

May 2010**Inside this issue:**

2010 Budget – Some Brief
Observations on the Tax
Changes

Directors:

Phillip Walker

Philip Bell

Bruce Watt

Graeme Carruthers

Lisa Murphy

Budget 2010

By now you have no doubt obtained details of the tax changes announced in yesterday's budget. As the broad changes have already been well summarised, we do not propose to restate them. Instead we have outlined below some preliminary thoughts on the implications of the change in the company tax rate, changes to LAQC's and depreciation changes.

Company Tax Rate Reduction

The drop in the corporate tax rate to 28% from the 2011/2012 tax year was perhaps the biggest surprise in this year's budget and, as many commentators have pointed out, is a rare chance for New Zealand to be one step ahead of Australia in its tax reforms.

The fact that the company tax rate will be 5% lower than the trustee tax rate and the highest marginal rate for individuals, may lead to an increase in family trust shareholders allocating dividends to corporate beneficiaries in order to obtain a tax deferral. This has been a common practice in Australia where there the tax rate differential has traditionally been 15% or higher.

We note that if debts owing by the family trust have been forgiven in consideration of natural love and affection for trust beneficiaries, any distribution (including beneficiary income) to a corporate beneficiary will be taxable income of the trust to the extent of any debt forgiveness.

In order to take advantage of the corporate beneficiary's lower tax rate, it may be necessary to transfer shares to a new "clean" trust, subject to satisfying any tax avoidance concerns. We note that the new trust must be established mainly to benefit natural persons or charities otherwise the transfer of shares will attract the same problem.

An alternative is for the trust to sell the shares to a company at market value so that the dividends are derived directly by the company.

As income accumulated in the corporate beneficiary will ultimately be distributed to its shareholders and taxed at their marginal rates, the use of the corporate may only yield a tax deferral benefit but in some cases that benefit could be significant.

LAQC's Now Partnerships?

Amidst the hype around the drop in tax rates, is a fairly significant proposal to change the tax treatment of qualifying companies and loss attributing qualifying companies. The changes aren't included in the Bill, rather they are outlined in principle in an issues paper released yesterday. The rationale behind the changes is that a shareholder who receives losses from an LAQC to offset against income at their marginal tax rate should also be subject to tax at their marginal tax rate when the LAQC makes a profit. Currently, the profits would be

Directors:

Phillip Walker

Philip Bell

Bruce Watt

Graeme Carruthers

Lisa Murphy

subject to tax at the company rate. Given the government's intention of removing distortions in the tax system and making things fairer, the reasoning seems fair enough.

However, the effect of the proposed changes is that QC's/LAQC's will be removed from the definition of "company" and instead come within the definition of "partnership" for tax purposes. This represents a huge change to the way these entities are taxed. QC's/LAQC's will no longer be subject to the dividend or imputation rules. Income and losses will flow through to "partners" and a partnership return will be filed and shareholder/partners will now be subject to the disposal rules applying to partnerships when one shareholder disposes of their shares.

Perhaps most significantly, is that shareholders/partners will now be subject to the loss limitation rules. The discussion document is light on the detail as to how the loss limitation rule will work in practice. It states that shareholders/partners can only offset tax losses from the LAQC against other income to the extent of their investment in the LAQC. Any excess losses will be carried forward and "ring fenced" until the shareholder's equity increases. A comment is made that an investment in the LAQC includes the share of any debt guaranteed by the shareholder. It therefore appears that a tax loss will be permitted up to the level of paid up share capital plus the amount of debt guaranteed by the shareholder. Where any LAQC borrowings are subject to personal guarantees, the impact of the loss limitation rules may not be significant.

The issues paper requests comments by 5 July 2010, no doubt so the legislation can be finalised in time for the intended commencement date of 1 April 2011.

Depreciation Changes

The rate of depreciation on buildings that have an estimated useful life of more than 50 years will be reduced to 0% with effect from the 2011/2012 tax year. The Government has stated that taxpayers will be able to apply for a provisional depreciation rate for a class of buildings (not individual buildings), but only if the estimated useful life is less than 50 years.

No guidance is given as to what types of buildings are expected to last less than 50 years (aside from barns and sheds). Presumably if you are making a case to state that your building has a useful life of less than 50 years, the onus will be on you to prove it. However, given that the Government intends to raise an additional \$685M from this in the 2012 income year it appears that this is intended to capture most buildings, with buildings with an estimated useful life of less than 50 years being the rare exception.

The importance in coming years will be on the ability of building owners to obtain full deductibility of repairs and maintenance costs, particularly if no depreciation claim is available if the cost of the work must be capitalised to the cost of the building.