

BUDGET 2007 TAX ANALYSIS



Budget 2007 delivers the much heralded company tax rate cut to 30% from the 2008-2009 income year (1 April 2008 for most companies). It makes major reforms to KiwiSaver that the Government expects will increase the take-up of the work-based savings scheme significantly. In practical terms KiwiSaver now looks very much like the Trojan horse for compulsory retirement savings.

The reduction in the corporate tax rate is a very positive development for businesses and the economy and brings New Zealand's corporate tax rate into line with the Australian rate. It should increase New Zealand businesses' competitiveness and productivity.

The Budget confirms that the Government will introduce refundable tax credits for research and development expenditure. The credit will be set at 15% of eligible expenditure, which is at the top end of the range foreshadowed in last year's Business Tax Review.

In addition to providing a kickstart payment of \$1,000 for each employee joining KiwiSaver, Minister of Finance, Dr Cullen, announced that the Government will also:

- provide a tax credit for each employee's contributions to KiwiSaver (capped at \$20 per week) that will be paid directly into the employee's KiwiSaver account;
- make it compulsory for employers to contribute up to 4% to KiwiSaver for employees who choose to contribute with the compulsory contributions phased in over four years from 1 April 2008 at 1% per year; and
- subsidise KiwiSaver scheme fees by \$40 annually per employee.

The Government will provide employers with a tax credit for the cost of matching employee contributions but this credit will be capped at \$20 a week. For employers with higher paid workforces the tax credit will fall short of covering the cost of the compulsory employer contributions.

According to the Government the net additional cost to employers of the compulsory contributions by the last year of the phase-in period (2011-2012) should not be more than approximately 1% of the national wage and salary bill at that time.

Legislation to provide for compulsory employer contributions and the tax credits is being introduced on Budget day and progressed through Parliament under urgency.

Tax breaks for KiwiSaver have been widely anticipated since Winston Peters' comments earlier this month and will be welcomed by employees. KiwiSaver is now a significantly tax enhanced saving opportunity for employees.

The Budget also announces that from 1 April 2008 the Government will:

- introduce tax incentives to boost charitable giving including removal of the current \$1890 rebate threshold for donations made by individuals and of the 5% deduction limit for donations made by companies; and
- provide an exemption from income tax for the active income of controlled foreign companies, as foreshadowed in last year's Discussion Document.

It is disappointing that the Budget does not confirm the Government's long term approach to personal tax rates. The Government's refusal to signal its intentions on personal tax rates is puzzling and frustrating. Although there is some justification for delaying personal tax cuts due to their potential

inflationary effect, there was nothing to stop the Government detailing its plans for the next three years.

The approach is in stark contrast to that in Australia where the Treasurer, Peter Costello, has confirmed A\$31.5 billion of tax rate reductions for 2007-2008 (the fifth consecutive year of personal tax cuts) and foreshadowed further reductions in future years.

New Zealand's top marginal tax rate applies at \$60,000, which is 1.4 times the average wage. In comparison, the highest threshold in Australia (45%) applies at 3 times the average

CONTENTS

Budget 2007: Tax Analysis

Headline rate down to 30%	3
International tax changes	3
KiwiSaver turbo-charged	4
Encouraging R&D	6
Charitable giving	7
Other Budget initiatives	7
Tax policy work programme	7
Sustainability and climate change	7
PricewaterhouseCoopers offices	8

wage and in the United States the highest rate applies at 9 times the average wage.

In our view, at a minimum, the Government should commit now to introducing lower rates in the medium term (by 2010). Its aim should be twofold:

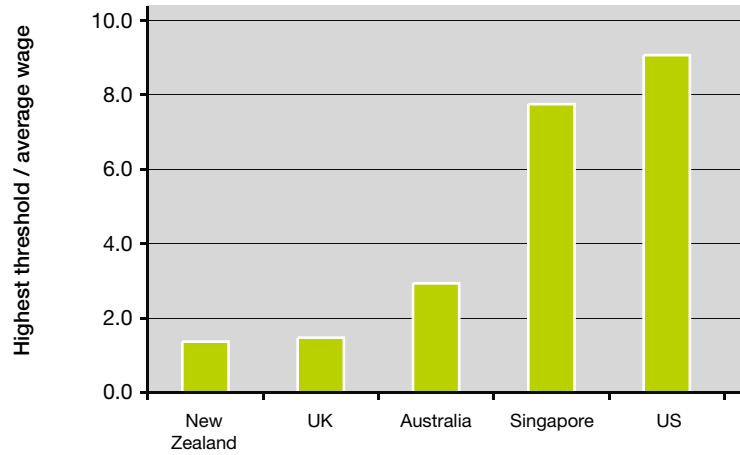
- a top marginal tax rate of 30% and a trustee tax rate of 30% - ie alignment of all three rates (highest marginal rate, corporate and trustee rates) at 30%; and
- a two tier marginal rate system with a lower rate of, say, 18% applying to income up to \$50,000 and a 30% rate applying to income in excess of \$50,000.

The need to signal personal tax cuts has been exacerbated by the company rate reduction. Recently the OECD sensibly cautioned that the corporate rate reduction should not be made in isolation. Many businesses do not operate as companies, and, in the absence of any indication of personal rate reductions, they will rush to incorporate. The 9% gap between the top personal rate and new corporate rate is undesirable and unsustainable and the source of much legislative and administrative complexity in the operation of the tax system.

Dr Cullen also announced that a further tax simplification review would take place later this year. While any simplification exercise is welcomed, the single biggest simplification measure the Government could implement would be to align the key rates at 30%.

In his 2005 Budget Dr Cullen announced that the Government would adjust the personal income tax rates every three years for inflation with the first such adjustment effective from 1 April 2008. Dr Cullen made it clear this afternoon that this indexation is currently off the table as the revenue cost has been

Highest marginal tax threshold as multiple of average wage



“spent” elsewhere. However, it is sobering to note that according to the Government’s own statistics 14% of all income earners are now on the 39% top marginal rate compared to the Government’s promise that only 5% of taxpayers would be affected when the rate was increased in 1999.

The amount of tax forecast to be collected in 2007 is \$51.5 billion, a \$1.8 billion increase on 2006. The tax collected from companies has increased by 136% since Labour came to office in 1999.

Tax take 1999-2007

	1999		2007 forecast		Increase
	\$b	%	\$b	%	
Corporate	3.69	11.5	8.73	16.9	136.5
Individual	14.94	46.5	25.09	48.7	68.0
GST	8.40	26.0	10.71	20.8	27.5
Other	5.13	16.0	6.98	13.6	36.1
Total	32.16	100.0	51.51	100.0	60.2



Headline rate down to 30%

The corporate tax rate will be reduced to 30% from the income year commencing 1 April 2008. This means that for companies with early balance dates the new rate will apply from as early as 2 October 2007 and for companies with late balance dates the 30% rate will not apply until, in the worst case, as late as 1 October 2008. The company tax rate has not changed since 1989, when it increased from 28% to 33%. The new rate will also apply to unit trusts and certain widely held savings vehicles including portfolio investment entities (PIEs).

We welcome this rate cut, which was first foreshadowed in the July 2006 Business Tax Review. It will make New Zealand a more competitive location for business and contribute to conditions that promote investment, growth and productivity.

Those who argue that the reduction should not be conferred on foreign-owned businesses are mistaken. They overlook the fact that capital is mobile. An uncompetitive tax rate discourages investment and encourages payment of tax in other countries, at New Zealand's expense. Higher investment from both foreign and local investors generates widespread benefits for the community. Denying a rate reduction to foreign investors would be a foolhardy and costly move that would cause significant damage to the economy. Advocates of higher tax on foreign investment also overlook the fact that taxes

on foreign equity investors are ultimately borne by inputs, including labour, that are not internationally mobile.

The new rate of 30% will not apply to businesses that are not companies. Sole traders and partners will continue to pay tax on the profits of their businesses at the applicable marginal tax rate, which in many cases will be 39%.

The increase in the differential between the company tax rate and both the middle and highest marginal tax rates, which are remaining at 33% and 39%, is likely to result in an increase in the number of businesses that choose to operate as companies. The size of the differential is also likely to increase compliance costs for some businesses and for Inland Revenue. It will undoubtedly increase the administrative pressure on the tax system as taxpayers respond to the size of the differential in their choice of business structures. An early indication that personal tax rates will trend downward from next year would reduce the likelihood that taxpayers will undertake aggressive tax planning.

Given that the middle and highest marginal tax rates are remaining at 33% and 39% respectively, a 30% company tax rate will mean that, to the extent that profits are distributed to New Zealand taxpaying shareholders, less tax will have been paid at the company level and additional tax will be required to be paid at the shareholder level.

The benefit of the lower rate arises only as long as the profits are retained and reinvested in the company.

Companies will need to consider whether there are any legitimate opportunities to incur expenditure before the tax rate change which they might have otherwise deferred until next year to ensure they can deduct the expenditure at 33% or, conversely, legitimately to defer the derivation of income until 2008/2009 when it will be taxed at 30%.

The reduction in the company tax rate will impact imputation credit and other memorandum accounts (BETA and conduit tax relief accounts). It will also require amendments to the foreign investor tax credit (FITC) and available subscribed capital (ASC) formulae and changes to the qualifying company rules.

The Government is to be commended for its decision to make the current 33% imputation ratio available until 31 March 2010. The transitional period will mean that shareholders will obtain the benefit of the higher rate of tax for the next three years. When Australia last reduced its corporate tax rate it took a less generous approach to transition.

The tax rate change will also have an impact on companies' accounting results as deferred tax balances will need to be restated at the new lower rate.

International tax changes



The Government has confirmed that it will introduce a tax exemption for the active income of New Zealand businesses operating overseas – a proposal first outlined in its Discussion Document *New Zealand's International Tax Review: a direction for change* in December 2006 (see Tax Tips 24/2006).

We welcome the change as it will bring the New Zealand treatment into line with that applied overseas and assist New Zealand businesses investing offshore to compete on a level footing with foreign businesses. It is, however, unfortunate that it has taken over 15 years to unwind the old regime, which was extreme by world standards. Unfortunately many of New Zealand's international horses have already bolted.

Broadly, the active income exemption proposed would:

- exempt active income (eg income from manufacturing and industrial activity) earned by New Zealand resident companies through their controlled foreign companies (CFCs) from New Zealand tax. Only passive income (such

as dividends, interest, royalties and rent) will be taxed;

- introduce an "active business" test that exempts all CFCs with less than 5% passive income, irrespective of where they operate;
- exempt dividends from CFCs received by the New Zealand parent from New Zealand tax; and
- remove the current "grey list" exemption.

It is disappointing that the "active business" test is restricted to CFCs with less than 5 per cent passive income. This compares with the Australian regime which has a threshold of less than 10% passive income in its "active business" test.

As part of the proposed changes, the existing thin capitalisation rules will be extended to apply to all New Zealand companies with CFC investments. In addition, investments in CFCs will be removed from the definition of "assets" for the purposes of calculating the amount of debt on which interest deductions will be available. This will limit the extent to which New Zealand businesses can deduct interest

costs relating to offshore investments that are outside the New Zealand tax base.

It is pleasing to see that the 75% and 110% debt thresholds and on-lending concession will be maintained and goodwill will continue to be included in asset calculations.

Disappointingly, the current conduit tax regime is set to be abolished under the proposed reform. This is a missed opportunity to level the investment playing field with Australia by introducing a genuine conduit regime to allow income to flow through New Zealand without a withholding tax impost.

The Government has also indicated that changes to non resident withholding tax rates will be progressed through the bilateral treaty negotiation process. This will give rise to consequent changes to foreign investor tax credits and approved issuer levy which will be considered at that time.

Due to the complexity of the issues and the need for further consultation, supporting legislation is not expected to be introduced until early 2008, and will be effective from the beginning of the 2009/2010 income year.

KiwiSaver turbo-charged



As anticipated, Dr Cullen announced a number of major changes to KiwiSaver, which together will make the scheme far more attractive. We anticipate that the take-up rate will now rise dramatically.

The key changes include:

- a new 'dollar for dollar' tax credit for member contributions to KiwiSaver of up to \$20 per week from 1 July 2007;
- compulsory employer contributions to match member contributions up to 4% of an employee's gross salary or wages - phased in over four years and commencing from 1 April 2008;
- a new tax credit for employers of up to \$20 per week per worker, towards the cost of compulsory contributions;
- minimum employee contributions to be 4% of gross salary or wages from 1 April 2008; and
- the Government's annual fee subsidy is set at \$40 per member per annum (available also to the self employed).

The changes will see the Government contributing an additional \$3.2 billion to KiwiSaver over the next four years. The changes are likely to be well received by potential members but employers may be less enthusiastic. The Government will now provide up to \$40 a week per member in tax credits: \$20 per week to the member (albeit paid to the member's account annually) and \$20 a week to employers to subsidise employer contributions.

Unchanged are the entitlement to the \$1,000 Government 'kickstart' for all members on joining KiwiSaver and the exemption from specified superannuation withholding tax (SSCWT) for employer contributions, up to the lesser of the member's contribution or 4% of the member's gross salary or wages.

Member tax credit

From 1 July 2007, the Government will match members' contributions to KiwiSaver (or to a 'complying superannuation fund') up to a maximum of \$20 per week per member. This equates to an annual contribution of up to \$1,040 and members with gross income of \$26,000 or more each year will be eligible for the maximum credit.

The credit will be paid into a person's KiwiSaver account annually, based on information provided by the member's scheme provider to the IRD.

Members will not be able to withdraw the credit for reasons of financial hardship or if they permanently emigrate. In addition, the credit will not be able to be withdrawn under KiwiSaver's mortgage diversion facility or for making a deposit on a member's first home.

The use of a tax credit mechanism as a Government incentive to save obviously provides greater relative benefit to those on lower incomes. However, as the credit will not be indexed to inflation, its value as a percentage of a member's income will fall as the member's income rises with inflation over time.

Compulsory employer contributions

From 1 April 2008, employers must match their employees' contributions to KiwiSaver (or to a complying superannuation fund) up to 4% of an employee's gross salary or wages. The compulsory employer contributions will be phased in over a four year period, starting at 1% of an employee's gross salary from 1 April 2008 and rising to 4% by 1 April 2011 as follows:

From	Minimum employee contribution (% of gross salary)	Minimum employer contribution (% of gross salary)	Total employer and employee contributions (% of gross salary)
1 April 2008	4	1	5
1 April 2009	4	2	6
1 April 2010	4	3	7
1 April 2011	4	4	8

Making it compulsory for an employer to contribute to an employee's KiwiSaver account is a bold change to the KiwiSaver scheme as originally proposed. Some will argue that such compulsion is unfair and intrusive. The Government maintains that workplace superannuation is a key feature of salary packages offered by internationally competitive businesses and that both employers and employees have a stake in lifting the savings performance of New Zealand.

To contribute towards the cost of employers' matching employee contributions compulsorily, the Government will provide employers with a tax credit of up to \$20 per week (\$1,040 per year) per employee. This credit will cover the cost of compulsory employer contributions in the first year for employees earning up to \$104,000 during that year. The Government concedes that employer contributions may form part of the remuneration negotiation process in subsequent years when the cost to employers of the compulsory contribution exceeds the credit. Employers are likely to find reasonable opportunities to take the compulsory contributions into account in remuneration negotiations as the 1% steps each year are less than the expected rate of inflation.

Employer tax credits will be paid to employers through the PAYE system by offsetting the credit against the employer's contribution and other PAYE liabilities. The credit will be paid at the same time the employer contribution is made, to minimise cashflow and compliance costs.

Employee minimum contributions

As originally proposed, employer contributions could count towards an employee's minimum KiwiSaver contribution of 4% or the optional 8%. From 1 April 2008, an employee's minimum KiwiSaver contribution must be 4% which, coupled with compulsory employer contributions, will result in greater contributions to an employee's KiwiSaver account. For an employee earning an \$80,000 salary, this change means that they must contribute over \$60 from net salary or wages each week to KiwiSaver.

Transitional arrangements will apply to those who join KiwiSaver from 1 July 2007 and agree to have employer contributions counting towards the minimum contribution rate.

KiwiSaver in action

The positive effect of the Budget KiwiSaver announcements on an individual's savings over time can be seen from the following example.

An employee on an \$80,000 gross salary who joins KiwiSaver and contributes 4% of gross salary will save \$3,200 each year.

The employee's annual KiwiSaver savings will increase to \$5,040 in the 2008/2009 income year because of the Budget announcements, increasing to \$7,440 in the 2011/2012 income year.

	Income year			
	2008/2009	2009/2010	2010/2011	2011/2012
Employee contribution (4% of gross salary)	3,200	3,200	3,200	3,200
Member tax credit	1,040	1,040	1,040	1,040
Employer compulsory contribution	800	1,600	2,400	3,200
Total annual KiwiSaver savings	5,040	5,840	6,640	7,440
Total savings as % of gross salary	6.3%	7.3%	8.3%	9.3%

	Income year			
	2008/2009	2009/2010	2010/2011	2011/2012
Current take home pay (excl ACC)	57,530	57,530	57,530	57,530
Take home pay after KiwiSaver member contribution	54,330	54,330	54,330	54,330
Reduction in take home pay	5.56%	5.56%	5.56%	5.56%
Total take home pay and KiwiSaver savings	59,370	60,170	60,970	61,770
Additional savings - post Budget 2007	1,840	2,640	3,440	4,240

Encouraging R&D

New Zealand businesses carrying on research and development (R&D) will be eligible for a tax credit of 15% of allowable expenditure from the 2008/09 income year, which could be as soon as October 2007 for early balance date taxpayers. The fact that the credit will be refundable in cash means that it will also benefit businesses that are in a loss position or are tax exempt entities.

The definition of R&D looks to be broadly similar to that used in Australia. To qualify, R&D activities must be systematic, investigative and experimental. They must either seek to resolve scientific or technological uncertainty or involve an appreciable element of novelty and be directed at acquiring new knowledge or creating new or improved products or processes. Supporting activities which are required for or are integral to carrying on the core R&D activity can also be eligible.

Activities that are not eligible as a core activity include research in social sciences, the arts or humanities, making stylistic or cosmetic changes and market research, although these activities may qualify if they support another core activity.

To qualify for the credit the business must:

- control the project, bear the financial and technical risk and own the project results;
- spend at least \$20,000 unless the R&D is outsourced to a listed research provider; and
- carry out the R&D predominantly in New Zealand. R&D carried out overseas as part of a New Zealand based project will qualify for up to 10% of the eligible expenditure incurred in New Zealand.

Crown Research Institutes, tertiary institutions, District Health Boards their associates or entities controlled by them are not eligible for R&D credits. However, tax credits may be paid to businesses that commission qualifying R&D work from these institutions.

Eligible expenditure includes employee remuneration, overheads, consumables, depreciation of tangible assets used primarily in conducting R&D and payments to listed researcher providers. Ineligible expenditure includes interest, expenditure on intangible assets, loss on disposal of depreciable property, the cost of acquiring technology used as a basis for further R&D, expenditure funded by government grants and professional fees to determine eligibility.

Businesses that are taxpayers will:

- claim the credits as part of the normal tax return process; and
- be able to reduce provisional tax payments in anticipation of receiving R&D credits.

An interesting feature is that imputation credits will arise for the amount of the R&D credit used to satisfy a tax liability and will be available to attach to dividends as though the tax was actually paid.

Businesses with only exempt income will need to file an income tax return to access the R&D credits. For both taxpaying and exempt businesses a supporting statement will need to be filed with the income tax return.

There is no cap on the level of credit that can be claimed unless the expenditure relates to in-house software development which is subject to a \$2 million expenditure cap. There is scope to approach the Minister of Finance for an increase in the limit provided the Minister is satisfied that three requirements are met:

- the R&D will be exploited mainly for the benefit of the New Zealand economy;
- New Zealand will derive a substantial net benefit from the activities; and
- the claimant is committed to keeping the value of their business in New Zealand.

There will be special provisions for industry research co-operatives enabling them to access the R&D credits if contributions/levies

received from businesses are applied to R&D relating to those businesses.

The credit will be based on the volume of R&D carried out in an income year rather than incremental R&D carried out over a base year. This should give rise to greater certainty when planning R&D investment and make the credits easier to claim (and presumably review). The downside is that it is more difficult to ascertain whether introducing the R&D credit has encouraged greater R&D.

Setting the R&D credit at 15% is at the top end of the range originally discussed and is a generous incentive. For every eligible \$1 spent on R&D the Government will provide a tax deduction worth 30c and a 15c tax refund. The Government estimates the fiscal cost will rise to \$260m per annum over the next four years and total \$630m. This is a significant investment by the Government and it is important that the effect of the R&D credit is closely monitored to ensure that the projected benefits for New Zealand as a whole are captured. To this end it is pleasing to see that the Government has allocated \$1.2m to fund the evaluation of the effectiveness of the credit.

Example

Bio Limited employs a scientist full time to investigate a climate change initiative and incurs eligible expenditure ie salary, consumables, overheads and payments to a third party to test the process. Bio Limited's tax position looks like this:

Gross income		\$1,000,000
Less	Eligible expenditure	\$300,000
	Net income	\$700,000
	Tax liability (30%)	\$210,000
Less	R&D tax credit	\$45,000
	Tax to pay	\$165,000

If Bio Limited is exempt from tax or in a tax loss position with no other outstanding liabilities, it will receive \$45,000 in cash.



Charitable giving

Changes to the tax rules governing charitable giving will provide a welcome boost to New Zealand's charitable sector. As a society we need to become more philanthropic and the removal of the impediments to giving should bolster support for the charitable sector.

From 1 April 2008 the Government will remove:

- the \$1,890 rebate threshold applying to cash donations to charities made by individuals;
- the 5% limit on deductions companies can claim for cash donations to charities; and
- the restriction on closely held companies claiming deductions for donations.

Under the new rules:

- individual donors will be able to claim a 33.3% tax rebate on all donations up to their annual net income; and
- companies (including unlisted close companies) and Maori authorities will be able to claim a tax deduction for donations up to their annual net income.

We support the changes as they illustrate that the Government is serious about its commitment to encourage and promote charitable giving.

The removal of the rebate cap brings New Zealand into line with the treatment of donations in other OECD countries such as Australia and the United Kingdom.

These proposals are costed at a relatively modest \$65m of foregone tax revenue over the next 4 years. It will be interesting to see if Kiwis exceed Treasury's relatively modest expectations of our philanthropic behaviour.

Revenue Minister, Peter Dunne, has confirmed that the Government is committed to the ongoing development of further proposals to assist charitable organisations and encourage philanthropy in New Zealand.

In particular, as part of this year's tax policy work programme, further work will be carried out to:

- consider whether a tax deduction should be allowed for non-monetary donations to charities – such as property;
- clarify and streamline the tax treatment of volunteers' reimbursement payments and honoraria; and
- consider the introduction of a payroll giving scheme – as exists in Australia and the United Kingdom.

It is anticipated that these measures will be included in a Government Discussion Document to be released in November 2007.

The signalled changes to the rebate thresholds will be part of the May 2007 Bill. They should receive cross-party support as they are essentially the same as the proposal announced by Opposition Leader John Key last month.

Other Budget initiatives

The Government is also:

- introducing a regional fuel tax to assist in funding region specific transport projects;
- providing an additional \$88 million over four years for the Market Development Assistance Scheme and an additional \$53 million over four years towards industry training in lieu of tax credits for export market development and skills training incentives; and
- providing the IRD with additional funding to strengthen its auditing of property transactions.

Tax policy work programme

In addition to ongoing work on the international tax review and further consideration of ways to encourage charitable giving, the Government's tax policy work programme includes:

- a discussion document on compliance cost issues aimed at small and medium sized enterprises;
- consideration of the tax treatment of redundancy payments; and
- re-negotiation of the New Zealand and Australia double tax agreement.



Sustainability and climate change

The Government's recent focus on Climate Change continued with a number of initiatives announced in the transport, sustainability and energy efficiency areas. However, most of the sustainability and energy efficiency measures were in the household and public sectors, with little real focus on business.

Rail infrastructure in Auckland and Wellington is set to receive a \$650m boost over the next six years.

The Government has committed \$72m toward energy efficiency measures including the fitting of home insulation, energy efficient home heating and a home energy rating scheme.

Significant funds have been earmarked in the public sector for initiatives such as sustainable Government procurement and shifting the public service toward carbon neutrality.



PricewaterhouseCoopers offices

Auckland

188 Quay Street
Private Bag 92162
AUCKLAND
Telephone: +64 9 355 8000
Facsimile: +64 9 355 8001

Wellington

113-119 The Terrace
PO Box 243
WELLINGTON
Telephone: +64 4 462 7000
Facsimile: +64 4 462 7001

Christchurch

119 Armagh Street
PO Box 13244
CHRISTCHURCH
Telephone: +64 3 374 3000
Facsimile: +64 3 374 3001

Dunedin

Forsyth Barr House, The Octagon
PO Box 5848
DUNEDIN
Telephone: +64 3 477 8784
Facsimile: +64 3 477 1186

Hamilton

Corner Bryce and Anglesea Streets
PO Box 13244
HAMILTON
Telephone: +64 7 838 3838
Facsimile: +64 7 839 4178

Napier

Corner Munroe and Raffles Streets
PO Box 645
NAPIER
Telephone: +64 6 835 6144
Facsimile: +64 6 835 0360

New Plymouth

Corner Devon and Robe Streets
PO Box 144
NEW PLYMOUTH
Telephone: +64 6 757 5477
Facsimile: +64 6 757 9497

www.pwc.com/nz