de Lacey & Associates Limited

CHARTERED ACCOUNTANTS

NEWSLETTER

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INSIDE THIS EDITION

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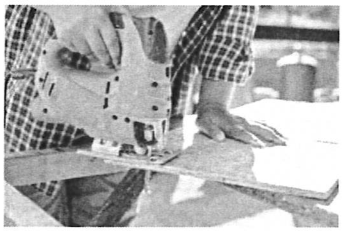
Tax ourselves out of recession?

The buoyant covid subsidy funded days are behind us, New Zealand has entered a 'technical' recession. This was reinforced by the recent announcement that New Zealand's corporate tax paid was almost 11% down in the 11 months to May relative to Government expectations.



A drop in the corporate tax take reflects the declining profits of businesses, coinciding with a decline in output. While profits have declined, there is little to ease the tax burden for businesses with no relief measures in place in a volatile market.

From all the industries feeling the pinch of economic downturn, the construction sector has arguably been hit hardest. As property prices decline, construction costs continue to rise sharply, impacting margins and the ability of property focused businesses to service debt.

Many builders and property developers will be holding land that has dropped in value within months of acquisition. By valuing closing stock at "market selling value" most businesses are able to claim a tax deduction for the drop in the value of their inventory prior to sale, as long as the value is supported by market data. However, as land is specifically excluded from the trading stock rules, businesses that derive income from the sale of land cannot deduct losses in value until the land is sold. The misalignment in treatment is arguably a kick to an industry that is already down.

One of the temporary tax measures introduced in response to Covid-19 enabled tax losses to be carried back to the prior year to recoup previously paid tax. A strong 2022 financial year followed by a volatile 2023

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raises the question whether a similar loss carry back scheme could be implemented now to cash out current year losses when businesses need it most. With the next 12 months showing little signs of an economic boom, it could be a few years before some businesses can claim current period losses under the current tax rules.

With operating costs growing, investment in capital is being reconsidered and potentially delayed. The ability to claim an immediate tax deduction for small capital items could incentivise businesses to proceed with projects. The reintroduction of a higher threshold for low value assets at $5,000 or more is another option for the government to encourage investment in productive assets that create more opportunities. This could be further extended similar to the relief measures Australia provided where small businesses had the potential to temporarily write-off assets to the value of $150,000 encouraging investment at a greater scale.

While the timeframe for such write-off's has ended in Australia, similar to New Zealand, these relief measures during the pandemic illustrated how tax can be used to drive business investment and reduce the tax burden on businesses during an economic downturn.

Tax policy from two sides of the political aisle

Given that either Labour or National are likely to enter into coalition agreements of some form with the Green Party and Act, respectively, and the tax policies of the two main parties are more 'vanilla', it is worth reviewing the tax policies of the two minor parties as this is where unexpected change may come from.

The Greens have taken the approach of increasing tax across the board. Their key policy is a 2.5% annual tax on net wealth above $2m ($4m for couples). This would apply to most forms of assets, with things like property and shares valued based on their market value. They have indicated that taxpayers would have the option to defer the payment of the wealth tax until the asset is sold, to assist those who don't have the cashflow necessary to pay the tax. They also propose an annual 1.5% tax on all assets held in private trusts to ensure taxpayers cannot avoid the wealth tax through sheltering assets in a trust. No minimum asset value exists before the tax applies, meaning those who own an average family home in a trust would be caught by the tax, despite having net wealth below $2m.

In contrast, Act is looking to reduce taxes levied on assets. Act has opposed the bright-line test since National introduced it in 2015, with Seymour describing it as an "acorn of a capital gains tax". Currently, any residential investment property that is sold within 10 years of purchase (that is not a 'new build') is subject to the bright-line test and any capital gain will be taxed. They plan to abolish the test, as well as reinstating interest deductibility for residential rental properties.

When it comes to marginal tax rates, the Green Party are looking to introduce a new top tax rate of 45% on income above $180,000, as well as reducing the brackets such that the 39% rate kicks in at $120,000. A tax free threshold would also be introduced between $0 - $10,000.

Act wants to simplify things, eventually reducing down to a two-tier system. Income from $0-$70,000 would be taxed at 17.5%, and all income above $70,000 would be taxed at 28%. They note this would result in low and middle income earners becoming worse off in many cases, so would also introduce a specific tax credit for these earners to offset this.

Other notable policies are that the Greens would increase the corporate tax rate back to 33%, and Act would divert emission trading scheme revenues into an annual tax refund for every New Zealander.

Looking at these policies, a clear dichotomy exists between the two parties. Execution of the policies will be tempered by their respective coalition partners, but as more voters stray from the centre who's to say what will make it through to tax policy when the new government is formed.

Taxation Principles Reporting Bill

The Taxation Principles Reporting Bill was introduced to parliament on 18 May 2023, and has since been reviewed by the Finance and Expenditure committee. If passed, it will require the Commissioner of Inland Revenue to report on New Zealand's current tax settings based on specific principles. A hybrid reporting model will be used where a full comprehensive report will be produced three-yearly, with interim reports produced annually. The first full report is proposed in 2025. The Bill proposes seven 'universally accepted' tax principles to be reported on, these are horizontal equity, efficiency, vertical equity, revenue integrity, compliance and administrative costs, certainty and predictability, and flexibility and adaptability.

Two of the principles, horizontal and vertical equity, are often central to discussions regarding fairness in the tax system. Horizontal equity refers to the idea that individuals with similar economic income and circumstances should pay similar tax amounts. Vertical equity aims to ensure the tax system is progressive, with the amount of tax an individual pays aligning with their ability to pay. Therefore, those with higher economic income, should contribute a higher proportion of their income to pay tax.

Instead of imposing clear-cut methods and measures for the principles, the Bill focuses on specific categories (measurements) of information which relate to the principles. These measurements are:

- income distribution and income tax paid
- distribution of exemptions from tax, and of lower rates of taxation
- perceptions of integrity of the tax system
- compliance with the law by taxpayers

The intentional focus on categories of information is to avoid restricting the Commissioner's reporting, empowering them to judge which are the most appropriate analysis techniques. It intends to help to future-proof the reporting framework, allowing for flexibility for new developments and best practices in economic research and data analysis to be used.

The Bill is intended to promote fairness within the tax system throughout changes in Government over time. However, a problem lies in who decides what is fair. It is inherently subjective and a matter of opinion. For example, when referencing horizontal and vertical equity the Bill refers to economic income rather than taxable income. In New Zealand, not all economic income is taxable, such as capital gains and the value of the family home.

The draft legislation states "wealthy people should pay no lower an average rate of tax relative to their economic income than middle New Zealanders". Given all economic income is not currently taxed, it would not be possible to satisfy this statement. Whether that is fair or not is open to debate and is ultimately decided by the public when voting at the General Election.

It is difficult to see this legislation surviving a change in Government, in its existing form, or at all.

Leaky home repairs concluded as not deductible

The leaky homes crisis represents one of the most severe problems faced by New Zealand's property sector and continues to cause stress and anxiety for those affected.

Adding to the uncertainty for rental property owners has been the question of whether repair costs are immediately deductible as 'repairs and maintenance' (R&M).

Inland Revenue has assisted by providing guidance on determining whether repairs are deductible. The 2012 Interpretation Statement 'IS 12/03 Income - deductibility of repairs and maintenance expenditure - general principles' includes specific examples, but the issue is very fact specific and a matter of judgement.

Illustrating the continued uncertainty, Inland Revenue recently released Technical Decision Summary 23/07: Whether expenditure to resolve weathertightness issues is deductible. The TDS covers a dispute regarding leaky home expenditure deducted by a taxpayer and the decision by the Tax Counsel Office (TCO).

The dispute concerned a taxpayer who owned a rental unit within a block of six units, which were all connected by inter-tenancy walls. The block was also a part of a wider complex, consisting of other similar blocks. The unit in question required remediation work to resolve weathertightness issues.

While the property was untenanted, the remediation work was carried out by the body corporate and paid for by the taxpayer via a special levy. Simultaneously, the taxpayer also incurred expenditure for their unit to be painted.

The question was whether the capital limitation applied to deny the deductions claimed by the taxpayer in relation to the remediation and the painting. Inland Revenue asserted that the entire cost (including the painting) was capital, as the remediation work involved a reconstruction of the whole asset, or at the least, changed the character of the asset.

Conversely, the taxpayer argued that the expenditure incurred was deductible R&M as the remediation work was mostly limited to certain portions of the inter-tenancy walls and decks, while the painting comprised ordinary repairs and maintenance expenditure.

The TCO considered three relevant elements:

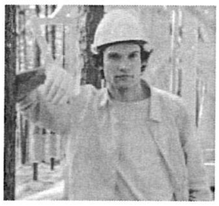
- Whether the work resulted in the reconstruction, replacement, or renewal of the asset, or substantially the whole of the asset?
- Whether the work done had the effect of changing the character of the asset?
- Whether the work was part of one overall project or was a series of projects that merely happened to be undertaken at the same time?

The TCO concluded that in the context of the remediation, the relevant asset was the block, given that the work was undertaken by the body corporate on a block-by-block basis and was not carried out solely within the boundaries of the unit. The work changed the character of the block due to the proportionally high costs, and the structurally significant improvements to the affected areas, which were important to the operation of the asset.

Hence, the capital limitation applied to deny a deduction for the remediation work. Conversely, the painting work was undertaken separately from the remediation work and considered deductible R&M.

Snippets

Retention money amendment



Legislation has recently been passed that will strengthen the protection subcontractors have that they will receive retention money owed to them should the head contractor become insolvent.

Retention money relates to money owed to a subcontractor that is retained by a head contractor, usually a percentage of the contract value, to ensure work is completed as per the contract. This retention would then be paid out on completion of the work or warranty period.

Minister for Building and Construction Megan Woods stated that the Construction Contracts (Retention Money) Amendment Act 2023 (Act), will "provide important protections for subcontractors so they can be certain their payment is kept safe, can't be used for any other purpose, and will be paid out should the head contractor's business fail."

Under the Act, retention money will be required to be held on trust by the head contractor, and must be held separate from other money or assets; and hence not available for use as working capital. The head contractor must keep accounting and other records (as specified in the Act) of all retention money held for each party. This information must be made available for them to inspect and be provided as a report at least once every 3 months.

The Act also introduces penalties for non-compliance with fines for each offence of up to $50,000 for directors and up to $200,000 for companies. The Ministry of Business, Innovation and Employment, which will monitor and enforce compliance, will have the power to obtain information and apply for search warrants to carry out its function.

The new requirements come into force from 5 October 2023, and will apply to new commercial construction contracts entered into, or contracts renewed, after the Act commences.

GST registration checks

A standard data policing check completed by Inland Revenue is to review taxpayer GST filing patterns to identify taxpayers that are GST registered, but perhaps shouldn't be.

In order to qualify for GST registration, a taxpayer needs to be conducting a "taxable activity". This comprises a continuous or regular activity that involves making a supply of goods or services for consideration. This is a different test to whether a person is operating a "business" for income tax purposes, as it does not require an intention to make a profit.

A person is required to register for GST when the value of their sales exceed or are expected to exceed $60,000 in a 12 month period. But this issue is not about sales volume, because a taxpayer can voluntarily register for GST if sales are below this threshold.

The issue is whether the activity has stagnated to the point there is either no or very low activity levels, or sales have declined to the point where it suggests the activity has stagnated.

On deregistration, assets retained are deemed to be sold, which can give rise to a cash cost. But if reviewed by Inland Revenue there is a risk they may determine the GST registration should be cancelled at a past date or that the entity never qualified for GST registration – thereby requiring past GST refunds to be paid back.

Knowing that a 'knock on the door' might be coming, it is worthwhile to pre-emptively consider whether an entity you are responsible for should not be GST registered.

If you have any questions about the newsletter items, please contact us, we are here to help.