2) can be reduced by 50% of the employer-sourced superannuation savings contributed during 2010–11 if:

- the withdrawal relates to an employer's superannuation contribution made during 2010–11; and
- the trustee of the fund cannot identify whether an employer's superannuation contribution was made in the last pay period ending on or after 1 October 2010.

Section CS 1 will provide that FWT will not apply to any withdrawals from income years beginning on or after 1 April 2015.



### **Child taxpayer credit (clause 59)**

The child taxpayer credit provides children with a tax rebate on income that is not interest or dividends. This allows an eligible child to earn income (less interest and dividends) up to \$2,340 a year tax-free.

As a result of the reduction in the lowest tax rate from 12.5% to 10.5%, section LC 3 of the Income Tax Act 2007 will be consequentially amended so that the current tax-free threshold stays at the same level.

The changes will apply to 2010–11 and later income years.

### **Transitional circumstances credit (clause 60)**

The transitional circumstances credit effectively provides a tax-free threshold of \$5,824. It is available for some people who earn under \$9,880. As a result of the reduction in the lowest tax rate from 12.5% to 10.5%, section LC 4 of the Income Tax Act 2007 will be consequentially amended so that the current tax-free threshold stays at the same level.

The changes will apply to 2010–11 and later income years.

### **Redundancy tax credit (clauses 10 and 11)**

Section ML 2(1) will be amended to remove the redundancy tax credit from 1 October 2010. The redundancy tax credit was originally introduced to ensure that the receipt of a redundancy payment did not cause a person to move up a tax threshold and be taxed at a significantly higher tax rate than they would ordinarily (the top personal tax rate at the time was 39%, which was 6% higher than the next highest personal tax rate at the time. The 39% rate has since been reduced to 38%). Because the 38% rate will be reduced to 33% from 1 October, and because there will be a smaller gap between the new 33% top personal tax rates and the next lowest rate of 30%, it is proposed this credit be repealed from 1 October.

# New tax rates for companies and savings

*(Clauses 5 to 9, 12 to 30, 39, 43, 87 to 91, 97 and 98)*

The Taxation (Budget Measures) Bill proposes changes to the tax rules for business and investments.

- The company tax rate is being reduced from 30% to 28%.
- The top tax rate for people saving through portfolio investment entities (PIEs) – including KiwiSaver funds – and other managed funds will also be reduced from 30% to 28%.
- Other tax rates that apply to KiwiSaver funds and other PIEs are being reduced in line with the changes to personal income tax rates.
- The safe harbour in the thin capitalisation rules that apply to foreign-controlled entities is being reduced from 75% to 60%.

Together, these reforms are intended to improve the competitiveness of New Zealand's company tax system and to encourage saving. The changes to the thin capitalisation rules support this objective by ensuring that tax rates apply effectively to foreign-controlled entities.

## **Key features**

The company tax rate will be reduced from 30% to 28%. This change also applies to unit trusts, which are taxed as companies. The resident withholding tax rules for interest paid to companies will be amended accordingly.

The top rate for people saving through PIEs and other managed funds is currently set at 30%. This will be reduced to 28%. The other tax rates that apply to multi-rate PIEs will be reduced in line with changes to personal income tax rates. Tax rates for investors in multi-rate PIEs will shift automatically from the old rates to the new rates when the changes take effect on 1 October 2010. The rates of retirement scheme contributions tax will be reduced in line with the changes to personal income tax rates.

The thin capitalisation rules deny interest deductions to the extent that the debt percentage (essentially, the debt-to-asset ratio) of a person's New Zealand group exceeds a specified "safe harbour" threshold and is also more than 110 percent of the debt percentage of that person's worldwide group. The safe harbour applying to foreign-controlled entities will be reduced from 75% to 60%. This will reduce the scope for foreign multinational enterprises to reduce the amount of New Zealand tax they pay by loading debt against their New Zealand operations.

A number of transitional arrangements will accompany the reduction in the company tax rate. These are based on similar arrangements that accompanied the previous reduction in the company tax rate to 30%. The transitional rules will:

- allow companies to continue to pay out imputation credits at the current 30/70 credit-to-dividend ratio until 31 March 2013, provided the credits arose when the company tax rate was 30% or 33%;
- allow shareholders – other than those eligible for the new 28% tax rate – to use these additional imputation credits to offset their tax; and
- allow companies that pay provisional tax using the uplift method or the GST ratio method to have immediate access to the tax cut.

## **Application dates**

For investments through multi-rate PIEs, including most KiwiSaver funds, the reduced tax rates – including the new 28% top rate – will apply from 1 October 2010.

For companies, and for investments through other managed funds, the reduction in the tax rate to 28% will apply for the 2011–12 and subsequent income years. The changes to the thin capitalisation rules will also apply for the 2011–12 and subsequent income years.

## **Detailed analysis**

Unless otherwise stated, references in the following paragraphs to sections and schedules relate to the Income Tax Act 2007.

### **Tax rates**

Under the proposed changes, the reduction in the company tax rate and the changes to the tax rates that apply to investments through PIEs and other managed funds will be achieved through amendments to a number of provisions.

Clause 2 of schedule 1, part A will be amended to reduce the company tax rate to 28%. Since the definition of “company” in section YA 1 includes unit trusts, this reduction will also apply to unit trusts. The lower company tax rate will automatically affect the maximum imputation and FDP crediting ratio under section OA 18, which will change from 30/70 to 28/72. A consequential amendment will be made to the formula in section LP 2(2) for calculating tax credits for supplementary dividends.

Clauses 5 and 6 of schedule 1, part A will be amended to similarly reduce the tax rate for group investment funds deriving category A income, approved unit trusts to which the Income Tax (Exempt Unit Trusts) Order 1990 applies, widely held group investment funds, and widely held superannuation funds. Clause 8 of schedule 1, part A will be amended to reduce the rate for life insurance policyholder income.

In schedule 1, part D, table 3, rows 1 and 2 will be amended to reduce the rate of resident withholding tax applicable to interest paid to companies where the payer of the interest has been supplied with the tax file number of the company and has either not received a payment rate election or has received a payment rate election choosing the 28% payment rate. Rows 3 and 4 will be amended in line with the changes to personal income tax rates, reducing the rate of resident withholding tax from 38% to 33% for interest paid to a company when the recipient of the interest has either elected for the top personal rate to apply or has not supplied their tax file number to the payer.

Changes to the prescribed rates for multi-rate PIEs will be effected through amendments to schedule 6, table 1.

Section HM 58, as amended, will operate to adjust automatically notified investor rates for multi-rate PIEs, unless the investor advises the PIE that a different rate should apply. Section HM 60(6) will be amended so that, if an investor does not notify a multi-rate PIE of their notified investor rate, the rate applied will be 28%.

Section HM 60(3) will be replaced by a new subsection (3) so that multi-rate PIEs can calculate tax for the 2010–11 income year using current notified investor rates for each day in the year up to and including 30 September, and the new lower rates for remaining days in the income year. The new lower rates that the multi-rate PIE will apply from 1 October will be the rate that was automatically adjusted on 1 October under the revised section HM 58 or another rate notified by the investor on or after 1 October. Consequential amendments to the PIE multi-rate calculation provisions in section HM 47(4)(a)(i) will be made to support this treatment.

Section HM 47(4)(ii) will be amended so that, if the PIE is treated as the sole investor, the rate applied will be 28%.

Retirement scheme contributions tax will be reduced by amendments to schedule 6, table 2.

Note that section CS 1, which deals with fund withdrawal tax on superannuation funds, will be amended as a consequence of the alignment of the top rate of employer superannuation contribution tax with a taxpayer's marginal rate. This is discussed further in the special report item that deals with the changes to personal income tax rates.

### **Provisional tax rules for companies and other 28% taxpayers excepting PIEs**

Provisional tax involves payments being made during an income year, in anticipation of an income tax liability for that year. Section RC 5 sets out various methods of calculating provisional tax.

The “standard method” of determining provisional tax liability, under section RC 5(2) and (3), looks to a person's residual income tax for a previous year, uplifting that amount by a specified percentage – normally either 5% or 10%, depending on the circumstances. In view of the reduction in the company tax rate, section RZ 3 will be amended to reduce temporarily the amount of that uplift for persons subject to the new company tax rate of 28%.

- Where the 5% uplift method applies, section RZ 3(1)(b) and (2)(b)(ii) modifies section RC 5(2) to eliminate any uplift for the 2011–12 income year.
- Where the 10% uplift method applies, section RZ 3(1)(b), (3)(b)(ii) and (c)(ii) modifies section RC 5(3) to reduce the amount of the uplift to 5% for the 2011–12 and 2012–13 income years (in this case, the modification applies for two years, because section RC 5(3) looks to a person’s residual income tax for the tax year *before* the preceding tax year).

Corresponding modifications to section RC 10 will be made by section RZ 5.

Some provisional taxpayers can choose to calculate their provisional tax payments using the “GST ratio method” under section RC 8. The GST ratio is normally calculated by dividing residual income tax for the preceding year by taxable supplies in that year, although in certain circumstances amounts from earlier years may be used instead. Section RZ 4 will modify section RC 8, reducing the income tax amounts used for the purposes of calculating the GST ratio to reflect the reduction in the company tax rate. For the 2011–12, 2012–13 and 2013–14 income years, section RZ 4(1)(b) and (2)(d) provides that the relevant income tax amount for a new company tax rate person is to be multiplied by 0.95 as set out in the following table:

<i>Tax year</i>	<i>Previous year</i>	<i>Year before previous year</i>	<i>2 years before previous year</i>
2011–12	.95	.95	.95
2012–13	na	.95	.95
2013–14	na	na	.95

### **Thin capitalisation rules for foreign-controlled entities**

For a person falling within their ambit, the thin capitalisation rules deny interest deductions to the extent that the debt percentage of that person’s New Zealand group exceeds the higher of two thresholds specified in section FE 5. One threshold is a “safe harbour”, currently set at 75%. The other threshold is determined as being 110% of the debt percentage of the person’s worldwide group (this threshold does not apply to natural persons).

The scope of the thin capitalisation rules was recently extended by the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009. Previously, the rules only applied to New Zealand taxpayers if they were, or were controlled by, a non-resident (section FE 2(1)(a) to (d)). They now also apply to New Zealand residents with an income interest in a CFC or with control of a resident company with such an interest (section FE 2(1)(e) to (g)).

Section FE 5 will be amended to reduce the safe harbour for taxpayers that are, or are controlled by, a non-resident from 75% to 60%. This lower safe-harbour is set by section FE 5(1)(a)(i) and (3)(a). The safe harbour for New Zealand residents with CFC interests remains at 75% (section FE 5(1)(b)(i) and (3)(b)). The 110% threshold is also unchanged (section FE 5(1)(a)(ii) and (b)(ii)). Consequential amendments will be made to section FE 6(3)(e) and section FE 12(2).

Section FE 18(5) sets the default percentage for the worldwide group of an excess debt entity. Currently, the default percentage is 68.1818, an amount that when multiplied by 110% is equivalent to a 75% safe harbour. This section will be amended so that, for taxpayers subject to the reduced safe harbour, the default percentage will become 54.5454: multiplied by 110%. This matches a 60% safe harbour.

The special thin capitalisation rules for banks are not affected by these changes.

## **Company tax: transitional arrangements**

### ***Imputation and FDP crediting ratios***

An immediate reduction of the crediting ratio allowed under section OA 18, which caps the ratio of imputation or FDP credits to dividends, has the potential to disadvantage shareholders if the dividends to which it applies represent a distribution of income that was taxed at 30%. Therefore, the legislation will allow this maximum ratio to be overridden for dividends paid during a transitional period, beginning on the first day of the company's 2011–12 income year and ending on 31 March 2013. During that period, companies will be able to attach imputation and FDP credits to dividends up to a maximum ratio of 30/70, provided the underlying income was taxed at 30% or 33%. This will be achieved by updating sections OZ 7 and OZ 8, which were introduced to deal with the previous company tax rate cut.

If a company imputes dividends using a 30/70 ratio after the 2010–11 income year to an extent that exceeds the credit balance in its imputation credit account relating to income taxed at 30%, a 10% transitional imputation penalty tax will apply under section 140C of the Tax Administration Act 1994. Penalty tax will only arise under section 140C if there is a debit balance relating to 30/70 credits on 31 March 2013. If penalty tax is also payable under section 140B because of an overdrawn balance at 31 March 2013, it will be reduced by any amount payable under section 140C.

### ***Benchmark dividends***

Under the current rules, sections OB 61 and OC 28 provide that the amount of imputation or FDP credits attached to the first dividend paid by a company in a tax year (the “benchmark dividend”) sets the imputation ratio for that year. The imputation ratio of subsequent dividends paid in the year must be the same as for the benchmark dividend, unless the company makes a ratio change declaration.

Section OZ 9 will be updated to modify the benchmark dividend ratios in sections OB 61(4) and OC 28(4). This will allow companies to change their crediting ratio from 30/70 to 28/72 without making a ratio change declaration. When the benchmark dividend was paid before the start of the 2011–12 income year and credited using a 30/70 ratio, section OZ 9 will allow subsequent dividends paid during the transitional period to be credited using a 28/72 ratio. In addition, if the benchmark dividend was credited using a 30/70 ratio under section OZ 8, section OZ 9 will allow a 28/72 ratio to be used for subsequent dividends once credits accrued under the 30% tax rate have run out.

### ***Shareholders' tax credits***

If the amount of imputation credits or FDP credits exceeds the maximum ratio allowed under section OA 18, the tax credit available to the shareholder is normally limited to that maximum. Section OZ 10 will be updated to modify sections LE 8 and LE 9 and sections LF 6 and LF 7, allowing shareholders to benefit from additional credits during the transitional period, when these have been attached to dividends in accordance with section OZ 8.

However, if the shareholder is a person, including a multi-rate PIE, eligible for the new 28% rate, section OZ 11 will limit the credit available against their tax liability based on a 28/72 ratio, even if the actual crediting ratio of the dividend was higher than this by virtue of section OZ 8. Since a new company tax rate person will only be subject to 28% tax on the dividend, it would be inappropriate to allow them to benefit from additional credits, which could be used to offset tax on other income.

### ***Tax credits for non-residents.***

The formula in section LP 2(2) for calculating tax credits for supplementary dividends will be amended, reflecting the new 28/72 crediting ratio. Section OZ 12 will be updated to maintain the existing formula for dividends imputed using a 30/70 ratio under the transitional rules.

### ***Available subscribed capital***

The concept of “available subscribed capital” is relevant when a company cancels its shares and pays consideration to compensate a shareholder for that cancellation. For the purposes of determining available subscribed capital, the extent to which a dividend is fully credited may be relevant. The extent to which a dividend is treated as credited is determined using the formula in section CD 43(26). Section OZ 13 will be updated to provide that a ratio of 28/72 should be used for the purposes of this formula even if a dividend has an imputation ratio up to 30/70 during the transitional period.

### ***Dividends from qualifying companies***

A dividend paid by a qualifying company is only taxable in the hands of the shareholder to the extent it is imputed: these dividends are therefore required to be imputed to the maximum extent possible under the imputation rules given the company's available credits. The formula for calculating the amount of a fully imputed distribution is set out in section HA 15(2). Section OZ 14 will be updated to modify this formula, to treat the tax rate as 30%, rather than 28%, for dividends paid during the transitional period to which section OZ 8 applies.

### ***Statutory producer boards and cooperative companies***

For a statutory producer board, the allocation of credits to cash distributions must be done according to the formula in section OB 73(4), while section OB 75(2) allocates credits to notional distributions. For cooperative companies, the equivalent provisions are sections OB 78(3) and OB 80(2). Section OZ 15 will be updated to allow these entities to use a 30/70 crediting ratio during the transitional period.

***Branch equivalent tax accounts and conduit tax relief accounts***

Sections OZ 16 and OZ 17 will be updated so that entries in the branch equivalent tax accounts or conduit tax relief accounts of companies or consolidated groups that relate to 2010–11 or earlier income years are adjusted in line with the proposed reduction in the company tax rate. This is because credit balances in these accounts will be used to offset tax liabilities calculated under the proposed new company tax rate.



# GST rate increase

This section of the Budget 2010 Special Tax Report provides early information on the proposed increase in the rate of goods and services tax (GST) covered in the Taxation (Budget Measures) Bill.

The rate of goods and services tax (GST) is being increased to 15% from 1 October 2010, as part of a switch in the tax mix from income tax to consumption tax. The GST rate was last increased in 1989.

New Zealand relies heavily on income taxes in order to fund expenditure. Income taxes may, however, be harmful for efficiency and growth. Taxes on consumption, such as GST, tend to be less harmful to growth as, unlike income taxes, they do not apply to savings and, therefore, do not discourage this activity. A switch from income tax towards GST can, therefore, boost incentives to save and encourage economic growth.

The merits of changing the tax mix were discussed in the report of Victoria University of Wellington's Tax Working Group *A Tax System for New Zealand's Future* released in January this year.

## Background

### How will it be calculated?

Under the proposed rate change, businesses and organisations registered for GST will be required to account for GST at the new rate of 15% from 1 October 2010. The rate of increase will also apply to goods imported on or after 1 October 2010.

The new tax fraction (the tax rate divided by the sum of 100 plus the tax rate) will be 3/23. This fraction can be applied to the price of goods or services to see how much GST is included in the price. For example, if the cost of a fridge is \$2,000 inclusive of GST, the GST included in the price will be \$260.87:<sup>1</sup>

$$\frac{(\$2,000 \times 3)}{23}$$

### Altering systems and prices

Businesses will need to alter their systems to incorporate the new rate. They may also alter the prices they charge for the goods and services they supply to cover the increased GST liability. This may not only impact on businesses' current stocks or transactions but also on their forward orders or deferred supplies.

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<sup>1</sup> The tax fraction under a 12.5% GST is 1/9, calculated as 12.5/112.5. Under that scenario the GST is  $\$2000/9 = \$222.22$ .

There are already rules within the GST Act to deal with transitional issues arising from a rate change. These rules provide for prices in existing contracts to be increased by the amount of GST in certain circumstances, and fees and other charges set by Act or regulation are automatically increased by the amount of the GST rate increase.

The current legislation ensures that government grants and subsidies are not automatically increased when there is a change in the GST rate. Instead the relevant administering public authorities will be considering the implications for grant recipients on a case-by-case basis over the coming months.

### **Filing returns**

As happened in 1989 when GST was last increased, there will be an effect on businesses' return filing. In particular, registered persons will continue to file GST returns at their normal times, but if the return period straddles 1 October 2010 the return will need to be split into two parts – the first covering the period up to 30 September and the second covering the remainder of the return period from 1 October. A special return will be provided for this purpose.

To simplify the accounting for those who return GST on either a payments or hybrid basis, the new 15% rate will apply to all payments made or received from 1 October. An adjustment based on the registered person's creditors and debtors as at 30 September 2010 will ensure that supplies provided before 1 October but which have not been paid for by that date will in effect be subject to the old lower rate. A similar adjustment mechanism applied in 1989.

If a taxpayer's GST taxable period spans the GST rate change and the taxpayer is required to make a combined GST and provisional tax payment, the transitional return will provide guidance on how to make the combined payment. Advice will also be provided on how to account for the GST on FBT, entertainment tax and other deemed supplies during the transition.

### **Time of supply rules**

The GST Act contains rules that determine the point in time when a GST-registered person must recognise a supply of goods and services that give rise to an output tax liability. In most cases this will be when the supplier issues an invoice or receives payment. The rules attempt to approximate when a transaction has been concluded and economic control of the goods and services has passed from the supplier to the recipient.<sup>2</sup>

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<sup>2</sup> Although the time-of-supply rules determine when GST-registered persons are required to recognise a liability for GST, the accounting basis adopted by the registered person can alter the taxable period in which that liability must be disclosed to Inland Revenue.

In general, the normal time of supply rules will apply over the transition period. For example, goods purchased through layby accounts will attract the higher 15% rate if the final payment is made on or after 1 October 2010.

Reliance on the normal time of supply rules may allow businesses to bring forward invoicing so they can take advantage of the old lower GST rate. In excessive cases the general anti-avoidance provision in the GST Act may be applicable if it is clearly evident that businesses are restructuring their business practices to bring forward a material number of transactions.

## **Communication**

Inland Revenue will be providing explanatory material to taxpayers on the changed requirements and transition arrangements. This includes advising taxpayers who use accounting software to manage their GST obligations about the need to contact their provider for upgrades to support a rate change. Inland Revenue will also be speaking to groups around the country about the tax package.

## **Legislative changes**

Some minor legislative changes are being made to the transitional provisions to remove interpretative ambiguity, to cover deemed supplies and to simplify the Act's return filing and record-keeping requirements for returns that straddle the rate-change date. Changes to the penalties rules are also proposed, to provide remission of late payment and late filing penalties and use-of-money interest in certain circumstances. These changes are explained below.

## **Key features**

- The rate of GST is being increased to 15% from 1 October 2010. All other key aspects of the GST rules are unaffected. The goods and services subject to GST are not being altered.
- The transitional rules that applied in 1989 will, with some minor modification, apply to this latest rate change.

## **Application date**

All changes apply from 1 October 2010.

## **Detailed analysis**

The minor legislative changes to the GST transitional provisions are:

### **Rate references (clauses 45–47)**

The rate specified in the GST Act is being amended so that businesses and organisations registered for GST are required to account for GST at the new rate of 15% from 1 October 2010. This also applies to goods imported on or after 1 October 2010. Accordingly, the rate references in sections 8(1) and 12(1) are being changed from “12.5” to “15”. The rate reference in section 10(6), which sets the GST rate charged on goods and service provided to individuals in long-term commercial accommodation, such as rest homes, is also being changed, from “7.5” to “9”.

### **Contract prices (clause 51)**

Some commentators have suggested that there is interpretative uncertainty over whether contract prices expressed as “inclusive of GST” can be increased by the amount of the GST rate increase. Given that many contracts will be expressed on a GST-inclusive basis, this issue should be put beyond doubt by amending the relevant section of the GST Act. The policy intent is clearly that contract prices expressed as GST inclusive should be able to be adjusted.

The uncertainty arises from the words in section 78(2) of the GST Act “or where the alteration in the law has been taken into account”. Accordingly, these words are being removed.

### **Deemed supplies (clauses 48–50)**

The GST Act deems supplies to take place in certain situations, such as when there is a fringe benefit, entertainment expenditure and change of use. Since the last GST rate increase in 1989, a number of changes have been made to these time of supply rules, aimed at reducing compliance costs by enabling taxpayers to file less frequently. An unintentional result is that when the GST rate is increased, some transactions that took place before the rate-change date will be subject to the new higher rate, in effect applying the rate change in advance of 1 October 2010. Additional transitional provisions are proposed to ensure that the old rate applies in these cases, to ensure that registered persons are neither disadvantaged nor advantaged by the rate change.

This is not an issue for FBT as under the FBT time of supply rule the supply is treated as taking place at the time the fringe benefit is or is deemed to be provided or granted. This means that the GST on fringe benefits provided before 1 October will be charged at 12.5%.

### ***Entertainment expenditure***

There is no similar rule for entertainment expenditure. That part of entertainment expenditure that is precluded from being deducted will be subject to the higher rate of GST as the supply is recognised on the date the registered person furnishes their income tax return for the tax year, irrespective of when within the year the entertainment took place.

The proposed solution is that for the 2010–11 tax year, the registered person would have the option of using the normal time of supply rule applicable to the deemed supply or treating the entertainment expenditure incurred before 1 October 2010 as being supplied on 30 September 2010. The expenses incurred over the rest of the tax year would be recognised on the date the registered person furnishes their income tax return for the 2010–11 tax year.

### ***Change-of-use adjustments***

Supplies are also deemed to occur when there is a change of use. Goods and services intended originally for business purposes may be used for making non-taxable supplies (that is, for exempt or private purposes). In this case output tax is payable. Conversely, goods and services intended originally for exempt or private purposes may be used in the registered person's business. In this case there is a deduction from output tax (calculated as the tax fraction applied to the lower of the market value or cost price of the good or service).

Some registered persons will be making the respective output tax or deduction from output tax in a period other than the taxable period in which there is a change of use. For example, many registered persons make the tax adjustment after the end of the tax year as part of finalising their annual accounts – the adjustments for 2010 would therefore be made in mid-2011. In this situation, the higher GST rate may apply even when the change of use took place before 1 October 2010.<sup>3</sup>

To ensure the old rate applies in such instances, the legislation will, with regard to a deduction from output tax, require a registered person to identify items that changed to a business use before 1 October 2010 and to apply a rate of 12.5% to them even if the deduction is made on or after 1 October. The legislative change will make it clear that the tax fraction mentioned in section 21F(1) is, in such cases, the tax fraction at the time the goods were acquired or imported by the registered person.

Similarly, when output tax is required to be paid as a result of the change of use, the legislation will explicitly provide the registered person with the additional option of identifying items that changed to a private use before 1 October 2010 and applying a rate of 12.5% to them, even if the output tax is attributed on or after 1 October 2010.

### **Return filing (clauses 51 and 53)**

Some minor legislative changes are being made to simplify the Act's return filing and record-keeping requirements for returns that straddle the rate change date.

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<sup>3</sup> This means, for example, that when a deduction in output tax is required, the deduction from output tax would be at the rate of 15% even though output tax would have been originally paid at 12.5% when the good or service was purchased.

Under the current rules, when there is a rate change the transitional mechanism in section 78B avoids the need for special time-of-supply rules for registered persons returning GST on a payments or hybrid basis. The adjustment also affects persons on an invoice basis who have purchased second-hand goods for their business which meet the “qualifying supplies” definition. All the amounts that they pay or receive are accounted for at the new rate but with an adjustment to recognise the fact that the time of supply for some of the transactions would have been before the rate change date.

Basically, the adjustment mechanism takes the difference between a registered person’s debtors and creditors immediately before the rate change and multiplies it by the difference between the old and new tax fractions. If the result is a positive amount (that is, creditors on hand exceed debtors on hand) it is treated as output tax in the return period. If it is negative (that is, debtors exceed creditors), the amount must be set off against GST liabilities in the preceding return period, with any balance being carried forward for use in the current return period, and so on. Any excess cannot be offset against the registered person’s other tax liabilities, or refunded.

The adjustments are recorded on a special adjustment form which must be furnished to the Commissioner of Inland Revenue.

The proposed legislative changes are:

- The requirement (in section 78B(2)(b)) that the registered person furnish the form on which they do their adjustment calculation to the Commissioner, is being removed. Instead, registered persons will only need to retain the form as part of their records, and include the adjustment with any other GST adjustments relevant to that return period. As a consequence of the removal of section 78B(2)(b), section 78B(4) which cross-referred to section 78B(2)(b), is being amended to include the references that were in section 78B(2)(b)(i) and (ii).
- Any excess credits will be able to be offset against the registered person’s other tax liabilities, or even refunded.

### **Application of penalties and use-of-money interest (clauses 55 and 56)**

The proposed new section 183AA of the Tax Administration Act 1994 provides for the automatic remission of late payment and late filing penalties and use-of-money interest in certain circumstances. Those circumstances are:

- that the lateness in filing or paying is reasonably attributable to the change in the GST rate (for example, the required systems changes to accommodate the new rate have not been able to be made in time); and
- the registered person has made reasonable efforts to comply and, therefore, shortfall penalties such as lack of reasonable care, would not be applicable.

If a shortfall penalty was imposed, then the registered person would not be eligible for the remission of late payment/late filing penalties and use-of-money interest under the proposed new remission provision. The remission would be for a limited time, focussing on the transitional return period(s). Subject to the passing of the Taxation (Budget Measures) Bill, Inland Revenue is intending to issue a statement shortly after Budget day expanding on this point.

Further legislative changes to section 139B of the Tax Administration Act ensure that the remitted penalties do not affect the late payment penalty grace period. That grace period allows a taxpayer to make an occasional error without the late payment penalty being imposed.

# Depreciation & capital contributions

This section of the Budget 2010 Special Tax Report describes the proposed changes to the depreciation rules that, if enacted, will take effect between 21 May 2010 and the beginning of the 2011–12 income year. The Taxation (Budget Measures) Bill 2010, introduced on 20 May 2010, gives effect to these announcements.

The bill changes the depreciation rate of buildings with long estimated useful lives to 0%, and removes depreciation loading on items purchased after 20 May 2010. Additionally, the bill changes the treatment of capital contributions, so that recipients of these payments will have to choose either to treat the contribution as income spread over 10 years, or alternatively, reduce the tax book value of the subsidised assets. Finally, the bill introduces provisions to grandparent the treatment of buildings affected by the release by Inland Revenue of Interpretation Statement 10/02.

## Background

The proposed changes are intended to make New Zealand's tax rules more neutral and non-distortionary. Allowing depreciation on long-lived buildings and the application of depreciation loading on certain assets provides tax depreciation rates in excess of true economic depreciation rates. When this occurs, the tax rules can make an investment profitable when this would not be so in the absence of taxes.

The bill also changes the tax treatment of capital contributions. These contributions are generally not taxed even though businesses may be able to deduct, by way of depreciation, the full cost of any assets that the contributions have been used to pay for. This, in effect, is a tax subsidy.

## Building depreciation

Currently, buildings with an estimated useful life of 50 years can be depreciated for tax purposes. However, analysis of New Zealand building price data between 1993 and 2009 shows that, on average, buildings have actually been increasing in value. This suggests that the current depreciation rate of 2% is not appropriate.

To address this concern, the bill sets a 0% depreciation rate for buildings with an estimated useful life of 50 years or more. This new rate will apply to all such buildings regardless of when they were purchased.

## Grandparenting existing treatment of some buildings

Inland Revenue's Public Rulings unit has recently released the interpretation statement *Meaning of "building" in the depreciation provisions* (IS 10/02). Under this statement, some items that were previously treated as structures will come within the meaning of "building". This means there will be a change to the way these investments are treated for tax depreciation purposes.



On 30 July 2009, following the release of a draft of this interpretation statement, the Minister of Revenue issued a statement providing that the existing treatment of any affected structure acquired on or before the day of the announcement would be grandfathered. To facilitate this grandfathering, the bill specifies that a “building” does not include these affected structures.

### **Depreciation loading**

Under the current rules, depreciation loading increases the depreciation rate by 20% for qualifying items. This concession has been available for items purchased during or after the 1995–96 income year.

Depreciation loading was introduced as an incentive to encourage New Zealand businesses to invest in new capital equipment. However, this concession is inconsistent with a broad-based, low rate tax system, and the bill therefore seeks its removal from items purchased after 20 May 2010.

### **Capital contributions**

A capital contribution is a subsidy or similar payment to a person that compensates them for some capital expenditure. A common example is a payment from a farmer to an electricity lines company towards the cost of connecting their farmhouse to the company’s network.

Currently, capital contributions are not taxable in the hands of the recipient as they are capital in nature. Additionally, the recipient may be able to deduct, by way of depreciation, the cost of the assets acquired with the capital contribution. In other words, the recipient can claim deductions for expenditure they have not borne the financial cost of.

The bill changes the tax treatment of capital contributions so that people who receive capital contributions will, in their tax return in the year the contribution is received, be required to elect either to treat the contribution as income, spread over 10 years, or alternatively reduce the tax value of the assets the contribution has been used to pay for. These new rules apply to capital contributions derived after 20 May 2010.

## **Key features**

### **0% depreciation rate for certain buildings**

- Under the changes in the bill, the annual depreciation rate for buildings will be set to 0% if they have estimated useful lives of 50 years or more, as determined by the Commissioner of Inland Revenue.
- The annual depreciation rate will also be set to 0% for certain buildings that are excluded depreciable property and that are similar to the types of buildings with estimated useful lives of 50 years, as these do not have estimated useful lives.
- This new rate will apply regardless of when a building was acquired.

- Building owners that have previously claimed a depreciation deduction on their buildings will still be required to pay depreciation recovery if they sell a building for more than its tax book value.
- To ensure that the policy works as intended, special depreciation rates will no longer be allowed for buildings and the definition of “temporary building” will also be amended.

### **Grandparenting existing treatment of some buildings**

- Certain buildings that have been treated as structures and were purchased on or before 30 July 2009, will continue to be treated as structures for tax depreciation purposes.
- Any improvements to these buildings made after 30 July 2009 will not receive grandparented treatment.

### **No depreciation loading for assets acquired after 20 May 2010**

- The bill removes depreciation loading for assets purchased after 20 May 2010.
- Depreciation loading will continue to apply to qualifying assets purchased on or before 20 May 2010.
- Any improvements to assets that continue to receive loading made after 20 May 2010 will have to be treated as a separate asset and will not qualify for loading.

### **New treatment of capital contributions**

- The bill requires businesses who receive a capital contribution to choose how to treat the receipt for income tax purposes – either as income or as a reduction in their depreciation base. Different treatments can be elected for each capital contribution; however, once an election is made it may not be changed.
- If a business decides to treat a contribution as income, then it would return 1/10th of the contribution as taxable income every year for 10 years.
- If a business decides to reduce its depreciation base, it would reduce the tax book value of the relevant assets to the extent that they have been funded through the capital contribution.
- This proposed change only affects new capital contribution arrangements. It would not affect contributions derived on or before 20 May 2010.

### **Application date**

The new rules for building depreciation will generally apply from the beginning of the 2011–12 income year. For most people this is 1 April 2011, but if you have had a different income year approved by the Commissioner of Inland Revenue, these would apply from that date. For taxpayers with an early balance date, this may be as soon as 2 October 2010.

Taxpayers will no longer be able to apply for special depreciation rates for buildings from 20 May 2010.

The new rules for depreciation loading will apply to all items for which a binding contract for acquisition or construction was entered into after 20 May 2010.

The new rules for capital contributions will apply to all contributions derived after 20 May 2010.

The rules providing the grandparenting of buildings affected by IS 10/02 will apply retrospectively from 30 July 2009.

## **Detailed analysis**

The depreciation provisions are largely contained in subpart EE of the Income Tax Act 2007. The proposed rules for the new treatment of capital contributions are set out in new sections CG 8 and DB 64 of the Income Tax Act 2007.

Unless otherwise stated, all section references are to the Income Tax Act 2007.

### **0% depreciation rate for long-lived buildings**

#### ***Annual rate for buildings with long estimated useful lives (clauses 77, 81, 85 and 86)***

The bill amends sections EE 31 and EZ 13 to provide that buildings with an estimated useful life of 50 years or more will have an annual depreciation rate of 0% for tax purposes. This 0% rate is a statutory rate and overrides the rates set by determination.

The changes to section EE 31 apply to buildings acquired during or after the 1995–96 income year, while the changes to section EZ 13 apply to buildings acquired after 1 April 1993 but before the end of the 1994–95 income year.

These buildings will still be depreciable property, but with a 0% annual depreciation rate. This means that the other depreciation provisions, such as those providing for depreciation recovery still apply.

While the depreciation rate for these buildings will be set to 0%, the depreciation rate for items used in, but not part of, these buildings remains unchanged, and they will be able to continue to be depreciated separately from the building itself.

For residential rental properties, the interpretation statement *Residential rental properties – depreciation of depreciable assets* (IS 10/01) sets out how to determine whether an item is part of a building or separately depreciable.

For non-residential properties, the Government has indicated it will be reviewing which items can be depreciated separately from a building. If necessary, the tax rules will be amended before 1 April 2011 to clarify the law.

## ***Repairs and maintenance***

The proposed changes will not affect the deductibility of repairs and maintenance. While this can be a complicated matter, with the correct treatment often being a question of both fact and degree, some general guidance is set out below.

There is a two-stage approach to determine whether certain expenditure is deductible:

1. Identify the relevant asset – that is, is the item being repaired/replaced part of a larger asset (such as the roof of a house), or is it a single asset (for example, a television).
2. Ascertain the nature, extent and cost of the work undertaken. This will involve determining whether the work remedied wear and tear (generally deductible), or whether the asset has been improved or otherwise substantially changed (generally non-deductible).

In relation to step 2, some relevant factors are:

- If the expenditure does no more than restore an asset to its condition on purchase, it is likely to be deductible. This can hold even if the work is carried out over several years.
- This applies even if what is being replaced or repaired is improved – for example, because of new technology or better design, provided the work does not alter a substantial part of the asset.
- Expenditure on the renewal, replacement or reconstruction of a substantial portion of the asset goes beyond repair, and is generally not deductible repairs and maintenance.
- Work that results in a significant increase in an asset's value, or is unusually expensive, is more likely to be considered capital in nature.

As discussed above, a building can have many different parts. Repairing or replacing something that forms part of a building, provided it does not substantially improve or alter value or function of the building, is likely to be deductible. If, on the other hand, a substantial amount of work is involved, or the building is improved in some way, it is likely that this will be non-deductible capital expenditure. For example, the replacement of a toilet that has fallen into disrepair in a residential house (which is part of the building as per IS 10/01) is likely to be deductible as repairs and maintenance. On the other hand, if the entire bathroom were to be re-designed and completely re-fitted, this is more likely to be a non-deductible capital improvement.

## ***Definition of “building”***

The bill only affects the depreciation rate of buildings – there is no proposed change to the depreciation rates for structures. What a “building” is, for the purposes of the depreciation provisions, therefore becomes important. The Commissioner of Inland Revenue's view on this is set out in the recently released interpretation statement *Meaning of “building” in the depreciation provisions* (IS 10/02).

In essence, a building is a structure that has walls and a roof, is of considerable size, is meant to last a considerable period of time and is generally fixed to the land where it stands. For example, a house has the above features and so would be considered a building; however, a dam does not (it lacks walls and a roof), so would not be considered a building.

For more guidance on this issue, the interpretation statement IS 10/02 is available on Inland Revenue's website, [www.ird.govt.nz](http://www.ird.govt.nz).

### ***Interpretation of estimated useful life***

An item's estimated useful life is the estimated useful life for that type of item, as set out in a determination issued by the Commissioner of Inland Revenue. Additionally, when interpreting an item's estimated useful life, the "whole of life" approach should be taken. For example, if a person purchases a second-hand item with an estimated useful life of 50 years, its estimated useful life will still be 50 years, regardless of how old the item actually is.

### ***No special rate for buildings (clause 78)***

The bill amends section EE 35(2) so that special depreciation rates would not be able to be set for buildings, regardless of their estimated useful lives. Special depreciation rates are granted in situations where a specific item's economic depreciation rate is either faster or slower than the rate set by the Commissioner of Inland Revenue. This change would have effect from 20 May 2010.

The bill removes this ability to apply for special rates for buildings as allowing these would be inconsistent with the general view that buildings, do not on average, decline in value.

However, provisional depreciation rates will still be able to be set for classes of buildings. If the Commissioner of Inland Revenue issues a provisional rate for a class of building stating that it has an estimated useful life of less than 50 years, owners of affected buildings will be able to claim depreciation deductions.

Provisional depreciation rates are granted when there is no applicable rate for the type of item you own, excluding the default class. To have a provisional rate granted, you must satisfy the Commissioner that the building you own does not come within an existing asset category.

Applications for provisional rates can be made using the form IR 260A, available from Inland Revenue's website at [www.ird.govt.nz](http://www.ird.govt.nz).

### ***Special excluded depreciable property (clauses 82, 83, 96 and 99)***

Section EE 67 will be amended to provide a definition for "special excluded depreciable property". Special excluded depreciable property will be all buildings not listed in the proposed new schedule 39.

In practice, special excluded depreciable property will be buildings that were excluded depreciable property, and are similar to the current categories of building that have estimated useful lives of 50 years or more.

The asset classes listed in this schedule are from the depreciation rates issued by the Commissioner of Inland Revenue before 1 April 1993. In some cases, the names of these classes differ from those currently used in the depreciation determinations.

This definition of “special excluded depreciable property” is necessary because items of excluded depreciable property do not have estimated useful lives. It is therefore not possible to refer to these buildings using estimated useful lives.

***0% annual depreciation rate for special excluded depreciable property (clause 81)***

Section EE 61 is being amended with new subsection 7B, which will provide that the annual depreciation rate for items of special excluded depreciable property that are excluded depreciable property is 0%.

This statutory rate will override any depreciation rate issued by the Commissioner of Inland Revenue.

Buildings that are excluded depreciable property but not special excluded depreciable property would continue to be depreciated using the appropriate depreciation rates.

***Change to the meaning of “temporary building” (clause 96)***

Paragraph (a) in the definition of “temporary building” in section YA 1 will be repealed. This paragraph provides that a “temporary building” includes buildings issued under a permit by a local or public authority that stipulates that the building be removed or demolished at their request.

This will ensure the proposed changes work as intended, as otherwise building owners could claim that their building was a temporary building using this section of the definition.

**Example 1: Building depreciation – proposed treatment**

Jack owns two buildings that he is currently allowed to claim depreciation deductions for. One building is a residential rental house and the other is a glasshouse.

For the 2010–11 income year, the applicable depreciation rates are 2% straight-line for the rental house and 5% straight-line for the glasshouse. This means Jack can claim depreciation deductions of 2% and 5% of the respective building’s cost.

Depreciation determination DEP1 provides that the rental house currently has a useful life of 50 years and that the glasshouse has a useful life of 20 years. Therefore, for the 2011–12 income year, the applicable depreciation rates are 0% for the rental house and 5% straight-line for the glasshouse. This means Jack cannot claim depreciation deductions for his rental house, but can continue to claim them for the glasshouse at a rate of 5%.

## **Grandparenting existing treatment of some buildings**

### ***Certain structures purchased on or before 30 July 2009 not buildings (clause 96)***

Amendments to section YA 1 will add a definition for buildings, which specifies that, in the depreciation provisions, “building” does not include a grandparented structure. This definition of “building” excludes “grandparented structures” from the common law meaning of “building”. This proposed definition is not intended to detract from the Commissioner’s interpretation statement IS 10/02 *Meaning of Building*. Instead, the definition is intended to grandparent investments, made before 30 July 2009, in certain types of structures from the depreciation rules applying to buildings.

This means these buildings will continue to be treated as structures for the purposes of the depreciation provisions (notwithstanding that they are buildings under the Commissioner’s interpretation statement IS 10/02). For example, their relevant depreciation rates will still be set using the double-declining balance method, and losses incurred on disposal will remain tax deductible.

The proposed definition of “grandparented structure” is an item on the following list, provided its owner acquired it, or entered into a binding contract for its acquisition or construction, on or before 30 July 2009:

- (a) barns, including barns (drying)
- (b) carparks (buildings)
- (c) chemical works
- (d) fertiliser works
- (e) powder drying buildings
- (f) site huts.

More detail on the types of items covered by the definition of “grandparented structure” can be found in IS 10/02, available on Inland Revenue’s website. For example, carparks (buildings) does not include a commercial building that contains carparks.

### ***Some carparking buildings continue to depreciate***

The proposed grandparenting of carparking buildings, described above, will mean that carparking buildings purchased on or before 30 July 2009 will not be subject to a 0% annual depreciation rate.

### ***Improvements to grandparented structures building (clause 79)***

Changes to section EE 37 provide that if a person owns a grandparented structure, and they make the improvements, or enter into a binding contract to make them, after 30 July 2009, then the improvement must be treated as a separate item.

This effect of this proposed amendment is that any new improvements to grandparented structures will be treated as buildings. This will mean, for example, losses on disposal on the improvements will not be available. In the case of carparking buildings, this will mean the annual depreciation rate of any improvements will be 0%.

## **Removal of depreciation loading**

### ***No depreciation loading for items purchased after 20 May 2010 (clauses 77 and 81)***

The bill amends EE 31 with new subsection (3). This subsection will apply when a binding contract for an asset's acquisition or construction is entered into after 20 May 2010, and provide that an asset's annual depreciation rate is just its applicable economic, special or provisional rate, unless the item is a long-lived building or international aircraft.

This contrasts with existing subsection (2), which applies to assets for which a binding contract for acquisition existed on or before 20 May 2010. Under this section, many assets have an annual rate of their applicable economic, special or provisional depreciation rates multiplied by 1.2. This acceleration of depreciation rates is often referred to as depreciation loading.

### ***Treatment of improvements (clause 79)***

Amendments to section EE 37 apply if a person owns an asset that will continue to receive loading after 20 May 2010. It provides that if they make improvements to it, or enter into a binding contract to make improvements to it, then they must treat the improvements as separate items. Therefore, the annual depreciation rate for these improvements would be set by the proposed subsection EE 31(3) (Rate for item acquired after 20 May 2010).

The effect of this is that any improvements made to existing assets will not be eligible for depreciation loading. Such improvements will depreciate for tax purposes at the appropriate rate as set by the Commissioner of Inland Revenue.

#### **Example 2: Depreciation loading – proposed treatment**

On 1 April 2010, A Co Ltd. purchased \$10,000 worth of laptop computers. Laptop computers have a 40% straight-line depreciation rate, but as they are eligible for loading, A Co Ltd. is able to claim depreciation deductions of 48% of their value, or \$4,800 each year.

On 1 April 2011, A Co Ltd. purchased another order of \$10,000 worth of laptop computers. However, as they have been purchased after 20 May 2010, A Co Ltd. is only able to claim depreciation deductions of 40% of their value, or \$4,000 each year.

This means, for the 2011–12 income year, A Co Ltd. can deduct \$4,800 for depreciation of the earlier laptops and \$4,000 for the later laptops.

## **New treatment of capital contributions**

### ***Capital contributions either income or non-deductible (clauses 75, 76 and 96)***

New sections CG 8 and DB 64 set out a new tax treatment for capital contributions.



The bill amends the definition of “capital contribution” in section YA 1. Outside of section HG 11, a capital contribution would mean an amount that:

- (i) is paid to a person (the payer) to a person (the recipient) under an agreement between them that is not a contract of insurance;
- (ii) is paid by the payer other than in their capacity of settler, partner or shareholder of the recipient;
- (iii) is not income of the recipient, ignoring section CG 8;
- (iv) is paid, under the express terms and conditions of the agreement, as a contribution for depreciable property owned or to be acquired by the recipient.

Part (i) of this definition ensures that insurance pay-outs to cover the replacement of damaged assets do not fall within this definition, as they are not capital contributions. Part (ii) ensures that payments by settlers, partners or shareholders who are introducing capital into their own businesses in their capacity as owners are not included.

The proposed new section CG 8 provides that a capital contribution that a person receives is treated as income in the income year it is received and the nine following income years. The formula for calculating the amount that is income in each income year is set out in section CG 8(2). This is simply the amount of the contribution divided by 10.

Section CG 8 provides the default treatment. However, if a person elects, they could instead use the treatment in section DB 64. This election is provided because it was recognised that some businesses would have difficulty implementing section DB 64.

Section DB 64, applies when a person derives a capital contribution and would be allowed an amount of depreciation loss for the acquired assets. Subsection (2) provides that the amount of the capital contribution would be excluded from the item’s adjusted tax value, base value, cost, or value, as applicable, for the purposes of part EE (Depreciation). Essentially, this means the recipient would not be able to claim depreciation deductions to the extent that any acquired assets have been paid for by capital contributions.

Any election must be made in the recipient’s tax return for the income year in which the relevant capital contribution is derived. Each new capital contribution would require a new election, and the recipient can elect to treat different contributions differently. Once an election has been made in respect of a contribution, it would be unchangeable.

***Effect on disposal (clause 80)***

The bill amends section EE 48 so that, if a person has elected to apply proposed section DB 64, then the amount of the capital contribution is added to the calculation of subsection (1)(b) for the purposes of calculating depreciation recovery income.

### **Example 3: Capital contributions**

#### ***Under the old rules***

Ben's Electricity Company is an electricity lines company. On 1 June 2009, a farmer requested that his farmhouse be connected to Ben's Electricity network. As the work, costing \$10,000, would otherwise be uneconomic, Ben's Electricity required a \$6,000 capital contribution from the farmer.

Ben's Electricity Company can claim depreciation deductions on the full \$10,000 cost of the connection to the farmhouse. Also, Ben's Electricity Company successfully argues that the capital contribution payment is a capital receipt and, therefore, is not taxable.

#### ***Under the proposed new rules***

On 1 June 2010, a different farmer requested for his farmhouse to be connected to Ben's Electricity network. The work, again costing \$10,000, would have otherwise been uneconomic, so Ben's Electricity again required a \$6,000 capital contribution from the farmer.

#### ***Election to treat as income***

If Ben's Electricity Company elects to treat the capital contribution as income, it will return 1/10th of the \$6,000 capital contribution as taxable income for the next 10 years. In other words, it will return \$600 extra income in its 2010–11 income year, and continue to do this until its 2019–20 income year.

#### ***Election to reduce depreciation base***

If Ben's Electricity Company elects to reduce its depreciation base, it will be unable to claim depreciation on the cabling and other assets that make up the new connection to the extent that they were funded by the capital contribution. In other words, it can only claim depreciation deductions on the \$4,000 cost for which it bore the financial burden.

## Working for Families: removing the automatic indexation of the income threshold and excluding investment losses

As a part of the Taxation (Budget Measures) Bill 2010, the indexation of the income threshold for Working for Families (WFF) tax credits will be removed. This means that the income threshold at which WFF begins to abate will be set at the current threshold of \$36,827 and this threshold will no longer be automatically indexed to inflation. However, the amounts of Family Tax Credit will continue to be automatically indexed to inflation. The removal of automatic indexation of the income threshold is intended to more effectively target WFF tax credits to those on lower incomes. This threshold can be increased by Order in Council if the Government wishes.

In addition, as a first step to improve the integrity of social assistance, the Taxation (Budget Measures) Bill 2010 will exclude investment losses, such as losses from rental properties, from the calculation of income for WFF tax credit purposes. This measure is intended to prevent higher income people gaining access to assistance they would not normally be entitled to.

This special report item outlines the amendments that affect the calculation of WFF tax credit entitlements.

### **Background**

#### **Removal of automatic indexation of the income threshold for WFF tax credits**

At present, the amount of the Family Tax Credit (the main WFF tax credit) and the income threshold are both automatically indexed to the Consumer Price Index (CPI). The adjustment occurs once the cumulative increase in the CPI reaches 5% from the last adjustment (which was in October 2008). Although the Treasury forecasts at Budget Economic Fiscal Update (BEFU) 2010 indicated that the next adjustment will take place in time for increases to be paid from 1 April 2012, there is also a possibility that the 5% CPI accumulation may trigger an increase in payments from 1 April 2011.

While indexation of the Family Tax Credit maintains the real level of the tax credit for those on incomes below the current \$36,827 threshold, it results in a double benefit for those on incomes above the threshold. For this group, indexation of the amount of the Family Tax Credit serves to increase the amount they receive, while indexation of the income threshold increases the amount a family can earn before it begins to abate. It extends eligibility to Family Tax Credit to people on even higher incomes. In contrast, removing the indexation of the abatement threshold will not impact on families with nominal incomes below the current \$36,827 threshold. Over time, the effect of inflation would mean that WFF tax credits would increasingly be targeted to lower income families.

## **Exclusion of investment losses from the calculation of WFF tax credits**

The Victoria University Tax Working Group report of January raised concerns about the integrity of the social assistance programmes, in particular, arrangements that have the effect of increasing social assistance entitlements such as WFF tax credits. As a first step to address the integrity concerns in this area, the Government proposes to exclude investment losses for the purposes of determining entitlements to WFF tax credits. Investment losses include losses from rental properties and trading in shares on revenue account. Currently, such investment losses can be used to reduce a person's income and therefore increase their WFF tax credit entitlements.

Furthermore, excluding investment losses will make the treatment of losses for calculating WFF tax credit entitlements more consistent. Currently, other losses such as business losses and carried-forward losses are not taken into account for calculating WFF tax credit entitlements.

The Government will undertake a wider review of the rules determining entitlements for social assistance, especially arrangements that have the effect of increasing entitlements beyond what people's true economic circumstances justify. An example is income from trusts. This review will cover WFF tax credits, student allowances and community services cards. An officials' issues paper will be released later this year seeking public feedback on proposed legislative solutions that will make arrangements that undermine the intent of social assistance ineffective.

The goal is for legislation to be enacted later this year, with application on 1 April 2011.

## **Key features**

### **Removal of automatic indexation of the income threshold for WFF tax credits (section MF 7 of the Income Tax Act 2007)**

The income threshold at which WFF tax credits begin to abate will be set at the current threshold of \$36,827. Section MF 7(1) will be amended so that this threshold will no longer be automatically indexed to inflation. However, the current WFF income threshold could be replaced by Order in Council if the Government wishes. The amounts of Family Tax Credit will continue to be automatically indexed to inflation.

### **Exclusion of investment losses from the calculation of WFF tax credits (section MB 3 of the Income Tax Act 2007)**

Section MB 3 of the Income Tax Act 2007 will be amended to exclude investment losses from the calculation of family scheme income for WFF tax credit purposes. This means that if a person has an investment in an income year, such as a rental property, and that investment produces a net loss, the income and deductions from that investment will be ignored for calculating income for WFF tax credit purposes.

## **Application dates**

The amendment to remove the automatic indexation of the income threshold for WFF tax credits will take effect on 20 May 2010.

The amendment to exclude investment losses for the purpose of calculating WFF tax credit entitlements will take effect on 1 April 2011.