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## IR's Long-term Insights Briefing

Inland Revenue has commenced consultation on what topic should be covered in its next Long-Term Insights Briefing (LTIB). Inland Revenue, like other government departments, is required to produce a LTIB once every three years.



The purpose of an LTIB is to identify and explore long-term issues to help plan for the future. Initial work has noted that New Zealand's tax revenue is just below the OECD average – 33.3% of GDP compared to the OECD's 34.2%. The means by which New Zealand's tax is generated differs from other OECD countries as follows:

- no compulsory social security contributions,
- no tax on capital gains,
- higher comparative tax revenue generated through GST,
- higher company tax rate,
- high effective tax rates on inbound investments, and
- higher than normal revenue from local government rates.

The proposed topic is "Our tax system: Bases and regimes". This will focus on two key aspects:

1. How to maintain a tax system with a stable core structure that can flex to changing revenue needs (such as due to an aging population).
2. How to address the current tensions within the tax system – integrity versus efficiency versus equity.

Both aspects become important if there is the need to increase revenue. Income tax is New Zealand's

largest revenue source and increasing income tax rates could generate substantial revenue. However, raising income tax, especially for high earners, could discourage investment and economic activity. It may also prompt tax avoidance and reduce foreign investment, as New Zealand's current corporate tax rate is already higher than the OECD average.

Increasing the GST rate is another possibility. New Zealand's GST is already broad-based and effective in raising revenue, contributing more to GDP than many other OECD countries. Raising GST further would disproportionately impact lower-income households, as they spend a larger share of income on goods and services. This could exacerbate inequality, making the option an unpopular route unless offsetting measures are introduced to protect vulnerable groups.

Both options, raising income tax and GST, could provide immediate revenue boosts, but they can come with challenges.

Another option is to introduce new tax policies, with a comprehensive Capital Gains Tax (CGT) being the most discussed. Currently, New Zealand does not tax capital gains on asset sales, except in specific cases like the bright-line test on property sales. This hints at the renewed possibility of a CGT as a way to diversify New Zealand's tax base and ensure that wealth accumulation is taxed similarly to wage income.

As fiscal pressures grow, New Zealand needs to decide whether to raise existing tax rates or introduce new tax policies to meet its future needs. Both options come with significant trade-offs, and the decision will shape the country's economic landscape for decades to come.

The LTIB's exploration of these issues provides opportunity for public debate, as New Zealand looks to ensure that its tax system is fit for the future while maintaining fairness and economic efficiency.

## The depreciable asset

The depreciation rate for non-residential buildings has been reduced to 0%, effective from the 2024 / 25 income year. However, commercial fit-out remains depreciable. This makes the distinction between the two important because it is the difference between not being able to deduct any depreciation at all versus being able to claim a good proportion of a building's cost as 'fit-out'.

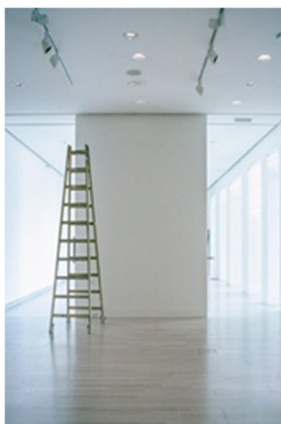
Inland Revenue has recently issued a draft interpretation statement that provides essential guidance on how to correctly identify what the asset is for depreciation purposes. The guidance can be used for the purpose of identifying components of fit-out and depreciable assets generally. At its core, depreciation is an allowance for the loss in value of a capital asset as it is used to derive income. An asset's correct depreciation rate is a function of its estimated useful life and the industry in which it is used.

The legislation treats property as depreciable and therefore it is important to isolate separate items of property to depreciate them independently. The following indicators serve to ascertain whether an item is considered separate property or not.

- Is it physically distinct - can the item be separated based on its physical characteristics such as location or size?
- Is it functionally complete - can the item function on its own? However, this does not necessarily

mean that the item must be capable of independent use or be self-contained.

- Does the item vary in function from another? The item remains separate where one item varies the function of the other, rather than combining to form a larger unified item.



Items are not required to be applicable to all three indicators as it always comes down to a matter of fact and degree. Identifying the relevant item of property can be straightforward in many cases but challenging in others.

The draft interpretation statement provides the example of a vehicle and a trailer, giving several reasons why they are treated as separate items of property for depreciation purposes.

Firstly, they serve different functions: the primary purpose of a vehicle is to transport people, while a trailer is designed to carry cargo. The trailer is used to transport items that cannot be suitably carried by the vehicle, acting as a supplementary addition, rather than an integral part of the vehicle's function. Additionally, the vehicle is functionally complete and can operate independently of the trailer. Although a trailer cannot transport cargo without being towed by a vehicle, it is still considered functionally complete as it contains everything necessary to fulfil its role as a trailer. Therefore, for depreciation purposes, a trailer and a vehicle are regarded as separate items of property.

By understanding and applying these principles, businesses can achieve accurate tax compliance, avoiding the risks of under or overclaiming depreciation. Once finalised, the new interpretation

statement will provide comprehensive guidance on the identification process for separate items of property, ensuring that depreciation deductions are correctly claimed.

## The LTC option

If a company sells a capital asset (e.g. commercial land) and derives a non-taxable capital gain, it's reasonable to expect the shareholders to want access to the cash. However, the problem often arises that in order for a capital gain to be distributed tax-free, the company needs to be wound up.

This is a result of the fact that if a capital gain is distributed in the absence of a wind-up, the distribution comprises a taxable dividend.

Winding-up a company is not always desirable or the most practical route because it may own other assets or otherwise serve a purpose that means it needs to stay in existence. This can mean the capital gain becomes 'trapped'.

Enter the look-through company (LTC) to save the day. An LTC is legally an ordinary company, that elects to be treated as a partnership for tax purposes. As such, the income, expenses, tax credits and losses of the company are attributed to the shareholders based on their ownership percentage.

Just as important in this situation, dividends paid by an LTC to its shareholders are ignored for tax purposes. Hence, electing for a company to be an LTC is an option to enable a capital gain to be extracted tax free. But this gives rise to the question, is this tax avoidance? This exact question was recently covered by Inland Revenue in Technical Decision Summary 24/16 (TDS) issued in August 2024. The TDS notes:



*The Applicant's decision to elect into the LTC regime was to allow the shareholders to retain administrative and financial reporting simplicity, while also allowing tax-free capital gains (e.g., from the sale of assets) to be paid out to the family without requiring the liquidation of the Applicant.*

It was acknowledged that the LTC rules clearly provide for a company to be treated as transparent as intended by Parliament. Therefore, Parliament would consider that the tax treatment of the arrangement is consistent with Parliament's purpose and is therefore not tax avoidance.

It is important to note that the TDS did state that it is a summary only, and does not include various facts or assumptions and hence cannot be relied upon. However, it would be unusual for Inland Revenue to release the TDS without a stronger comment to the contrary if the LTC option was not acceptable for this purpose.

However, the LTC option is not perfect. A tax cost to enter the regime can apply, calculated based on the company's retained earnings. There are also a number of criteria that need to be satisfied, such as it needing to have five or fewer 'look-through counted owners'; which itself can be complex to confirm.

That being said, it is an option to have 'in the back pocket' if the need arises.

## Protect your reputation

Over the last 18 months there have been a number of businesses fall over – which in and of itself has not been surprising given the recent economic climate. However, one element that serves as a warning for us all is the flow on effect of those failures. Not just in a tangible sense, where suppliers or 'subbies' are left out of pocket and can't survive, but where acquaintance businesses can be tarred with the same brush.

We tend to associate the word "brand" with large multi-national companies such as Apple, Microsoft



and BMW, and less so with smaller local businesses. Maybe an equivalent description for a local business is "reputation". It is less tangible, a product of individual perspective, rather than a wider shared view, and can change rapidly. So, what can you do to make sure you are not tarred with

the same brush to ensure you protect your reputation?

Review your customer and supplier list with a non-financial lens. Consider whether there are businesses that have a reputation for trading

aggressively, unexplained profitability or other warning signs – do the owners share similar values to you? Review their on-line profile to confirm their social media posts, images, and videos are not offensive or misleading. Is your relationship with an at-risk business a matter of public record?

Regularly review your own online presence to stay aware of what people are saying about your business. Whether it's praise or criticism, showing that you listen and respond in a constructive way may help prevent people from assuming the worst.

Consider whether you have a disproportionate relationship with a single supplier or customer where if something goes wrong, you could be assumed to be involved or complicit.

When employing new staff, consider where the employees are coming from. Is it a business that has a poor reputation? Is the employee the product of that poor reputation? Or are they a good hire because they left due to that poor reputation.

Beyond your direct business relationships, think broader. For example, if you are sponsoring the local rowing club ask who else is sponsoring it, and who your logo will be sitting beside. Consider what impression being associated with that business will have on your stakeholders.

Finally, have a plan in place for handling issues if they arise. One of the biggest decisions you might face is whether to cut ties with a customer or supplier early, or risk being dragged down with them.

## Snippets

### Trusts - The big picture



For some, the increase in the trust tax rate from 33% to 39% has prompted them to ask the question – should we wind up our trust?

Rather than looking at the purpose of having a trust with a narrow tax

lens, it may be of benefit to consider your circumstances more broadly and ask whether it is time to actually alter and even increase the role of your trust.

A trust provides a number of benefits such as asset and relationship property protection, succession and a way to manage complex family relationships. So instead, it may be worth asking:

- Do you have the right trustees, both now and on your passing.
- What happens on your death (is your will up to date), should the trustees change if you pass away.
- Who should benefit under the trust, in what proportions and is that recorded.
- If you make a distribution to your adult children and their relationship breaks down what happens – are risks mitigated.
- In what circumstances should the trust be wound up.

A will sets out how your assets should be dealt with in the event you pass away. A trust can survive beyond your death, hence it is important that they continue to function and operate as you intend - and it is better to sort this while you're here.

### FBT and home to work travel

A common complaint made by employers is that the amount of time it takes to meet their FBT obligations is disproportionate to the amount of tax it actually generates.

This frustration is arguably borne out in the number of mistakes that are often made when calculating the amount of FBT payable. A good example is employers taking the view that an employee's home is a place of work and therefore FBT does not apply to the use of a company car to drive to and from work.

Inland Revenue has been working on a new interpretation statement that provides guidance on the treatment of home to work travel. It covers topics such as whether taking a vehicle home for charging or security reasons is sufficient to conclude that FBT does not apply. For the purpose of these two examples, the conclusion is that FBT would still apply, which hopefully does not come as a surprise.

The guidance is expected to be finalised shortly. Current treatment should be confirmed based on the guidance once released. However, in line with the original complaint, the draft statement is over 50 pages long and is likely to only reinforce the conclusion that maybe Inland Revenue's resources should have been put into how to simplify the regime instead.



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