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NEWSLETTER

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INSIDE THIS EDITION

Labour shortages

A new year's resolution to grow your business is likely to require growing your team. It's fair to say that the labour market is tight at the moment and seems to be getting tighter with each passing month. Recruitment for staff is taking much longer, with a reduction in both the number and skills of applicants. What is driving it? Is it a NZ issue only, or is there a wider global issue at play?

An obvious observation is the closure of our borders for over two years which prevented international employees from entering the NZ labour market. The hospitality industry in particular has been feeling the impact of this over the past year. Not being able to draw upon the pool of individuals travelling around New Zealand to experience their "OE" has meant it is rare to not see a "short of staff, please be patient" sign when dining out.

The re-opening of our borders in mid-2022 has had the equal and opposite impact, with some skilled New Zealanders finally able to take steps to move and work overseas, thereby reducing the labour pool.

In an attempt to attract high-skilled workers from overseas for the long term, NZ's "Green List" (previously known as the skills shortage list) was significantly expanded in December 2022. Roles added to the "straight to residence" tier include registered nurses and midwives from 15 December 2022, and registered auditors from March 2023, with secondary and primary school teachers being added to the "work to residence" tier from March 2023.

Another theory is that we have an overreliance on labour trained overseas, and that employers are reluctant to invest in the education of migrant workers to ensure they are ready for the NZ workforce, which means, often, they leave. This theory suggests that NZ's labour shortages predate the pandemic, and that underlying fundamental changes need to occur in the way employers treat migrant employees in order to see any improvements.

Another popular suggestion is that we are currently undergoing a structural change in our employment demographic with a "retiring population", which sped up due to the pandemic. Due to the various lockdowns and challenging work environments in recent years, experienced employees who had intended on working for several more years instead decided to retire early. In America, there are around 3.5 million fewer people in the job market compared to pre-pandemic, of which, 2 million has been attributed to this unexpected surge in retirements.

As the labour shortage lingers, employers will either need to think of creative ways to firstly attract and then retain valuable staff members, or decide whether they have no choice but to either pivot and automate a particular role or simply discontinue it.

Residential property – A class of its own

Despite recent reductions in property prices, there is little doubt that the passion New Zealanders have for investing in residential property will survive. However, the tax treatment of residential rental investments has increasingly become a tangled web of complexity due to changes in legislation over the past few years.

It used to be that 'mum and dad' would setup a look through company, purchase the property, all expenses would be claimed (including interest and depreciation) and the loss would offset against other income and be 'exchanged' for a tax refund. Years down the track when the property was sold, the profit was a non-taxable capital gain. Simple.

Roll forward to today and:

- Excess tax losses are 'ring-fenced', carried forward, able to be offset against future rental income and offset against taxable income arising from the disposal of a residential property.
- Depreciation is no longer able to be claimed on residential rental properties, even though it was re-introduced for commercial properties.
- Interest on debt incurred to purchase a residential rental property prior to 27 March 2021 is currently being phased out. If a property is purchased on or after 27 March 2021, interest is non-deductible from 1 October 2021. However, if the property qualifies as a new build, interest remains deductible. The cost of increasing interest rates is being exacerbated by this change because a tax deduction would have otherwise been able to be claimed.
- Finally, the 'capital gain' on sale may also be taxed under the brightline rule. This itself has been extended from an initial 2 year period, to 5 years and is now 10 years, while new builds remain under a 5 year period. This creates the need to not only examine the date of acquisition and sale to quantify the ownership period, but also work out which bright line period actually applies.
- Where a taxable loss on disposal is incurred within an applicable brightline period, it must be carried forward and can only be offset against income from future taxable land disposals.

A cynical person might suggest the next change will be to prohibit a deduction for accounting and legal fees incurred to navigate the rules.

The changes have altered the residential property landscape, placing residential properties into their own category by virtue of their tax treatment. It is now common for landlords to have an income tax liability, even though the property has not made a profit.

Whether these changes have fed into the current challenges facing the residential construction sector is unclear, but it is unlikely that they have helped.

IRD - Whether a subdivision was subject to income tax and GST

In November 2022 Inland Revenue issued TDS 22/21, a Technical Decision Summary on whether the profit from a subdivision was subject to income tax and GST.

TDS 22/21 covered a dispute involving a subdivision by the taxpayer of land into two lots. The taxpayer had acquired the property for the purpose of renovating and expanding it to live in with extended family. The taxpayer and extended family moved in, but after commencing renovation plans found that the existing dwelling had serious issues with drainage and asbestos.

As a result, the taxpayer decided to demolish the existing dwelling, subdivide the land into two lots and construct two new dwellings ('House A' and 'House B'). While the subdivision took place the family moved into a rental and subsequently moved into 'House A' when it was constructed. 'House B' was sold shortly after construction to a third party.

When determining whether a gain on disposal of land is subject to income tax, various land taxing provisions must be considered. If the taxing provisions don't apply, or a specific exclusion to a taxing provision applies, then the gain should not be taxable.

Inland Revenue's Customer & Compliance Services (CCS) team took the view that the following sections applied to tax the gain on sale of House B:

- The taxpayer entered into an undertaking or scheme for the dominate purpose of making a profit (section CB 3).
- The taxpayer acquired the property for a purpose or with an intention of disposing it (section CB 6).
- The disposal was a more than minor scheme for development or division begun within 10 years of acquisition (section CB 12) and the residential land exclusion (section CB 17) did not apply.

The CCS team also argued that a taxable activity was carried out and the sale should be subject to GST.

The Tax Council Office (TCO) disagreed with these assertions, predominately due to the taxpayer's intentions at the time of acquiring the property. As the property was acquired for the sole purpose of housing the taxpayer and their family members, the taxpayer had no intention of disposing of the property or making a profit at the time of acquisition and therefore both sections CB 3 and CB 6 did not apply.

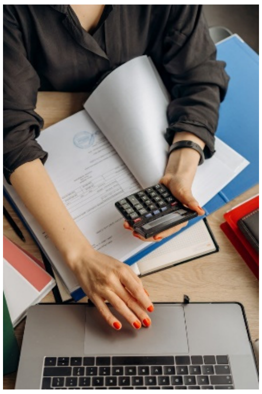
Given the land was occupied mainly as residential land by the taxpayer and their family members before it was subdivided, the TCO found that the residential exclusion under section CB 17 was available to exclude CB 12 from applying. There was specific contention on the application of this exclusion, but it was noted that the exclusion is based on the taxpayer's intended use of the land, and that, under this exclusion, there is no requirement for the taxpayer to reside on the land for more than 50% of the time of ownership – it is not a time-based test.

The TCO also found that the sale was not subject to GST on the basis that it was a 'one-off' activity, and did not constitute a 'continuous or regular' activity – one of the requirements to be subject to GST.

In this case we are left with the question, why did Inland Revenue enter into a dispute with the taxpayers at all? Based on the facts of the case it appears clear that neither income tax nor GST should apply. However, it's good to see that the Tax Counsel Office, which itself is part of Inland Revenue, and made the decision, got to the right answer in the end.

Provisional tax regime

In New Zealand the provisional tax regime is designed to help taxpayers manage their income tax obligations, by requiring certain taxpayers to pay tax in instalments throughout the year, instead of one large lump sum at the end of the year. This regime applies to taxpayers who have residual income tax (RIT) of greater than $5,000 in a tax year – RIT is the amount of income tax payable by a taxpayer after deducting tax credits (e.g. RWT, PAYE).



A provisional taxpayer has four different options available when determining the amount to pay at each instalment:

1. Standard uplift – based on the previous year's RIT + 5%. Where the prior year tax return has not been filed, the payment will be based on RIT from two years ago + 10%.
2. Estimation – this option allows you to estimate what tax you think you should pay. This is often used where income is expected to be less than the prior year.
3. Ratio – payments are calculated as a percentage of GST taxable supplies.
4. AIM (Accounting Income Method) – payments are calculated through accounting software, which allows smaller amounts to be paid more frequently.

Where a taxpayer fails to meet their provisional tax obligations, they will be subject to interest and penalties on any underpaid tax. The current interest rate applying from 17 January 2023 is 9.21% on underpaid tax.

The provisional tax regime has been subject to several concessional changes over the past 10 years, for example:

- As a result of COVID-19, the RIT threshold increased from $2,500 to $5,000, thereby reducing the number of taxpayers subject to the provisional tax regime.
- Where a taxpayer's RIT is less than $60,000, and the amount of provisional tax paid during the year using the standard uplift method results in a shortfall, they will be not be charged interest or penalties provided the shortfall is paid by terminal tax date.
- Where a taxpayer's RIT is $60,000 or more, and

they have paid provisional tax using the standard uplift method, they will only be charged interest from the final provisional tax instalment date. Historically interest and penalties could apply from each instalment date, even if a taxpayer had used the standard uplift method.

One other option that should not be overlooked is to use a tax pooling intermediary to manage provisional tax obligations. Tax pooling is a mechanism by which tax credits effective at a historic date can be purchased from another taxpayer at an interest rate that is less than what Inland Revenue charge.

Between the above concessionary changes enacted over recent years and the option of using tax pooling, the days of incurring large interest and penalty charges with Inland Revenue are in the past.

Snippets

Private school donations

Private schools will typically be registered as a charity. As such, parents will sometimes treat payments to the school as a charitable donation for tax purposes.

Inland Revenue are making it clear on its interpretation on this subject through the release in October 2022 of QB 22/09 – Income Tax – Payments made by parents to private schools and donation tax credits; which may impact the approach taken by some parents.

In summary, payments will qualify as a "gift" for donation tax credit purposes when all of the following apply:

- the school is a donee organisation;
- the payment is money of $5 or more;
- the parent makes the payment voluntarily to benefit the school either generally or for a specific purpose or project; and
- the parent or child gains no material benefit or advantage in return for making the payment.

QB 22/09 includes the below examples which Inland Revenue assert will not be eligible for a donation tax credit:

- A "donation" which results in a discount on tuition fees, or the payer's business being advertised in a school publication.
- Contributions requested by the school with reference to its operating costs, number of students and each family's circumstances.
- A donation of a non-cash prize for the school to use in a fundraising auction.
- The purchase of a ticket for a school event (e.g. quiz night), where part of the ticket proceeds will go towards a school project.

It would be wise to assume the circumstances surrounding a payment to a school will be reviewed by Inland Revenue if it is claimed as a charitable donation.

Marginal tax rates

In New Zealand, a marginal tax rate system is used to tax an individual's income, i.e. the tax rate increases as one's income increases. As at today, the marginal tax rates are as follows:

Taxable income bracket	Applicable tax rate
$0 to $14,000	10.5%
$14,001 to $48,000	17.5%
$48,001 to $70,000	30%
$70,001 to $180,000	33%
> $180,000	39%

The first three thresholds have not changed since 1 October 2010, while the current top tax rate of 39% has applied from the 2021 / 2022.

With the rate of wage inflation being a hot topic at the moment, and a general election due later this year, we adjusted the marginal tax rates for inflation since October 2010 to see what they would look like – particularly given this is an election promise that might be made. The marginal tax thresholds would look something along the lines of:

Taxable income bracket	Applicable tax rate
$0 to $21,000	10.5%
$21,001 to $72,000	17.5%
$72,001 to $105,000	30%
$105,001 to $270,000	33%
> $270,000	39%

With the average salary in New Zealand being around $62,000. Under the current marginal tax rates, this results in $11,620 of income tax payable. However, applying the adjusted rates above, $9,380 would be payable – a difference of over $2,000. For someone on a $100,000 salary, the difference in annual tax payable between the thresholds is almost $4,400 a year.

How much less tax would you be paying?

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