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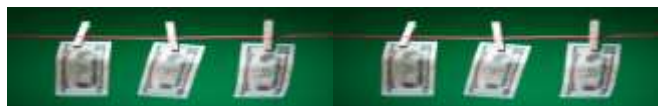
MENDING THE BROKEN TAX SYSTEM!!

Lower personal tax rates, alignment of all tax rates and a package of tax base broadening measures are required to rectify major concerns with New Zealand's current tax system according to the Tax Working Group ("TWG"). The TWG recently released its much-awaited report which outlines a number of workable options for a system-wide reform that the Government should consider in the middle of its three year term.

New Zealand's current tax system originated in the 1980s when domestic and international circumstances were very different to those today. Once regarded as one of the least discretionary tax systems in the OECD, the TWG believes that piecemeal changes to certain taxes, tax allowances and welfare policies (albeit well intentioned at the time) have undermined the coherence and integrity of the tax system and created a system that is unfair and inequitable. The TWG says the system relies too heavily on taxes harmful to growth (e.g. business and personal income taxes) which adversely affect savings, investment and productivity. Workers pay the lion's share of tax collected by the Government at \$28.5 billion or 53% of the total tax take.

Among the Report's recommendations was aligning the top personal rate, now 38% on income over \$70,000, with the 33% rate paid by trusts, while leaving room to lower the company rate from 30% to 27%. How much would you get if the top rate dropped to 33%? It would put about \$20 per week in the pockets of workers on \$90,000 a year but give those earning less than \$70,000 nothing.

The Report also suggested a rise in GST from 12.5% to 15% could be used to cover lower income taxes across the board. We currently pay \$11.6b a year in GST or 21% of the total tax take.



In 2007 the average household spent \$950 a week on living costs, including groceries, fuel, clothing and healthcare.

About \$106 of that was GST, so lifting that tax to 15% would add an extra \$21.25 to the weekly bill. The TWG considers that increasing the GST has merit on efficiency grounds as it would reduce the tax bias against savings and investment and would be easy to administer through existing systems. However, these advantages need considering alongside the impact of increasing GST on equity and fairness. Any compensation to those on lower incomes that would need to accompany an increase in the GST rate would significantly reduce the net revenue raised from increasing the GST rate.

There is a major hole in the tax base concerning the taxation of capital, evidenced in high investment in and low returns from the property market. The Tax Working Group has recommended taxing an investor's net equity in an investment property among its options to curtail New Zealander's passion for property investment. Under this option, real property, or a subset such as rental housing, would be taxed under a risk-free rate of return (RFRM) method. Instead of taxing the owner on gross rents and allowing a deduction for expenses (including interest and depreciation), imputed income would be calculated by applying a risk free rate to the equity that the owner holds in the property each year and taxing the result at the taxpayer's marginal rate. So, if you own an investment property valued at \$300,000 with a mortgage of \$200,000, you have an equity value of \$100,000. If your top tax rate is 38% and the annual risk-free return is 6%, then the taxable income is \$6,000 and the tax liability on the property for this hypothetical taxpayer is \$2,280.

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TAX WORKING GROUP TARGETS DEPRECIATION

Tougher rules for depreciation are among the more targeted base-broadening measures proposed by the Tax Working Group who have eyed billions extra from dumping depreciation tax breaks on buildings (or certain category of buildings). This measure could be adopted quickly by the Government, the Report says. The Group regards it as illogical that taxpayers can claim depreciation on assets that are in fact rising in value. The Report suggests denying depreciation on buildings if, as it suspects, empirical evidence suggests that buildings do not depreciate in value – this could potentially raise \$1.3 billion. They also recommend reducing or removing the 20% depreciation loading that applies to new assets (other than buildings) such as plant and machinery.

Investment Adviser Martin Hawes is quoted as saying many property investors relied on being able to claim depreciation as part of the cash flow for a rental property and used it in their calculations to borrow- “It is quite a major part of a lot of the promotion of property investment.” He believes the Government would need to mount a strong educational campaign to show the value of other asset classes, including shares. His concern is that if property investment is made unattractive, money goes into term deposits or possibly bonds, but investors will continue to shun shares.

The Tax Working Group believes the tax rules around residential property are unsustainable with about \$200 billion invested in rental houses, generating \$500 million in tax losses.

HOW WOULD A LAND TAX WORK?

Most members of the TWG support the introduction of a low-rate land tax as a means of funding other tax rate reductions. A land tax would impose an annual tax liability on land owners, calculated by reference to the value of the land owned.



A land tax is efficient as it does not impose any distortions on economic behaviour. Due to the size of the land base, a large amount of revenue could be raised at a low rate in an administratively efficient way.

The land tax would be levied on the unimproved value of your land (that is the value of the land, not the buildings on it). So if your section, for



example, was worth \$100,000, and the tax was 0.5 %, then you would be liable for \$500 a year. It would probably be added to your rates bill. The TWG recognises that an annual payment of land tax liabilities may give rise to cash flow issues for some landowners with lower income levels, such as retired people. For those unable to pay, it could be accumulated, plus interest, and paid when a property was sold or the owner died. However, estates that seek deferral may have significant liabilities for land tax.

The Land Tax would also be a significant cost on the farming sector which remains cash poor and asset rich and could make farm profitability even more difficult than currently.

The TWG has considered options for reducing the burden of a land tax on land extensive activities. One such option is a value-per-hectare threshold below which no land tax is payable (e.g. \$50,000 per hectare). This would shield land extensive activities such as farming and forestry.

Ironically, in the longer term a land tax would be expected to cause an initial fall in the value of land by up to the net present value of the expected future land tax liabilities. Therefore, a land tax would impose a lump-sum tax on those who own land at the date of its introduction.

ASSET CLASS LESSONS!

Michael Lang, Chief Investment Officer, New Zealand Funds Management, believes over time, asset class returns tend to ‘mean revert’. This means that if an asset class experiences a period of underperformance, then at some point it will experience a period of outperformance.

Historically, shares have returned around 9 per cent per annum, suggesting they may be due for a period of outperformance. However, underperformance in the ‘noughties’ might simply reflect their outperformance in the nineties.

Asset classes can take twenty years or longer to “mean revert” so when making decade projections, merely picking a previous underperformer is not necessarily the answer. Shares, for example, have experienced 20 years of underperformance, so a new decade may not signal a renaissance for them.

However, mathematically each decade that goes by with poor returns (and there can be two decades back to back) increases the probability of a decade of very strong share returns.

The global economy is entering the 'tens' with high debt levels, both private and public, and these debt levels are likely to constrain investment and consequently economic growth. Inflation is also a bigger risk for investors than it has been over the past decade. Governments facing debt problems may decide a little inflation is helpful in effectively devaluing those debts. Although real assets such as property and commodities tend to outperform in a high inflationary environment, residential property is entering the decade expensive which is likely to constrain performance over the next ten years.

Commodities on the other hand are entering the decade reasonably cheap, having underperformed in the 80's and 90's. But investing in commodities is a high risk strategy because commodities are one of the most volatile asset classes to invest in because supply is fixed in the short term. China is now the largest importer of commodities – if its economic growth slows, prices could decline sharply. Any change in demand is reflected in a change in price and price swings are too violent for the average investor. Moreover diversification alone is not enough to mitigate the volatility of commodities.

The Lesson!!

Asset Class	Decade	After Tax *
	(1999-2009)	* Assuming 33% taxpayer & new foreign investment tax regime
Cash	6.27%	4.20%
NZ Shares	6.19%	6.19%
Global Shares	-0.73%	-0.73%
NZ Govt Bonds	6.83%	4.58%
Property	7.18%	7.18%
Commodities	5.03%	3.38%
Source:	NZ Funds Management	

The key, as Michael Lang advises, is not to be financially dependent on the returns from any one asset class.

STUDENT LOAN REPAYMENT THRESHOLD REMAINS THE SAME

The income threshold at which New Zealand-based borrowers must begin repaying their student loans will remain at \$19,084 for the 2010-11 tax year. The threshold is reviewed annually and the decision to hold the repayment threshold unchanged takes into account the current economic climate and the very significant cost of the \$9.6 billion asset to the Crown.



CHANGES TO RWT

RWT rates for bank account holders earning interest are changing to align with the personal tax rate changes introduced on 1 April 2009. These changes will take effect from 1 April 2010.

Income threshold	Current RWT rate	RWT rate 1 April 2010
\$0 - \$14,000	19.5%	12.5%
\$14,001 - \$48,000	19.5%	21%
\$48,001 - \$70,000	33%	33%
\$70,001 and over	38% * or 39%	38%
Company rate	33%	30% ^ or 33%
No-notification rate	38% * or 39%	38%

* From 1 April 2009 interest payers (e.g. financial institutions, banks) had the option to withhold RWT at the lower top rate of 38%. If your interest payer did not offer the 38% rate, you can recover any overpaid RWT by showing the interest and RWT on your *Individual tax return (IR3)* or by requesting a *Personal tax summary* at the end of year.

^ From 1 April 2010 interest payers have the option to withhold RWT for companies at the rate of 30%. Interest payers are required to withhold RWT for companies from 1 April 2011.

If you are currently receiving interest which has RWT deducted at the rate of 19.5% you will be automatically moved to the new 21% rate from 1 April 2010. If you expect your annual taxable income to be under \$14,000 or less, or over \$48,000 from April 2010, you may want to change your RWT rate.

You should be careful in electing 12.5% rate of RWT – if your income is over \$14,000 for the year you may end up with a tax bill.

If you want to change your RWT rate do this through your bank from 1 April 2010.

NEWSLETTERS VIA THE WEBSITE

Thank you for viewing our newsletter online. If you are not already a subscriber and would like to receive our bi-monthly newsletter via email please [click here](#).

AUSSIE HUMOUR!

These were posted on an Australian Tourism website and the answers are the actual responses by the website officials who obviously have a great sense of humour! (not to mention a low tolerance threshold for fools!)

Q: Does it ever get wet in Australia? I've never seen it rain on TV, how do the plants grow? (UK)

A: We import all plants fully grown and then just sit and watch them die of thirst.

Q: Will I be able to see kangaroos in the city streets in Australia? (USA)

A: It depends on how much you've been drinking.

Q: I want to walk from Perth to Sydney. Could I follow the rail tracks? (Sweden)

A: Sure, it's only 3,000 miles – take plenty of water and some shade.

Q: Can you give me some information about hippo racing in Australia? (USA)

A: A-Fri-ca is the big triangle shaped continent south of Europe. Aus-tra-lia is that big island in the middle of the Pacific. Anyway, hippo racing is every Tuesday night in King's Cross. Come naked.

Q: Which direction is North in Australia? (USA)

A: Face south and then turn 180 degrees. Contact us when you get there for more directions.

Q: Can I wear high heels in Australia? (UK)

A: You are a British politician, right?

Q: I have developed a new fountain of youth product. Where can I sell it in Australia? (USA)

A: Anywhere significant numbers of Americans gather and are thirsty.

Q: Do you celebrate Christmas in Australia? (France)

A: Only at Christmas and only once a year.

Q: I am researching a famous Australian animal – I forget its name but it's a kind of bear and I think it lives in city trees. (USA)

A: It's called a Drop Bear because they drop out of gum trees and befriend brainless passersby.

