GARY CHAPMAN + ASSOCIATES LTD

NEWSLETTER

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What is the cost of your fixed term debt?

The Reserve Bank of New Zealand uses the Official Cash Rate (OCR) to maintain price stability, i.e. to keep inflation between 1% and 3% over the medium term. Given the recent drop in the OCR (from 3.5% to 3.25%) and the potential for future reductions, it is timely to consider the benefits of changing the terms of your fixed term debt. For example, Bob fixed the mortgage on his rental property at 6.25% for three years. One year later, Bob's bank is offering a 4.95% two year fixed interest rate. Bob is eager to change his mortgage to the lower rate, so he sets up a meeting with his bank manager. At the meeting Bob is told that he can change interest rates but will be charged a $10,000 Break Fee. Why is Bob charged this fee?

A break fee is generally charged as compensation for the loss the bank will suffer if the interest derived from an existing loan reduces as a result of a switch to a lower rate. It is generally calculated on the difference in the bank's margin on the interest rates the borrower is moving between. For example, Bob borrowed $550,000 on a five year fixed term at 6.75% p.a. After three years Bob has $500,000 remaining on his home loan balance and wants to change interest rates to the better 4.95% on offer. Changing over to this interest rate would result in Bob's bank losing about $18,000 of interest income.

As a consequence, the bank may look to negotiate a fee of say $10,000 with Bob if he remains with the bank as an ongoing customer.

As break fees can be significant, it is also important for Bob to know whether it can be deducted for tax purposes.

Tax deductibility of break fees

In 2012 Inland Revenue issued three public binding rulings relating to the deductibility of break fees incurred by landlords:

- BR Pub 12/01 - break fee paid by a landlord to exit early from a fixed interest rate loan.
- BR Pub 12/02 - break fee paid by a landlord to vary the interest rate of an existing fixed interest rate loan (Bob's situation).
- BR Pub 12/03 - break fee paid by a landlord to exit early from a fixed interest rate loan on sale of rental property.

Inland Revenue broadly concludes that break fees on borrowings are deductible where a landlord has borrowed to buy a property from which rental income is derived (or to refinance another loan for that purpose). However the timing of the tax deduction will depend on the situation in which the break fees are incurred.

If the break fee is incurred to repay the loan early, then the break fee will be deductible when it is incurred. In Bob's situation, where the break fee is paid to vary the interest rate under the loan, it will depend on whether he is a cash basis person or not. Whether someone is a cash basis person is determined by the levels of debt and deposit arrangements to which they are a party. Cash basis Bob is able to deduct the amount of the break fee when it is incurred, unless he has chosen to adopt a spreading method, in which case it will be required to be spread over the term of the loan. Non-cash basis Bob will have to spread the fee over the term of the loan.

Whether or not to switch should be decided based on the cash flow cost to do so, the final negotiated fee with the Bank, whether interest rates are expected to increase or decrease and when the benefit of the tax deduction will be claimed.

Land – Themes of Change

There is currently significant public interest in the New Zealand housing market, whether it be issues relating to the Auckland 'bubble', property speculation, non-resident buyers, banking restrictions or a combination of these. In response, the Government is introducing a number of changes designed to either directly influence the market, or assist with decision making when deciding whether further changes are required. The key changes are summarised below

Bright-line test

In the 2015 Budget the Government announced a new bright-line test that will apply to residential property acquired from 1 October 2015. The test will require income tax to be paid on any gains from the sale of residential property bought and sold within two years, with the exception of the 'family home', inherited property and property transferred in a relationship property settlement.

Inland Revenue has now released an issues paper setting out how the test might work and to ask for feedback on the finer details.

It is proposed that the two-year period will run from the date a purchase is registered on Landonline (Land Information New Zealand's online centre), and end on the date the person enters into a sale and purchase agreement.

Because of the risk (from the Government's perspective) that the new rules could apply at the height of Auckland's property bubble, the issues paper recommends that losses incurred on the sale of land should be ring-fenced and only able to be offset against profits from other land sales.

IRD numbers for purchase and sale of property

Buyers and sellers of residential property will be required to provide their IRD numbers at the time a property is transferred. Their IRD numbers will be included with the information submitted to Land Information New Zealand as part of the transaction process. There is an exclusion for New Zealand individuals purchasing or selling their main home (only one main home is allowed). But the exclusion doesn't apply to:

- someone selling their third main home in two years,
- trusts, or
- non-residents.

Where a person is currently a tax resident of another jurisdiction, they will also be required to provide their country of residence and their overseas equivalent of an IRD number.

This initiative is designed to provide the Government with better information regarding the volume of overseas buyers purchasing in New Zealand and improve Inland Revenue's ability to enforce income tax obligations and prevent tax evasion. Whilst the need for the change has merit, it will mean a large number of private Trusts that don't derive income will have to register with Inland Revenue and face annual compliance costs going forward.

Reserve Bank of NZ (RBNZ) Deposit changes

The RBNZ's deposit rules will change from 1 October 2015. Banks will be required to limit lending for residential property investment in Auckland at LVRs greater than 70% (i.e. a 30% deposit) to 2% of new lending. This initiative aims to promote financial stability by slowing down investor activity in the Auckland region.

For those outside Auckland, the minimum deposit requirement will remain at 20%, but instead of lending below this threshold being capped at 10%, it will be relaxed to allow 15% of new lending to have a deposit below 20%.

If you have any questions about the newsletter items, please contact us, we're here to help and look forward to your feedback.

Modernising New Zealand's Tax System

The Government has released two discussion papers to engage in public consultation on options for simplifying and modernising New Zealand's tax system. The documents introduce taxpayers to the general direction the Government intends to take to improve administration of the tax system.

Basically, the Government wants to simplify tax for individuals and businesses by reducing compliance costs, and making interactions with the IRD faster, more accurate and convenient with a greater use of electronic and online processes. As the IRD puts it, "tax obligations should be easy to comply with and hard to get wrong".

The first discussion paper 'Making tax simpler – A Government green paper on tax administration' outlines the overall direction of the tax administration modernisation programme. Key elements of potential change include:

- Simplifying tax for businesses, for example by streamlining the collection of PAYE, GST and other withholding taxes and integrating these obligations into business processes. Options will be investigated for simplifying the calculation of provisional tax – with more emphasis on real time information, together with payment options that better reflect taxpayer's cash flows.

- Simplifying tax for individuals by providing online income tax statements for individuals pre-populated with income details, so that all that would be required is to 'check and confirm'. Technology will be used more effectively to better manage both overpayments and underpayments of tax.

- Social policy objectives would be met by using information that the IRD or the Government already holds, providing for timely payments on a more real-time basis, resulting in certainty for individuals and families. With faster, more accurate information, there should be less chance of people receiving too much and going into debt.

The IRD wants to make tax obligations part of the normal day-to-day business processes, making it quick, easy and harder to get things wrong.

The second discussion document 'Making tax simpler - Better digital services' outlines proposals for greater use of electronic and online processes. In particular the discussion document considers whether secure digital services can be delivered using the current policy and legislative framework and discusses options to move people to digital services, these include:

- The IRD working with third parties such as banks and business software developers so that tax interactions are built into a customer's regular transactions rather than managing tax separately at specific times of the year.

- Non-digital services will need to be provided for those who still cannot use digital services.

- A process would be developed for moving to a digital format those who could potentially use digital systems for some services - in circumstances where there would be wider benefits accrued.

These are the first two releases in a series of public consultations designed to modernise and simplify the tax system. Further discussion documents will be released over the next two years and public feedback is requested.

The significance of this process can't be overstated. In an age where changes in lifestyle as a result of technology have moved at an explosive rate, the design, administration and technology associated with our tax system have not kept up.

The Impact of 'Dairy'

Fonterra's latest estimate of the dairy payout for the 2015/16 season is $3.85/kg milk solids. This comes off a record $8.40/kg for the 2013/2014 season. It is estimated the average dairy farmer needs $5.60/kg of milk solids to breakeven, so it goes without saying that financial upheaval is coming, but how significant and wide reaching will it be?

The extent of the impact is likely to go beyond discretionary commercial spending, on items such as infrastructure and new equipment, and extend to personal spending on items such as entertainment, transport and clothing. Rural communities across the country will feel the economic pressure. Banks will focus on highly indebted farmers, and some are likely to be forced to sell their farms. As the risk factor across the agricultural sector worsens, banks will adjust their margins across their wider lending portfolio (a means banks use to spread their risk) which could drive an increase in the cost of debt for all borrowers. The New Zealand exchange rate with the United States dollar has been consistently dropping over the past 18 months, in part being exacerbated by the drop in the dairy pay-out, and this will cause the price of all imports to rise – private and commercial.

On the bright side:

(a) 'dairy' comprises 20 per cent of New Zealand's exports, so although it is material, it is not the only egg in New Zealand's basket. The remaining 80 per cent of exporters will enjoy the benefit of the lower New Zealand dollar. The tourism sector is also expected to grow as a result of the change in the exchange rate.

(b) On 11th September dairy prices sharply surged higher for the third time in a row at the latest Global Dairy Trade auction, with the GDT price index rising by 16.5% since the last sale earlier this month.

Whole milk powder's average price was US$2,495 a tonne.

While the gains looked encouraging, prices still have a long way to go before Fonterra's $3.85 per kg of milksolids milk price forecast – which rests on wholemilk powder prices reaching US $3,000 a tonne next year – can be realised.

To survive, it is essential that all businesses that are reliant on the dairy industry ensure they are resilient and well prepared. Being proactive and talking to your banker and accountant early is key. Forecast cash flow and budgets should be reviewed and revised to ensure they are realistic. Further, methods for creating cost efficiencies should be implemented to ensure your business remains competitive…and survives.

Tax inspectors without borders

A new initiative, dubbed "tax inspectors without borders" has been launched to help poor countries crack down on tax avoidance and fund their own development.

According to policy research group, Global Financial Integrity, nearly US$1 trillion is estimated to leave poor countries each year in illicit finance, stemming from tax evasion, crime and corruption.

To help developing countries stop these outflows, the "tax inspectors without borders" initiative will see experts from well-functioning states lend a hand to officials in poorer countries with carrying out audits to detect tax dodging; mainly by multinationals (a number of multinationals are using aggressive tax planning to reduce their tax bills, or avoid paying taxes altogether).

It is hard to imagine how such an initiative will play out given the dangers that exist in some developing countries around the globe – do we picture paramilitary types carrying calculators?

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