NOBILO & CO. LTD

CHARTERED
ACCOUNTANTS

JOHN NOBILO, B.Com., CA (PP)

Member of the Institute of Chartered
Accountants of New Zealand

NEWSLETTER

Issue 3
August 2014 – October 2014

INSIDE THIS EDITION

Capital gains tax – ready or not here I come…maybe 1

2014 Budget 2

Motor vehicle options...3

Debt vs Equity..3

Snippets...4

Colorado legalises marijuana sales – six months on...4

Tax Bill enacted 4

All information in this newsletter is to the best of the authors' knowledge true and accurate. No liability is assumed by the authors, or publishers, for any losses suffered by any person relying directly or indirectly upon this newsletter. It is recommended that clients should consult a senior representative of the firm before acting upon this information.

Capital gains tax – ready or not here I come…maybe

Depending on the election outcome, after 20 September 2014 New Zealand may join other developed countries and introduce a 'capital gains tax' (CGT). CGT is on the agenda of several political parties. Where the general left/right divide sees National, ACT, the Conservatives and United Future against introducing a CGT, the other side sees Labour, the Green Party, and Mana-Internet actively campaigning for it. The positions of NZ First and the Maori Party are less clear.

If National wins the election the status quo is likely to remain. If Labour and/or the Green Party win, then the introduction of a CGT is likely.

The rationale for CGT

New Zealand's tax system is designed to be "broad-base, low-rate". The aim with such a system is to have lower tax rates applying across a broader range of transactions so that tax isn't a factor when weighing investment decisions. For advocates of CGT, the absence of taxing capital gains creates a gap in our broad-base system.

Technically New Zealand already taxes some capital gains, but only in narrowly defined circumstances. Introducing a broader based CGT will have a broader impact than the current rules, particularly in respect of land, as more property transactions will be subject to tax and this could promote investment away from the property market and into the productive sector. Once the tax bias towards investment property is removed, the housing market may stabilise.

The introduction of CGT also provides additional tax revenue (estimated at $25 million in year one) that

© 2014

parties such as Labour are relying on to support other policy initiatives.

Likely application of CGT
Given Labour's CGT policy is the most likely form if introduced, a summary has been provided below based on announcements made up to the time of writing.

Gains subject to CGT will be taxed at a flat rate of 15%. CGT would apply to rental properties, shares, commercial properties, farms (excluding owner-occupied farm houses), holiday homes, businesses and fine metals and minerals.

Certain exclusions will exist for the family home, items of personal property, cars, jewellery, art and antiques. An exemption for the sale of small businesses by persons over the age of 55 has also been proposed, along with various deferrals for death and relationship break-ups until the recipient sells the property.

Based on Labour's 2011 policy, implementation of CGT is likely to be on a "valuation day" approach. This will see assets that are going to be subject to CGT valued on implementation and any future increases above that value will be caught.

It is reasonable to expect that if the Labour / Green parties win the 2014 General Election a CGT regime will be implemented, with a likely introduction from 1 April 2016.

2014 Budget

Over recent years there has been a sense of déjà vu through the Budget cycle where we have seen a pattern of minor change and tweaks, with a steady as she goes approach. Given the upcoming election and the fact the 2014 Budget is potentially National's last, there was the potential for more substantive change. However, this did not eventuate and, as before, the focus has remained on maintaining a stable environment and steady economic growth.

Although not front and centre, several tax changes were announced. The Budget included proposals to change the tax treatment of certain research and development (R&D) costs. The Government estimates these R&D related initiatives will return over $58 million to eligible companies over the next four years. In particular, capitalised development expenditure (incurred on or after 7 November 2013) that relates to a patent will be depreciable (where the current tax treatment limits the depreciation to the cost of applying for the patent itself).

Also, a one-off deduction for capitalised expenditure on intangible property that is written off for accounting purposes will be allowed.

A further significant change in relation to R&D is that businesses will be allowed to "cash-out" an amount of their tax losses arising from qualifying R&D expenditure (instead of carrying them forward).

In the area of social assistance, changes have been targeted at low and middle income families with new born babies. In particular, the Budget sets out that eligible families receiving parental tax credits (i.e. those not on a benefit and not eligible for paid parental leave) will receive an increased tax credit (up to a maximum of $220 per week) for longer periods of time (out to 10 weeks from the current 8 weeks). As a result, over 1,200 additional lower-income families are expected to claim the parental tax credit because it will pay them more than they would otherwise receive from paid parental leave. There will also be changes to the abatement criteria to better target families in need.

Paid parental leave will be extended by four weeks. This will be implemented with a two week extension from 1 April 2015, and a further two weeks from 1 April 2016. The eligibility criteria for this will also be widened to include caregivers, and people who have recently changed jobs.

The Budget also included the abolishment of cheque duty from 1 July 2014. Cheque duty was acknowledged as an outdated tax due to changes in the way we transact. The tax previously raised $17 million in revenue (in 1991/1992) but had declined to just $4 million.

Other changes include reductions in ACC levies and freezing the Student Loan repayment threshold at the current level of $19,084. In addition, extra funding was allocated to the IRD to follow up on unfiled tax returns. It is estimated that this extra funding will generate a gross increase in Crown revenue of $297.5 million over the next five years.

The above changes, although minor, are broadly positive. It is difficult not to look ahead to next year with a sense of anticipation. It will either be a new government's first Budget, where 'change' is likely, or the National Government, full of confidence after winning an election, might introduce more significant change knowing they are safe for another three years.

© 2014

Motor vehicle options

Although the tax rules around the private use of motor vehicles have been stable for some years now, other variables can change, such as a person's circumstances. This makes it worthwhile to regularly revisit how vehicles are accounted for to make sure the most efficient outcome is being achieved.

Most small businesses operate through companies and this lends itself toward owning a vehicle in the company and paying fringe benefit tax (FBT) for non-business use. For shareholder employees, a variation of this is to charge the value of the vehicle benefit to the shareholder's current account, which arguably eliminates the need to account for the private use of the vehicle for FBT purposes.

In the first couple of years of a vehicle's ownership, the FBT route is typically the best option economically. This is because the tax benefit of being able to claim depreciation, FBT and the running costs, should outweigh the FBT cost itself.

While within the FBT net, it is important to ensure opportunities to minimise private use are taken advantage of. For example, if an employee does not need to have a vehicle available for their private use 24/7 it may be possible to wholly or partially exclude it. The most common way of doing so is for the vehicle to qualify as a "work related vehicle". If applicable, home to work and other incidental travel is not treated as private use. To qualify, the vehicle needs to be sign-written, not principally designed to carry passengers, and there be a condition of employment that the employee takes the vehicle home. The question of whether a vehicle has been principally designed to carry passengers or not, has been before the courts in the past. Basically, it is accepted practice that a double cab ute can qualify because they are not "mainly" designed to carry passengers. However, vehicles that are more in the nature of standard passenger carrying vehicles, such as sedans will not qualify, unless they are modified (such as by removing the back seats). Once a vehicle qualifies, appropriate restriction letters can be put in place and the FBT liability reduces.

Once into the third year of ownership, the cost of paying FBT tends to outweigh the benefit of the various deductions and therefore other options should be examined. For example, the vehicle could be sold out of the company to the user (potentially triggering a deductible loss on sale) and instead a tax free reimbursement approach could be taken. This can involve more administrative work because a record of actual travel and expenditure needs to be kept. However, this can be simplified through the use of a three month logbook and mileage rates. The mileage, as per the logbook, can be multiplied against a mileage rate to arrive at an estimate of the work related travel costs.

The current IRD mileage rate for employees is 77 cents per kilometre. Care needs to be taken though as reimbursements for high business use (in excess of 5,000km) can add up and there is a risk of a taxable benefit arising. However, it is possible to calculate your own rate based on your own specific circumstances. As long as the estimate is reasonable, i.e. broadly equates to actual costs, a mileage rate can be used regardless of the amount of business travel. Given a reimbursement of this nature is non-taxable to the employee and deductible to the employer there is a positive net benefit.

Next time you're filling out your FBT return, spare a moment to run some numbers to consider if there is a better approach, or contact your accountant to discuss what would work best for you.

Debt vs Equity

All businesses need some degree of funding in order to achieve long term operating objectives. One of the biggest decisions for a small business owner is whether to fund these long-term financial requirements through debt, equity, or a combination of both.

There are advantages and disadvantages to both forms of funding that should be considered when determining the optimal funding structure for a business.

Equity

One of the main sources of funding for a business is through equity. Equity funding can be raised in a number of ways, such as investment from the owners of the business, investment from family and friends, angel investors, venture capital investors, corporate investors or institutional investors.

Equity funding has several benefits. For example, the amount invested is not redeemable, there are no fixed repayment obligations and, profits can be

© 2014

maximised as there is no obligation to pay interest (which reduces the level of financial stress on cash flow). There is also no obligation for the business to pay dividends, which can be important during the start-up phase of a business where cash can be limited.

On the downside, the cost of equity funding is more expensive than debt funding. This is due to equity presenting a higher risk to investors because in the event of financial difficulty debt is repaid before equity. This results in a higher expected rate of return. Further to this, if dividend payments are made, they are not deductible for tax purposes.

Equity holders are also the last to receive repayment in the event of bankruptcy (hence the higher returns required).

Long-Term Debt
Many businesses use some form of debt funding with commitment to payments of interest and/or principal at regular intervals. The main type of long term debt funding used by businesses is loans, either from a bank or other private investors. Larger businesses may also issue bonds.

The main advantage of debt funding is that it is generally a cheaper form of funding than equity and the interest payments are tax deductible.

The downside to debt financing is that interest payments must be made on a regular basis, which can put financial pressure on a business and impact on profitability. The regular outflow of cash also means less cash is available for other projects. In addition, if the business has too much debt, it may be viewed as high risk, and it may be difficult to obtain equity funding if required.

Most businesses opt for a mix of both debt and equity in order to try and reduce the downside of each type of funding. In some cases this can provide other advantages, for example it is possible to shift tax deductions for interest from a company to its shareholders by borrowing to acquire shares. Ultimately, the right mix will come down to the size of the business, appetite for risk, and the stage the business is at in its life cycle.

Snippets

Colorado legalises marijuana sales – six months on
A topic that tends to polarise opinion is that of whether to legalise the sale of marijuana. The use and effect of so-called ‘legal highs’, re-ignited the debate around this issue. Based on recent experience in Colorado, and without getting into the arguments for and against, a brief comment on the revenue generating element of such a change is commented on below.

Colorado became the first US state to legalise the commercial sale of cannabis, effective from 1 January 2014. The tax rate applying to its sale varies depending on its use, with sales of medical marijuana generally taxed at a lower rate than recreational sales.

Approximately $25 million in tax revenue was raised in the first six months, with monthly collections reaching up to $4.8 million. Interestingly, the lower-taxed medical marijuana sales tend to outpace recreational sales.

The regulation of recreational cannabis sales is similar to alcohol sales. For example, you must hold a license to sell marijuana; and use and possession is limited to people over the age of 21 and the drug can only be smoked on private premises.

Although the drug is illegal under federal law, around 20 American states already allow for the sale of medical marijuana. However, Washington is also due to legalise the use of recreational marijuana, from July 2014.

Tax Bill enacted
The Taxation (Annual Rates, Employee Allowance, and Remedial Matters) Bill was enacted on 30 June 2014. One of the notable changes included in this Act included amendments to clarify the tax treatment of employer provided accommodation, accommodation allowances and other reimbursing payments made to employees. Most of these changes will come into effect on 1 April 2015.

The IRD has issued a special report that sets out information on the new rules regarding the changes to employee related payments. To view this report please use the following URL:
http://taxpolicy.ird.govt.nz/publications/2014-sr-employee-allowances/overview .

The Act also deals with distortions arising from the treatment of black hole expenditure, strengthens the thin capitalisation rules, reforms the income tax treatment of land related lease payments, and changes the tax treatment of receipts for easements.

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

© 2014