Tax Tips

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What the election results mean from a tax perspective

The Labour/New Zealand First coalition, combined with the Green Party's confidence and supply agreement, present interesting opportunities for the New Zealand tax system. Political tax policy discussion to date has focused on specific tax issues. However, with the impending formation of the Tax Working Group, there is now a real opportunity for us to engage in a broad tax policy discussion and to assess future options for our tax system.

The Labour-led Government has stated that it is committed to a progressive tax system where taxpayers contribute to society equitably according to their means. This commitment is evident in the 100-day plan announced by the new Government. It will be interesting to see over the next Government term, and particularly the next 100 days, which election policies are given priority. In terms of tax issues, we expect the new Government to focus on social reform, housing issues, and the commencement of a tax system review by way of a Tax Working Group.

Key focus areas from a tax perspective and the proposed steps to address these are summarised below:

Housing

- Extension of the residential properties bright-line test from two to five years
- Restrict the use of losses resulting from negative gearing

Families assistance reform

- Unwind of National's 1 April 2018 tax cuts announced as part of Budget 2017
- A reform of how social assistance is provided to families

Tax working group

- To be established and mandated by Cabinet pre-Christmas
- Proposed changes to be tested in 2020 election

International tax

- Consultations ongoing and expected to continue
- New initiatives may be considered e.g. a diverted profits tax

Research and development tax incentives

- Tax incentives to be reintroduced including a 12.5% refundable tax credit for R&D expenditure

Auckland regional fuel tax

- Legislation to be enacted within next four to five months
- Tax expected to be imposed within six months

Water tax

- Royalty on exported bottled water to be imposed
- Labour's wider tax on commercial use of water has been dropped

Secondary tax

- Secondary tax to be abolished and replaced with more accurate PAYE withholding leveraging new IR systems from business transformation

Business transformation of Inland Revenue

- Process ongoing and expected to continue
- Risk of further pressure on resources

The 100-day plan

The Government has announced an ambitious plan for its first 100 days. The key tax related policies that we expect to be introduced in this initial period will relate to the Families Package, housing, and the establishment of a Tax Working Group.

The Government intends that any proposed changes will take effect from 1 July 2018.

The Families Package reform

Labour and New Zealand First both campaigned heavily on changes to the Working for Families tax credit regime. Therefore, it is no surprise that this is a high priority of the newly established Government. The Government intends that any proposed changes will take effect from 1 July 2018.

As part of the reform, the Government will seek to unwind National's proposed tax cuts, which were enacted as part of Budget 2017 and are due to take effect from 1 April 2018. The reform will also include legislating to pass the Families Package including the Winter Energy Payment (an additional social support payment paid to benefit and superannuation recipients during winter months), Best Start (to assist families with costs during a child's early years) and increases to paid parental leave.

We expect that the Families Package changes will be implemented early given these changes were already reasonably detailed during Labour's election campaign. Therefore, implementation should be reasonably well thought out. These changes are targeted at addressing poverty and child welfare, topics that were debated heavily throughout the election.

From a practical perspective, changes to the Working for Families tax credit regime partway through an income year could be challenging as the current system operates on an annual basis. The short timeframe may also provide challenges to Inland Revenue as it will have little time to adjust its systems to cope with the impending change.

Housing

Labour, New Zealand First and the Green Party share the view that New Zealanders should have better access to housing. Recognising that the demand and supply of housing is problematic, a number of the new Government's policies relate to 'fixing' the housing crisis.

These include:

- a Healthy Homes Guarantee Bill (requiring all rentals to be warm and dry)
- the banning of overseas speculators from buying existing houses
- the instruction to Housing New Zealand to stop the state house sell off
- the establishment of the Affordable Housing Authority, and
- the foundations of the KiwiBuild programme.

To manage the above, the Government has announced the establishment of a Housing Commission.

From a tax perspective, the new Government will extend the current bright-line test on residential housing. This builds on the test implemented by the previous Government which made any gain on the sale of a residential property within two years of acquisition taxable (excluding the family home). The new Government intends to extend the bright-line period from two to five years. The purpose of which is to disincentivise the quick purchase and sale of properties to generate tax-free capital gains.

In addition, the Government will move to eliminate negative gearing by ring-fencing tax losses arising from rental properties therefore preventing those losses from being offset against other income. It is expected that any losses generated from negative gearing will be ring-fenced to each individual property as opposed to allowing the use of losses to offset tax on profitable properties.

Negative gearing refers to the practice of borrowing money to buy a rental property, claiming interest deductions that are generally higher than the rent from the property, and offsetting the resulting loss against other taxable income (e.g. salary) resulting in a tax refund. This current 'tax loophole' is perceived as allowing property speculators to reduce their overall taxable income, which provides an unfair advantage in comparison to people trying to buy their first home.

The restriction on losses generated from negative gearing could potentially have a marginal impact on property speculation (as it would make properties less affordable as an investment which may minimise the accumulation of properties by investors). However, we question whether limiting the changes to rental property only is a very principled reform as negative gearing may occur in other industries also. For example, farms and businesses may also negative gear making losses in the initial stages and utilising these losses to offset income generated by other means (including commonly owned companies).

The expected changes seek to address key concerns that were raised and discussed in New Zealand during the election process. It would be useful to see projections of the expected impact on housing as assessed by the Government (e.g. the impact on house prices or rent levels) as a result of the expected changes. However, it is likely that New Zealand will have to wait to see the changes in action before any meaningful assessment of the impact can be made. It may also be difficult to isolate the impact of these changes as there were clear signs that the housing market was already cooling in the run up to the election.

The measures being implemented focus on managing the 'demand' for housing. We also look forward to seeing more detail on how the Government intends to address supply and fulfil its election promise to build 100,000 new homes in the next decade.

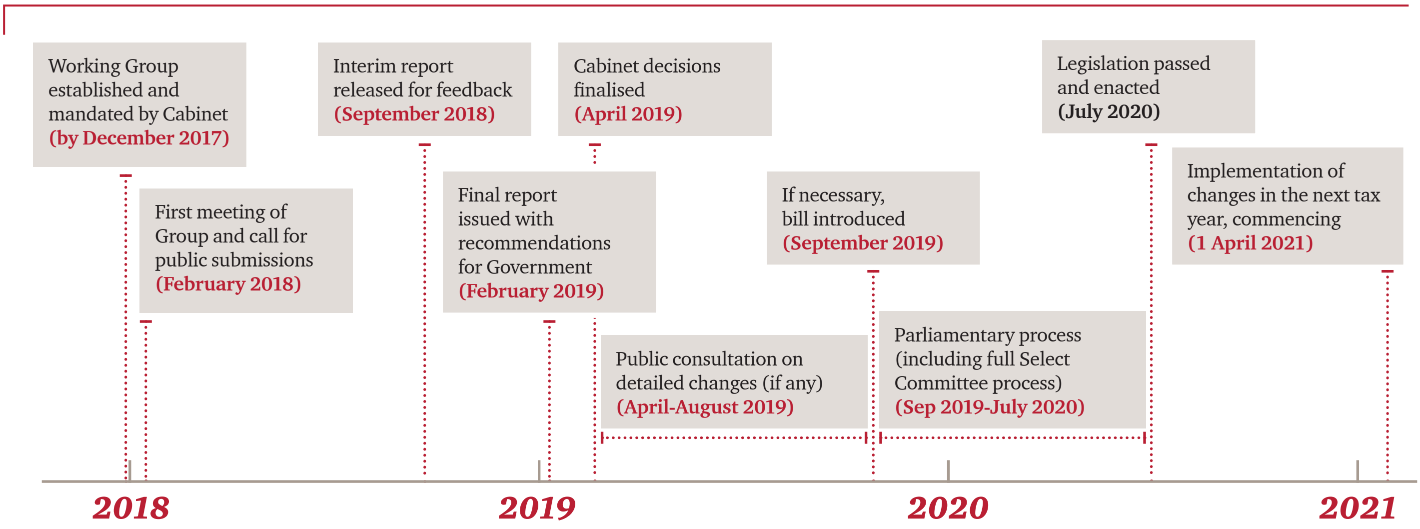
The Tax Working Group

We expect the Government to establish the new Tax Working Group early in the first 100 days. The intention is that the Group will have a broad mandate to consider options to improve the structure, fairness, and balance of the tax system, but with a primary focus on addressing the imbalance of taxation on gains from speculation in property and income from other sources.

The previous Tax Working Group was undertaken eight years ago and a lot has changed in our domestic and global environment since then. Factors such as the impact of rapidly evolving technology on our lives and on our economy, our changing demographics driven by strong immigration and a huge shift in global politics mean that it is timely to re-examine our tax system. So, we welcome the formation of the Tax Working Group and a review of the current tax policy settings. We hope the Tax Working Group will use this opportunity to take a broad review of New Zealand's current tax settings and test these against some of the longer term challenges that New Zealand is expecting to face in the future. While the current tax settings may be performing well now, future changes to New Zealand's economy and demographics could mean the current settings may no longer be fit for purpose in the future.It will, however, remain critical that the Tax Working Group's recommendations and any subsequent changes legislated by the Government are principled and coherent in the context of the broad framework of the New Zealand tax system.

The composition of the Tax Working Group is yet to be determined. We hope the Tax Working Group will consist of a diverse range of individuals who can provide a range of views and experience to achieve a balanced perspective ensuring the best outcomes for all of New Zealand.

A proposed timeline has been released. Any major tax proposals will be voted on at the 2020 election.



International tax (BEPS measures)

The previous Government made significant progress in relation to base erosion and profit shifting (BEPS) related measures, and had indicated that a number of the changes would take effect for income years from 1 July 2018. Following the release of the BEPS policy decision in August, Officials have continued to engage in targeted consultation on the proposals.

Labour had indicated support for the OECD's programme of BEPS-related work. Therefore, we expect the proposals will continue to progress. Further, given Labour's campaign included the introduction of a diverted profits tax on multinationals, and New Zealand First's focus on cracking down on compliance and tax evasion, it is possible that the new Government may take the BEPS proposals even further.

In our view, the current proposals are already highly complex and wide ranging. There is also a general concern as to the speed at which these (and any other potential changes) are progressing, particularly in comparison to other OECD countries. Given the number of items on the Government's agenda in the first 100 days, we question whether Officials can dedicate appropriate time and resource to ensuring the BEPS measures are coherent and "useable".

Re-introduce research and development tax incentives

The Government will proceed with reintroducing a tax credit for research and development (R&D) to encourage and promote R&D and boost the level of innovation in the New Zealand economy. Labour's policy suggests that this will be a refundable 12.5% credit.

The previous R&D tax credit regime was scrapped by the National Government in 2008. Given the inefficiencies of the last R&D tax credit regime, we hope the Labour-led Government will be open to differing approaches, perhaps leveraging off the Australian 'self-serve' R&D claim technology.

In our view, it is important that R&D is promoted to enhance New Zealand's competitive advantage. However, flow-on effects and complexities must be considered carefully to ensure the incentive is efficient and effective.

Regional fuel tax

The Auckland regional fuel tax has been confirmed. Auckland Council will be given the ability to implement a regional fuel tax. The legislation is expected to be passed within four to five months and the tax imposed within six months.

Funds raised will be put towards public transport improvements and infrastructure, with light rail to Auckland Airport being the priority.

Water tax

The water tax pushed by Labour has been 'watered-down'. Instead, a much more limited proposal of a royalty on exports of bottled water is expected to be introduced. The narrow down of the water tax is likely the result of the coalition compromise made by Labour given New Zealand First's strong opposition to it. New Zealand First saw the water tax as detrimental to the regional economy as irrigation is an important factor for growth.

In our view, we question the impact of a 'royalty on exported bottled water', given the amount of bottled water exported accounts for 0.0001% of water extracted each year. On a positive note, we expect that any funds gathered will be devoted to cleaning up waterways. This will be overseen by regional councils.

Secondary tax

The new Government plans to abolish secondary tax which is the default high PAYE rate imposed on the second and further jobs of the 75,000 New Zealanders working multiple jobs. To the extent that the secondary tax PAYE rate overtaxes people, a refund is available when the annual tax return is filed. The Government proposes to make this refund available automatically and in real time by leveraging Inland Revenue's business transformation to ensure more accurate rates of PAYE withholding in real time. While this is not an actual tax cut, it will be welcomed by workers with multiple jobs who would prefer to be accurately taxed as they earn rather than over-taxed and be required to pursue an annual refund.

Inland Revenue's business transformation

Inland Revenue is currently undergoing extensive business transformation to bring tax administration into the modern world. It is a four stage project involving Inland Revenue's people, processes, policy, and technology. Stage 1 is now complete and Stage 2 is estimated to be completed by 30 June 2018.

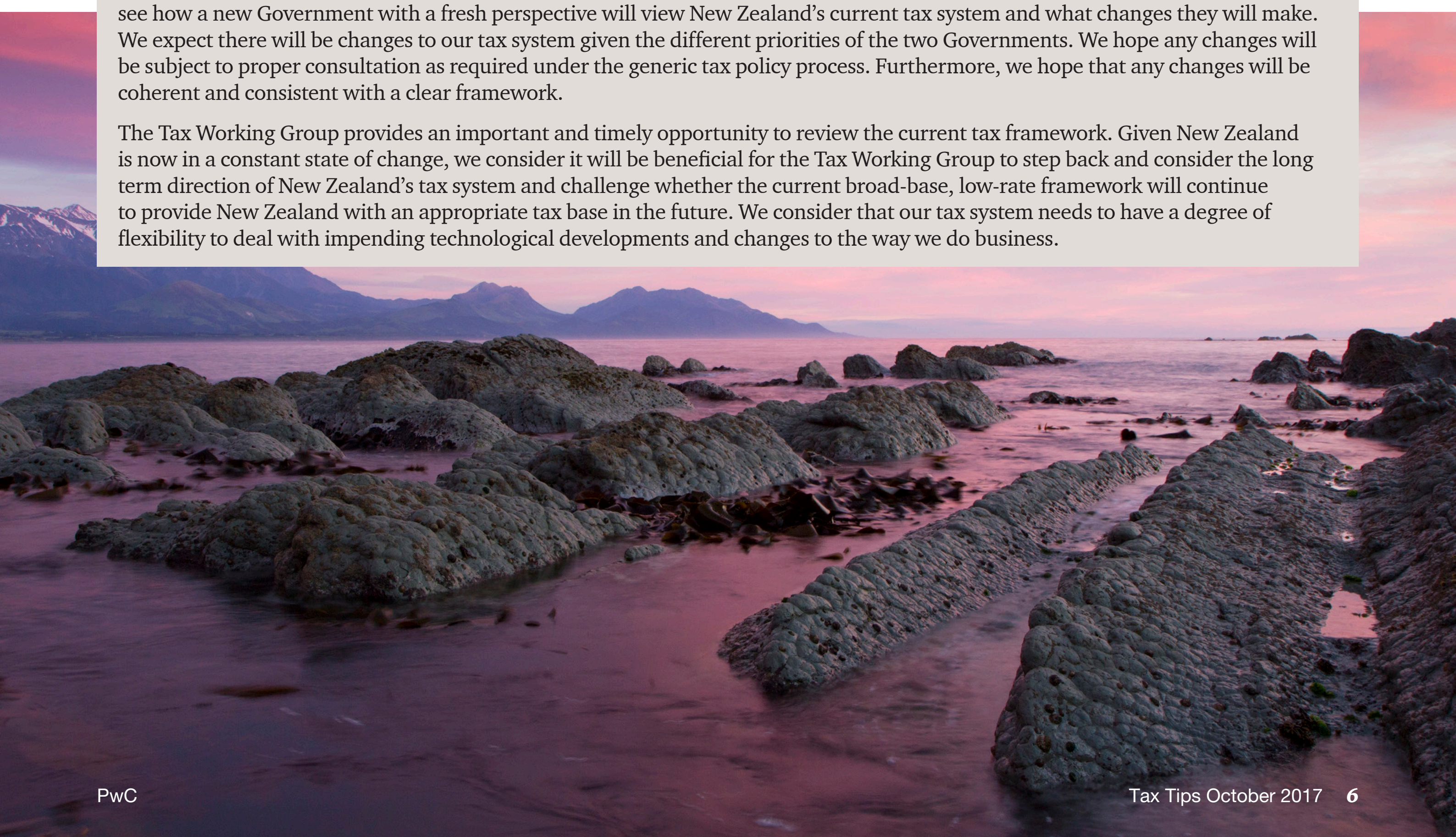
Labour has noted support for the project. However, it will be interesting to see whether the order of the transformation project will be adjusted to align with Labour's key concerns, particularly given their focus on social reform.

The Business Transformation project is a significant change for Inland Revenue's infrastructure. To date the project has been progressing in line with expected timeframes. There is a risk that, given there may be changes to the planned progression of the project and there are other tax changes to be actioned within the first 100 days, the business transformation project may be slowed due to the demand on resources.

Our final comments

The new Government has set itself an ambitious programme of changes to commence in its first 100 days. Given the country was governed under National for nine years, we have had a period of relatively consistent tax policy settings. It will be interesting to see how a new Government with a fresh perspective will view New Zealand's current tax system and what changes they will make. We expect there will be changes to our tax system given the different priorities of the two Governments. We hope any changes will be subject to proper consultation as required under the generic tax policy process. Furthermore, we hope that any changes will be coherent and consistent with a clear framework.

The Tax Working Group provides an important and timely opportunity to review the current tax framework. Given New Zealand is now in a constant state of change, we consider it will be beneficial for the Tax Working Group to step back and consider the long term direction of New Zealand's tax system and challenge whether the current broad-base, low-rate framework will continue to provide New Zealand with an appropriate tax base in the future. We consider that our tax system needs to have a degree of flexibility to deal with impending technological developments and changes to the way we do business.



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