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BELL GULLY

2018 BUDGET REPORT

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Wolters Kluwer

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This 2018 Budget Report has been prepared with the assistance of specialist practitioners from Bell Gully and EY. It covers announcements of interest to tax practitioners and the business community.

BELL GULLY

Bell Gully is a leading New Zealand corporate law firm with extensive commercial, corporate, taxation, finance, banking, litigation and commercial property experience. We are consistently recognised as the market leading legal tax team in New Zealand. From general corporate tax advice, including corporate restructuring, acquisitions and divestments, securitisation and financing to helping clients resolve tax disputes at all levels, customs & excise matters and set up trusts, our clients rely on our tax specialists for their technical excellence, commercial sense and ease of doing business.

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In this Budget Report

Income tax measures

Ministerial statement

> *As promised, we have already established a Tax Working Group to recommend how to create a better balance in our tax system. Getting these signals right is a vital step towards improving the long-term sustainability and productivity of the economy.*

Editorial comment

Based on the Budget papers, the Government has not proposed any significant tax reform policies. However, throughout the budget papers, various references are made to the Tax Working Group (TWG), an independent body tasked with providing recommendations to the Government that would improve the fairness, balance and structure of New Zealand's tax system. The TWG is due to report its final recommendations in February 2019, and although these final recommendations are yet to be seen, it is clear that the TWG will remain a key driver of significant tax reform in New Zealand going forward.

Separate from the TWG's recommendations, the Government has released its new revenue strategy, which sets out the Government's objectives for the tax system and tax policy in the context of its economic and fiscal strategies. Although there are a number of items on the agenda, of particular interest are the proposed R&D tax credit, ring-fenced rental losses, Winston Peters' "bloodstock initiative", black hole and feasibility expenditure, and the international tax and base erosion and profit shifting proposals. The bulk of these proposals are likely to be implemented within the next year.

Ministerial Statement

> *Budget 2018 begins steps to restore tax fairness. More funding is being given to Inland Revenue to crack down on tax dodgers. This is expected to recover more than $183 million over the next four years.*

Editorial comment

The Government will be providing an additional $31.3 million in operating spending to Inland Revenue to collect more taxes and, in particular, to ensure outstanding company tax returns are filed. The additional funding will be provided to the Inland Revenue in the current year and, based on budget forecasts, is expected to raise revenues in excess of $183 million.

Interestingly, the Government tax policy work programme carries on this theme. Topics in the work programme include the following:

- developing an optimal regime to maximise compliance including addressing corporate fraud and evasion
- drafting a discussion document containing proposals on various GST policy issues
- considering options to address the under-reporting of income and therefore under-taxation of the self-employed

- considering the tax treatment of carrying forward losses when business ownership changes
- developing a framework for tax administration with an emphasis on the key roles of the Commissioner, taxpayers and tax agents, as well as the rules around information collection and tax secrecy which underpin their interactions, and
- improving the tax system for business, including the calculation of provisional tax, the collection of information and reviewing the penalties and interest rules (including researching additional measures that have potential to deliver further benefits to businesses, reduce compliance costs and make the tax system simpler).

Ministerial Statement

Other recently announced initiatives will reduce distortion in the tax system. These include ring-fencing rental losses and closing the loophole on offshore companies avoiding GST on low-value goods sold locally.

Editorial comment

Unsurprisingly, the housing market remains an area of focus for the Government. Earlier this year, the two-year bright-line test (which imposes income tax on capital gains derived on the disposal of residential property within two years of acquisition) was extended to five years.

Off the back of this amendment, the Government is proposing to implement rules to ring-fence tax losses arising from investment properties. This would mean that where costs involved in owning a rental property, such as repairs and maintenance and interest, exceed the rental income from that property, the resulting loss cannot be claimed against other forms of income.

Aside from raising revenue, the Government's rationale for implementing these rules is to reduce property speculation and encourage investment in more productive assets.

This idea was recently floated in an issues paper from Inland Revenue and Treasury, and submissions on the proposal only closed on 11 May. Despite this, it appears from the Budget papers that the Government will go ahead with the proposals, which are expected to be implemented in the 2020 income year. The Budget forecasts revenues of $10 million in the 2020 income year followed by revenues of $125 million and $190 million respectively in the 2021 and 2022 income years.

On the GST front, the Government has confirmed it will proceed with its plans to require offshore suppliers of low-value goods to register, collect and return GST. The GST proposals are likely to come into effect during the 2020 income year, with the Budget forecasting revenues of $218 million between 2020 and 2022.

Interestingly (but somewhat expectedly), the Budget papers announce changes to the bloodstock tax rules for the New Zealand racing industry. Under the proposed changes, tax deductions will be able to be claimed for the costs of high-quality horses acquired with the intention to breed. This proposed amendment is intended to address the current rules around tax write-downs which, according to the Budget papers, do not serve their purpose of promoting new investment, but rather favour established breeding businesses. These proposed amendments will cost the Government approximately $4.8 million over the next five years, beginning from the 2020 income year.

Ministerial Statement

> *This is why Budget 2018 gives a major boost to innovation, with $1 billion over four years to finance a tax incentive for more Research & Development by Kiwi businesses. We have committed through the Coalition Agreement with New Zealand First to lifting our Research & Development spending as a country by 50 percent – to 2 percent of GDP inside 10 years.*

Editorial comment

Prior to the release of the Budget papers, a discussion document was released seeking comments on a proposed research and development (R&D) tax credit. The discussion document proposes a 12.5% non-refundable tax credit on eligible expenditure to businesses performing R&D in New Zealand and is expected to be available from 1 April 2019. The proposed R&D tax credit is intended to supplement the "R&D cash-out" incentive currently targeting innovative start-up companies and the Callaghan grant system.

As seen in other countries, a well-designed incentive can lead to increased innovation activity and overall productivity. Conversely, a poorly designed incentive can lead to high fiscal costs with little improvement in innovation. Based on Budget forecasts, the proposed R&D tax incentive is anticipated to cost the Government in excess of $1,024 million over the next five years. However, depending on the final design and real-life application, the forecasted cost of the incentive could be understated.

For the R&D incentive to have a positive impact on productivity it should not share the same fate as the previous Labour Government's 15% R&D tax credit (which lasted only a year before it was repealed). The proposed R&D tax credit should instead be sustainable, with a long-term commitment from the Government. In addition, significant resources should be committed to make the claims process easy and capable of being audited.

Objectives of the tax system

Ministerial statement

> *The Government will ensure a progressive taxation system that is fair, balanced and promotes the long-term sustainability and productivity of the economy. Taxation is an important tool for rebalancing the economy and setting New Zealand on a path to an economically and environmentally sustainable future. The Government believes that we need a better balance in our tax system to support our productive sector and ensure all taxpayers are paying their fair share.*
>
> *The Treasury forecasts show that reversing the previous Government's unfocused tax cuts creates $8.4 billion of fiscal headroom over five years – this is enough to pay for the operating commitments set out in the 100-Day Plan, including the Families Package. Further, the Government has established the Tax Working Group to investigate possible changes to make our tax system fairer and more balanced. This meets the PFA [Public Finance Act 1989]*

requirement to ensure efficiency and fairness in the tax system.

Further details on the Government's specific short-term intentions and long-term objectives, as required by the PFA, can be found in the Annex.

Editorial comment

Not a lot of additional details are provided in the Annex to the Fiscal Strategy Report. Short-term intentions and long-term objectives are said to include factors such as:

- having regard to efficiency and fairness, including the predictability and stability of tax rates
- taking into account the impact of fiscal policy on monetary policy, and
- prudently managing the fiscal risks facing Government.

The Fiscal Strategy Report also refers to the key assumptions upon which fiscal projections are modelled. These include that "the economy is assumed to grow at trend growth rates with no economic cycles in the projections".

Whether that assumption is realistic or not could be expected to engender real controversy. An economic downturn or a recession might seem inevitable to some.

Another important assumption, perhaps just as controversial, is the assumption that the price of West Texas Intermediate oil prices will fall to USD 60 per barrel by mid-2018 "and remain stable thereafter" (Budget Economic and Fiscal Update 2018 at 7). In light of oil barrel prices already approaching USD 70, this seems rather optimistic.

Inland Revenue activities

Vote Revenue

The Budget papers include Vote Revenue as a document providing a breakdown of Inland Revenue expenses. Vote Revenue includes the following items:

- $171.983 million is spent on Inland Revenue's investigation, audit and litigation activities
- $152.255 million is spent to prevent returns becoming outstanding and debt becoming overdue and to collect overdue payments
- $10.608 million is spent on the provision of policy advice
- $2,628 million is the cost of the Family Support tax credit
- $850 million is the cost of the KiwiSaver tax credit
- $360 million is the cost of Paid Parental Leave Payments
- $6.5 million is the cost of the subsidy paid to payroll agents, and

- $597.817 million is the estimated appropriation remaining of the appropriation for the design and implementation of Inland Revenue's Business Transformation Programme.

The item for the provision of policy advice is separate from the cost of the Tax Working Group. The budgeted cost of the Tax Working Group is $4 million over the 2017/18 and 2018/19 financial years.

Vote Revenue also budgets for the following impairments:

- $680 million write-off for bad debts exclusive of child support and student loans, and
- $610 million for initial fair value write-down of student loans.

On the income side Vote Revenue budgets for a collection of tax revenue totalling $76,559 million. In addition Inland Revenue expects to collect non-tax revenue of $1,111 million and capital receipts of $1,529 million.

Of Inland Revenue's projections, the Treasury's Budget Economic and Fiscal Update 2018 observes that the Treasury's forecasts of core Crown tax revenue are, on average, 0.2% higher than Inland Revenue's forecasts. The difference is said to be attributable to the different modelling methods that each agency uses to forecast some of the larger tax types such as PAYE, RWT and road user charges.

Some insight into the dimensions of tax in dispute is given by the Budget papers showing contingent liabilities of:

- $137 million for legal tax proceedings, and
- $148 million for other legal proceedings and disputes.

The first of these sums relates to tax in dispute under challenge proceedings, whilst the latter is in the nature of tax debt recovery. These seem relatively minor items.

Also small-scale is the item of $130 million shown as a contingent asset for legal proceedings and disputes.

Tax practitioners may also be interested to learn that the Budget papers forecast the tax cost of the measure to "ban overseas speculators from buying existing houses", which is projected to be $5.3 million for 2017/18 and $6.8 million for 2018/19.

Social policy announcements

Health

Ministerial statement

> *Health will receive a huge boost in new operating funding with $3.2 billion more over the next four years.*
>
> *This begins the journey to rebuild a health system that has simply not been given the resources to meet the demands of population growth and an ageing population over recent years.*

An increase of $2.3 billion for District Health Boards will enable our hospitals and health services to provide quality care at all times to those who need it. This funding means there will be more money for services, such as mental health, the opportunity to update technology and take pressure off over-worked staff. This is the bread and butter funding that makes our hospitals and health services work well, and that has been neglected for too long.

Editorial comment

A breakdown of the increase in operating funding includes the following items:

- $750 million of new capital for health projects
- a brand new hospital for Dunedin
- very low-cost GP visits for all community service card holders
- free doctors' visits for everyone under the age of 14
- $126 million for elective surgery
- a $103.6 million increase in fees for midwives
- $83 million for air ambulances
- $67 million for the bowel cancer screening programme, and
- $10.5 million for a pilot programme on mental health therapies for young people.

Education

Ministerial statement

In Education, this Budget provides $1.6 billion in new operating funding over four years. This new operating funding is a 45 percent increase on last year's Budget.

New funding will address increasing demand for early childhood education and roll growth. We will provide $590 million to better support the early learning needs of 200,000 children. This will be the first universal adjustment for early childhood education services in a decade.

Schools will receive a $203.6 million boost to their operating funding, to keep up with the growing number of students and help meet rising costs. This funding amounts to a 27 percent increase from the equivalent funding provided in last year's Budget.

We are also providing for an additional 1,500 teachers in our primary and secondary schools across the country over the next four years.

Another $395.8 million will be injected in new capital funding for better schools and to build hundreds of new classrooms.

Editorial comment

Areas of spending include:

- $272.8 million on Learning Support operating funding
- $133 million on the Ongoing Resourcing Scheme for children with additional and complex learning needs, and
- $59.3 million on teacher aide funding.

Housing

Ministerial statement

> *This Government is determined to take action on the housing crisis and the scourge of homelessness which has emerged in this country.*
>
> *In December's mini-Budget we allocated $2.1 billion for our ambitious KiwiBuild programme to deliver 100,000 long-overdue affordable houses built across the country, including 50,000 in Auckland over the next 10 years.*
>
> *Budget 2018 commits more than $1 billion in new funding to go towards Housing, including $369 million in new capital funding.*
>
> *The different priorities of this Government are never clearer than in housing. One of our first actions was to stop the state house sell-off.*
>
> *Today, I am announcing that this Government is taking serious action to increase the supply of public housing by investing $234.4 million in operating funding for Housing New Zealand and Community Housing Providers. This will provide more than 6,000 homes over the next four years.*

Editorial comment

Additional housing measures include:

- giving another $300 million to the Tamaki Regeneration Company to provide about 700 state houses and 1,400 houses in Tamaki for the open market, and
- providing $143 million in grants to those on lower incomes to insulate and heat their homes.

Child Poverty

Ministerial statement

This Government is committed to a bold plan to reduce poverty and material hardship for our children, so that New Zealand truly becomes the best place in the world to be a child.

The initiatives we have already put in place will lift tens of thousands of children out of poverty. But we know that we have more to do.

The Prime Minister's Child Poverty Reduction Bill is at the heart of our plan. It requires a strategy with bold new targets to be set to reduce child poverty over 10 years. We want to ensure constant progress towards improving the lives of children in New Zealand.

Two new expert units are being established within the Prime Minister's Department to develop strategy on this. The Child Poverty Unit and the Child Wellbeing Unit will advise on policies and develop the overall strategy to improve the wellbeing of all children.

We want New Zealanders' help on this and there will be widespread public consultation on the plan and the priorities later this year.

Oranga Tamariki, the Ministry for Children, will receive an additional $141.6 million over the next four years so more children and young people receive the care they need.

Grandparents raising their grandchildren and other caregivers will get extra support – we are entitling them to the same clothing allowance as foster carers.

Editorial comment

The Budget papers list the following items as part of the measures to improve children's living standards:

- extending free doctors' visits and prescriptions to under-14-year-olds – 56,000 newly eligible children
- expanding school-based health services to cover decile 4 secondary schools
- increasing the number of children in early childhood education
- increasing access to additional learning support and the amount of support each child gets, with an additional $284 million investment over four years
- increasing public housing by over 6,000 homes over the next four years
- grants for low-income home owners to insulate and heat their homes
- providing $105 million over four years for a clothing allowance for children supported by an Orphans or Unsupported Child's benefit, which was previously limited only to children in care
- improving the Government's efforts to reduce child poverty by establishing the expert Child

Poverty and Child Wellbeing Units

- expanding the sample size of the Household Economic Survey from about 3,500 households to about 20,000 households to provide a more accurate picture of child wellbeing and low income, so we can make sure our policies are making a difference.

Budget 2019

Ministerial statement

> *Next year we will be the first nation in the world to deliver a Wellbeing Budget reporting our annual progress against a range of measures that highlight the health and well-being of our people, our environment and our communities. We will use the Living Standards Framework developed by the New Zealand Treasury to help develop our Budget, and to measure our success.*

Editorial comment

The Budget papers contain no further details on this proposal. Consequently there is no information on the Treasury's Living Standards Framework in the Budget material. How the Framework addresses the subjective concept of "well being" awaits elaboration.