To: The Prime Minister
HonSimon Power
Hon Steven Joyce
Hon Paula Bennett

From: Minister of Finance and Minister of Revenue

Re: Ministers' Sub-Group on Tax Meeting on 8 March 2010

Date: 5 March 2010

Attached for the second meeting of Ministers' Sub-Group on Tax is:

- An agenda; and
- Summary papers on each of the issues to be discussed:
  - Appendix 1 – Depreciation changes
  - Appendix 2 – Other property taxation issues
  - Appendix 3 – Working for Families issues
  - Appendix 4 – Tax rate for savings vehicles
  - Appendix 5 – Thin capitalisation changes

A separate summary is provided of the overall revenue effect of the package of options to date. We note that the costings provided in the summary papers above are based on a scenario with no company tax rate change whereas the costings in the table in the bottom left-hand corner of the summary of costings are based on a company tax rate reduction scenario.

Key decisions to be made on Monday are listed at the start of each Appendix.

Ministers' Sub-Group on Tax

Agenda for meeting 2 – 8 March 2010

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1. **Depreciation** (15 minutes)
- Removal from buildings
- Depreciation loading
- Capital contributions

a. Briefing by officials (Robin Oliver / Steve Mack)
b. Sub-group discussion and key decisions on depreciation

2. **Other property taxation issues** (15 minutes):
- LAQCs;
- Ring-fencing of rental property losses;
- Capital/revenue boundary issues; and

a. Briefing by officials (Andrew McLoughlin / Robin Oliver)
b. Sub-group discussion and key decisions on property-related tax issues.

3. **Working for Families issues** (7 minutes):
- Integrity issues;
- Removing indexation of the abatement threshold.

a. Briefing by officials (Robin Oliver / Andrew McLoughlin)
b. Sub-group discussion and key decisions on Working for Families issues.

4. **Tax rate for savings vehicles – including PIEs** (7 minutes):

a. Briefing by officials (David Carrigan / Steve Mack)
b. Sub-group discussion and key decisions on tax rate for savings vehicles issues.

5. **Thin capitalisation rules issues** (7 minutes):

a. Briefing by officials (Steve Mack / Robin Oliver)
b. Sub-group discussion and key decisions on thin capitalisation rules issues.

6. **Summary of package options to date** (including costings) –

a. Update by officials (3 minutes) (Michelle Harding).
b. Mid-March report-back to Cabinet on progress of the design of the package.

7. **Agenda for meeting 3, 22 March 2010 –** consideration of:
- Compensation for any increase in GST (deferred from this week);
- Company tax rates;
- Company tax consequential issues (including provisional tax); and
- Composition of the final tax package.

APPENDIX 1

DEPRECIATION CHANGES

The recently released Tax Working Group (TWG) report made recommendations to remove depreciation from buildings where empirical evidence suggests they do not decline in value and to remove the 20% depreciation loading that currently applies to some assets.

Key decisions

Depreciation on buildings

- Whether tax depreciation should be removed from all buildings with an estimated useful life of 50 years or more (Treasury recommendation) or only residential and commercial buildings with an estimated life of 50 years or more (Inland Revenue recommendation).
- Whether the change should apply to existing buildings as well as newly acquired buildings (joint recommendation).
- Whether the current treatment of gains and losses on buildings (no deduction and no taxation) should be retained (joint recommendation).

Depreciation loading

- Whether the 20% depreciation loading should be removed.
- Whether the loading should be removed only in respect of new assets (Inland Revenue recommendation) or for all assets (Treasury recommendation).

Capital contributions

- Whether the cost of a depreciable asset should be reduced by the amount that is funded by a capital contribution so that taxpayers are not able to claim depreciation for costs that they have not, in fact, incurred.

Depreciation of buildings

Existing law provides a deduction (depreciation allowance) for the cost of a building used to earn taxable income over its estimated useful life. The estimated useful life of a building is generally 50 years. There are shorter life estimates for a number of other classes of building. Examples include barns, chemical works, dairy sheds and fowl houses.

If buildings are not expected to decline in value, allowing depreciation deductions is a subsidy that may encourage over investment in what becomes a tax preferred asset.

Of the countries we have looked at, many allow depreciation deductions on all categories of building, sometimes at higher rates than New Zealand currently allows. However, some deny depreciation deductions for residential and commercial property as shown in the following table:

	Depreciation treatment		
Country	**Residential rental buildings**	**Commercial buildings**	**Industrial buildings**
Australia	Yes	Yes	Yes
Germany	Yes (but at a lower rate than non-residential buildings)	Yes	Yes
Hong Kong	Yes	Yes	Yes
Ireland	Generally no	No	Yes if used for certain manufacturing activities
Japan	Yes	Yes	Yes
Malaysia	No	No unless explicitly allowed by the Minister of Finance	Yes
Singapore	No	No	Yes
Thailand	Yes	Yes	Yes. Hotels, hospitals and buildings used in research are classified as industrial buildings.
The Netherlands	Yes, but this is capped using the building's rating valuation	Yes, but this is capped using the building's rating valuation	Yes, but this is capped using the building's rating valuation
United Kingdom	No	No	No (Previous tax relief is being phased out)
United States	Yes	Yes	Yes

Two strands of evidence support the removal of depreciation for, at least, certain categories of buildings:

Under taxation of the property sector. For example losses on residential buildings and the fact that the absence of a capital gains tax may provide reasons for tighter rules on depreciation than would otherwise be the case.

Data on whether buildings decline in value. The evidence on depreciation rates is mixed across countries and across sectors. International studies generally find that buildings depreciate. However the rate of depreciation varies across sectors with most studies suggesting low rates for residential property, medium rates for commercial buildings and higher rates for industrial buildings. These studies do not use New Zealand data. To try to correct for this deficiency, the Treasury has obtained and analysed rating valuation data, complied by Quotable Value (QV).

Consistent data has been obtained for the period 1993 through 2009. The data suggests that all categories of buildings have, on average, appreciated over the period, in both nominal and real terms, although at different rates (approximately 1% in real terms for industrial buildings; 2% for commercial buildings; and 3% for residential buildings), even when the impact of major building improvements is omitted. However there are two main factors which could lead to these figures being over-estimates. First the period has been one of abnormally high appreciation in property values generally, although some properties in the QV data were depreciating over the first three years of the sample period. Secondly, the analysis does not capture scrapped buildings, and so may overstate appreciation. While the methodology employed attempts to control for these factors, some bias likely remains.

Overall, officials suggests that there is a strong case for the removal of depreciation on residential buildings, a less strong but reasonable case for removing depreciation on commercial property and a weaker case for doing so on industrial buildings.

Officials recommend that depreciation be removed for all residential and commercial buildings with an estimated useful life of 50 years or more.

Inland Revenue recommends that, on balance, the current depreciation rates should be retained for industrial buildings until the overall package and fiscal position is clearer. The intention to retain depreciation for such buildings could be announced in the Budget with focussed consultation carried out after the Budget to define the borderlines before the effective date of the depreciation changes.

Treasury recommends that depreciation also be removed for all industrial buildings with an estimated useful life of 50 years or more. Drawing border lines is complex and announcing that industrial buildings will be carved out in the Budget without knowing how that would be done raises significant fiscal and process risks. Buildings with a useful life of less than 50 years would continue to be allowed depreciation. These include barns, chemical plants, and dairy sheds, for example. Other classes of buildings could be depreciable in cases where it could be shown they have less than a 50 year useful life. Treasury understands that many industrial buildings have useful lives of less than 50 years so many will effectively be carved out by this approach without the need to hastily develop new rules defining what an industrial building is.

Officials also recommend that the change apply to existing buildings, rather than applying only to newly acquired buildings. While this is not the standard transition approach for depreciation rate changes, it is consistent with how many other tax changes are introduced.

Denying depreciation for all buildings (other than those with a less than 50 year useful life) is estimated to raise $720 million in 2011/12, increasing slowly in outyears. It is estimated that retaining depreciation for industrial buildings will reduce this to $540 million in 2011/12. [1]

Officials have examined the related issues of whether gains and losses on buildings should be allowed. On balance, officials recommend retaining the current treatment (with no deduction of losses, and no taxation of gains) subject to any changes arising from the Property-related tax issues report (T2010/225 PAD2010/28).

Building depreciation - impact of proposed changes

Jill and Mike own a residential rental property. The building cost $371,000. It is rented out for $400 a week giving rental income of $20,800 a year. The couple funded the purchase of the property by using $74,000 from their savings and through a $297,000 mortgage. Interest payments on the mortgage are $23,400 per year. When other property expenses are added, the total outgoings are $26,600 per year. They also currently claim $7,420 tax depreciation on the value of the apartment building. This means they have total tax deductions of $34,020, which they are able to offset against the rental income plus against the income from their jobs. This reduces their PAYE by $4,362.60 (assuming a 33% tax rate), leading to a cash loss of $1,437.40 or $27.64 per week.

Under the proposed changes, Jill and Mike will no longer be able to claim building depreciation. As a result, the level of expenses will be reduced to $26,600, increasing their tax liability by $2,448.60 and cash loss to $74.64 per week. However, this does not take into account the impact of other parts of the tax reform package, such as changes to personal tax rates.

This is illustrated in the following table.

[1] Both costings are done on the basis of the proposed personal tax rates, and a 30% company tax rate. Lowering the company tax rate to 28% would reduce these by approximately 5%.

	Current		Proposed – depreciation changes		Proposed – depreciation and loss ring-fencing	
	Tax	**Cash**	**Tax**	**Cash**	**Tax**	**Cash**
Income	20800	20800	20800	20800	20800	20800
Interest	(23400)	(23400)	(23400)	(23400)	(23400)	(23400)
Other expenses	(3200)	(3200)	(3200)	(3200)	(3200)	(3200)
Depreciation	(7420)	-	-	-		
loss	(13220)	(5800)	(5800)	(5800)	0	0
Tax benefit at 33% (annual)	4362.60	4362.60	1914	1914	0	0
Cash loss		(1437.40)		(3886)		(5800)

For comparative purposes, we have also included the impact of also introducing loss ring-fencing of rental property losses (as discussed in Appendix 2). This further reduces the tax loss by denying the ability to offset the rental loss against other income, thereby further increasing the cash loss.

Under the current system, the cash loss is partially offset by the depreciation deduction. Under the depreciation only proposal, that is no longer the case. Under the proposal of depreciation changes plus loss ring-fencing, the entire cash loss is borne by the property owner.

Depreciation loading

The TWG recommended the removal of depreciation loading. Depreciation loading applies to all new plant and equipment, and accelerates depreciation of an asset by 20%. It does not apply to some types of assets, including buildings, second-hand assets and intangible property.

Loading was originally introduced as an incentive for capital investment. Removal of loading would make the depreciation rates on such assets more closely approximate their true economic lives, increasing the neutrality and efficiency of the tax system. The removal of loading also provides increased revenue to fund tax rate reductions.

Inland Revenue recommends that loading be removed on a prospective basis as loading was explicitly introduced as an incentive to which businesses have reacted. Removing depreciation loading from new stock is estimated to raise $140 million in 2010/11, rising to $370 million in 2013/14. [2] Ministers should note that this is different from the recommended treatment for buildings.

Treasury considers that the case for grandfathering depreciation loading is no stronger than is the case for grandfathering building depreciation and recommends that depreciation loading be removed for all assets post-Budget 2010. This would raise additional fiscal revenue of $630 million in 2011/12, but this additional gain reduces to $160 million by 2013/14, and continues to fall sharply in outyears as the short-lived assets become fully depreciated.

[2] Both costings are done on the basis of the proposed personal tax rates, and a 30% company tax rate. Lowering the company tax rate to 28% would reduce these by approximately 5%.

Capital contributions

Some taxpayers, primarily electrical lines companies, receive a capital contribution from potential customers to pay for new lines installations to their business or residence. Receipt of the capital contribution is not taxable. However, using the capital contribution to pay for constructing the new lines becomes makes it become part of the cost basis of the lines and is currently depreciable.

The current treatment allows taxpayers to claim depreciation for costs that they have not, in fact, incurred. Moreover, if the payer of the contribution is a business, they may also be allowed a deduction, effectively allowing the same costs to be deducted twice.

Officials recommend that the cost of the depreciable asset be reduced by the amount that is funded by a capital contribution. Officials estimate that this proposal will increase revenues by approximately $5 million in 2010/11, growing to $8 million in 2013/14. Officials recommend that this change apply from Budget night, to prevent taxpayers accelerating expenditure to take advantage of the more generous treatment currently available

APPENDIX 2

OTHER PROPERTY TAX ISSUES

Three property-related tax issues are presented for your consideration:

- moving Loss Attributing Qualifying Companies (LAQCs) to a tax treatment that is consistent with limited partnerships.
- Ring-fencing to prevent losses on property being used to offset tax on other income.
- A bright-line test to clarify when gains on assets such as property are taxable.

Key decisions

- Whether an announcement should be made in Budget 2010 that LAQCs will become flow-through entities for income tax purposes, similar to limited partnerships. After Budget, officials would release an issues paper on implementation of the changes. Officials consider that the changes could apply for income years commencing on or after 1 April 2011.
- Whether officials should undertake further work on the ring-fencing of losses. Inland Revenue considers that the disadvantages of ring-fencing outweigh the advantages, while Treasury considers that further work may be worthy of consideration after the Budget. Officials do not consider that robust loss ring-fencing rules could be developed in time for Budget night enactment.
- Whether officials should undertake further work on a time-based test for disposals of property to clarify the boundary between capital and revenue (or income) in the tax system. Officials do not consider that a time-based test using a short period (say, 2 years) is desirable. Inland Revenue considers that a lengthy time-based test (say, 10 years) would raise much the same issues as a general capital gains tax.

LAQCs

Since their introduction, LAQCs have become a popular business form in New Zealand. From 2000 to 2008, the number of LAQCs grew from 39,211 to 132,308 (237 percent) and the total value of LAQC tax losses grew from $468 million to $2.294 billion (390 percent).

LAQCs are typically used for situations where tax losses are expected (such as start-up companies and for investments in forestry and rental properties), as they allow for losses to be passed through to shareholders to reduce an individual's personal tax liability. They have also been the vehicle of choice in many tax avoidance schemes.

There are significant problems with the current LAQC rules:

- Profits are taxed at the company rate (30 percent), but any losses can be allowed as a deduction at the shareholder's marginal rate (up to 38 percent). This disparity creates arbitrage opportunities and raises a number of issues around tax base integrity.

- An LAQC shareholder can deduct losses in excess of their equity in the LAQC, so the amount of losses may not be commensurate with the level of financial risk that the shareholder faces.

- A loophole in the LAQC rules allows shareholders to claim losses and then avoid personal liability for the company's tax by revoking LAQC status before remission[3] income arises.

Officials have recommended making qualifying companies (QCs) and LAQCs full flow-through entities for income tax purposes, similar to limited partnerships. Instead of only losses flowing through to shareholders, both the LAQC's income and losses would be passed through in the year they occur, so income would be taxed and losses deducted at the shareholder's marginal tax rate. A loss limitation rule would allow taxpayers to offset, for tax purposes, only those net tax losses they have actually borne (that is, the same tax rules applying to limited partners would apply to LAQC shareholders).

This proposal could be announced as part of Budget 2010. After Budget, officials could release an issues paper on the implementation of the changes. The changes could be included in a bill introduced later this year, which allows for further consultation at the select committee stage. Officials consider that the changes could apply for income years commencing on or after 1 April 2011.

Pros and cons

- The recommendation to make QCs and LAQCS full flow-through for income tax purposes would be more consistent with the original intention of LAQCs to approximate partnership treatment for income tax purposes.

- Full flow-through treatment would address concerns about integrity based on the current arbitrage opportunities, tax losses exceeding what shareholders are at financial risk for, and would fix the remission income loophole.

- Consequently, the proposal would improve the integrity and coherence of the tax system.

- The proposal is estimated to increase revenue by up to $65 million per annum. In addition, addressing the remission income loophole would increase revenue by upwards of $7 million per annum.

- There would be some minor compliance costs for QCs and LAQCs and their shareholders with the introduction of the proposed new rules.

Ring-fencing of rental property losses

Under current law, a loss arising from a rental property investment is able to be offset against the other income of the taxpayer. This reduces the tax payable on any other income earned.

Ring-fencing rental housing losses would limit the offset of such losses in any given year to the net income earned from rental housing investments. A number of OECD countries have some degree of loss ring-fencing for passive investments.

[3] Remission income includes the amount of debt forgiven by a creditor.

Pros and cons

A key objective of ring-fencing would be tax base maintenance. The rental housing stock is large in value but currently generates an overall loss for tax purposes. The proportion of rental housing owners reporting losses on their properties has increased substantially over the past decade.

Another objective would be to alter the long-term allocation of savings and investment. By reducing the after-tax return from investing in rental housing, there may be a marginal shift of investment into other investment assets. To the extent that there is, in aggregate, over-investment in housing, this would potentially provide growth benefits.

A third objective might be to assist in dampening house price cycles by reducing demand from investors with low levels of equity.

Prime facie, applying loss ring-fencing only to investments in residential rental housing and not to other investments would distort investment behaviour, given that losses in other situations are generally not ring-fenced. Distortions could occur between rental property and other forms of investment, and between investing through debt and investing through equity. This could lead to under-investment in housing compared to other assets, including real property assets.

The resulting marginal shift of investment may, however, improve efficiency if it offsets another distortion in favour of housing, such as the non-taxation of capital gains. In this context, the problem is that the investor is only being taxed on part of the economic return they are getting from the property. More specifically, the taxpayer is able to claim full deductions for expenditures incurred in respect of the rental property investment, while only being taxed on the rental income and not the capital gain.

Quarantining losses, however, addresses the symptoms but not the problem as the problem arises irrespective of whether or not investment in these assets is highly leveraged. The current tax treatment is, in fact, relatively neutral between debt-financed investment and equity-financed investment. Ring-fencing is likely to result merely in a switch in the composition of investors, with high tax rate investors with adequate equity likely to replace those low equity investors driven out of the market by the loss quarantining.

Furthermore, borrowing to finance other investments such as shares, which are also capable of making capital gains, would not be ring-fenced.

As is the case with any tax measure that reduces the tax benefits of an investment, loss ring-fencing is likely to put upward pressure on rents and, at least initially, downwards pressure on house prices. However, Treasury modelling suggests that these effects are likely to be modest.

Consequently, the impact that ring-fencing might have on property prices (and hence on property price cycles) should not be overstated. It is worth noting that countries which have quarantined losses have still experienced large property cycles.

There are a number of design issues around the practicality of loss ring-fencing. It may be difficult, for example, to prevent taxpayers structuring around ring-fencing rules due to the fungibility of money and the difficulty in tracing and matching borrowing to particular investments. Past rules in this area were relatively easy to plan around. There are boundary issues such as how to define rental housing and how to treat mixed use properties. There are transitional issues around how to deal with existing properties.

Limiting the ability to offset rental losses against other income will be fiscally positive. The actual revenue gain will depend on other budget initiatives (for example, denial of building depreciation, which may eliminate some losses) and tax rate changes; any transitional rules regarding existing properties; and the "water-tightness" of the rules. Depending on these factors, the static revenue estimates range from $200 million to $300 million per annum after five years. Behavioural changes will, however, result in lower revenue gains. It is a matter of judgement how large this reduction in revenue gain will be.

Capital/revenue boundary

The distinction between capital and revenue can be important, particularly given the absence of a general capital gains tax in New Zealand. In very general terms, the distinction is between flows of income (revenue) and one-off payments (capital).

Distinguishing between capital and revenue in any particular case is a subjective exercise. This creates complexity and uncertainty. Areas of uncertainty can include whether or not a person is in the business of dealing in property, and whether or not they intended to sell an item of property at the time they acquired it. The uncertainty creates compliance costs for taxpayers and cause challenges for audit and enforcement work.

A time-based test

The question is whether a time-based test would help to address these problems. Such a test could act as a rough proxy for determining whether a transaction was on capital (non-taxable) or revenue (taxable) account. An amount derived from disposing of an item of property would be treated as taxable income if the property had been owned for less than a specified period.

The rule could be applied generally or be limited to particular types of property (company shares and/or various categories of real property).

The period could be any length. There are pros and cons to a short period and a long period. The advantage of a short period (say 2 years) is that it is more likely to be viewed as an enhancement or clarification of the current intention test rather than a capital gains tax. A disadvantage is the tax can be easily avoided by holding the asset longer, creating behavioural distortions and yielding little revenue. There is also risk that even if the test is meant to enhance and not replace the current intention test, it may have the effect of becoming a safe-harbour from the intention test instead of an addition to it, and so could cost revenue.

A longer period test, say 10 years, would have the advantage of applying to some sales and so generate some revenue, as not everyone will hold the asset long enough to avoid the tax. There will still be behavioural distortions and lock-in effects when a taxpayer wants to sell an asset near the 10 year boundary. A 10 year test has an advantage of being consistent with a current 10 year test applying to property developers and dealers, so there is a precedent for it. A 10 year test has the disadvantage of possibly being viewed as a capital gains tax, which the government has announced it would not implement.

Issues to consider

A time-based test would remove some ambiguity from the tax system for property held for a limited period of time. The rule would be readily understood by taxpayers and more easily enforced by the Inland Revenue. But there would be significant drawbacks. In particular:

- Strong lock-in effects. People would be incentivised to hold onto property for the required period to escape tax. This would tie-up capital that could be more productively used elsewhere.

- The tax would fall mainly on those who *had* to sell within the time period and may give rise to difficult cases involving financial hardship, medical expenses and perhaps relocation.

- Scope for gaming, with people selling loss-making assets within the time period. This would only be expected to occur in order to cut losses (given taxpayers are otherwise unlikely to desire to incur a dollar of loss in order to save 38% of it)

It is also not clear a time-based test would address the problems identified. For sales that could be put off until after the time period, uncertainty and enforcement difficulties would not be resolved, simply deferred.

The fiscal impact would probably be positive, but is likely to be small because of strong behavioural responses. Quantifying the fiscal impact would depend on final policy design.

APPENDIX 3

WORKING FOR FAMILIES ISSUES

The TWG noted integrity concerns with respect to Working for Families (WFF) due to the ability of taxpayers to artificially lower their incomes and qualify for WFF tax credits.

Key decisions

- That a review to address integrity concerns relating to WFF tax credits should be announced as part of Budget 2010, with a view to developing comprehensive solutions for legislation potentially as early as 2011.
- That amendments which would prevent people offsetting investment losses (such as losses from rental properties) from their taxable income for the purposes of increasing their WFF entitlement should be enacted as part of Budget night legislation with effect from 1 April 2011 (Treasury recommendation).
- That the indexation of the WFF tax credits abatement threshold should be removed as part of Budget 2010.

WFF integrity issues

The income tax definition of "taxable income" is used as the basis for determining eligibility for social assistance programmes delivered through the tax system. Some adjustments are made to taxable income for WFF tax credits purposes. For example, business losses and LAQC losses are not taken into account for determining WFF tax credits.

Using adjusted taxable income is the current approach used to determine a family's entitlement to WFF tax credits. Other possible approaches include a cash flow approach based on a family's ability to pay for day-to-day expenses, and asset testing.

Some families have structured their financial affairs with an effect that they receive more WFF tax credits than they would in the absence of these arrangements and beyond what their true economic circumstances justify. For example, if the income of a family trust is taxed as trustee income, instead of as beneficiary income, it can be later distributed to beneficiaries without being included in their taxable income– and so are not included in their calculation for WFF purposes.

Pros and cons of reviewing integrity concerns relating to WFF tax credits

The objective of the review would be to determine the appropriate measure of income, from an integrity perspective, for determining WFF tax credits. The proposed review would consider how the WFF tax credits can best meet the objective of supporting low and middle income families with dependent children.

WFF integrity is jeopardised when people receive more assistance than what their true economic circumstances justify. This has a fiscal cost as more WFF tax credits are being paid out than should be the case. It is also inequitable because families in similar economic circumstances are treated differently.

Amending the definition of taxable income that is used for WFF purposes would enable WFF entitlements to better reflect a family's available financial resources. This would help to address some current concerns around integrity and inequity.

Inland Revenue calculates that disregarding investment losses for WFF purposes could reduce expenditure by approximately $15 million per annum.

The proposed review could have wider implications than WFF tax credits, because similar integrity issues arise with other types of social assistance, for example, income-tested student allowances. There would be some increase in compliance and administrative costs from having a more robust definition of income for WFF purposes.

Removing indexation of abatement threshold

Existing law requires that both the amount of the Family Tax Credit and the income threshold at which Working for Families (WFF) tax credits begin to abate be adjusted for inflation ("double indexation"). This ensures that the real value of assistance is maintained over time. However, it results in a double benefit for those above the abatement threshold.

Officials have recommended removing the indexation of the WFF tax credits abatement threshold only (and not removing indexation for the amount). This proposal would not affect families with incomes below the current $36,827 threshold.

The removal of indexation of the abatement threshold for WFF could be enacted on Budget night which would lock in the current threshold. Doing so is estimated to reduce expenditure by $95 million per annum once savings are fully realised in 2012-13. Note that the reduction in expenditure of $95 million may change before final decisions are made, depending on preliminary Budget 2010 forecasts.

There are sound policy reasons for the removal of indexation of the income threshold. While double indexation maintains the status quo in real terms for those receiving full unabated WFF tax credits (income below the abatement threshold), it increases the net real benefit of WFF for those families with incomes above the threshold. This is because indexing the amount of the WFF tax credits increases the gross amount they receive, while indexing the abatement threshold increases the amount kept before it begins to abate.

The double indexation benefits those with incomes above the abatement threshold more than those with incomes below the threshold. This result is inequitable and an inefficient targeting of Government support.

After removing the threshold indexation, over time the effect of inflation would increasingly target WFF tax credits to lower income families.

TAX RATE FOR SAVINGS VEHICLES

Portfolio investment entities (PIEs) are an optional set of tax rules for managed funds and other collective investment vehicles. The PIE rules were introduced in October 2007 to align with the launch of KiwiSaver.

The PIE rules are designed to reduce investment distortions by making the tax rules for managed funds more consistent with the tax treatment that would apply if the underlying investments were held directly. This is achieved by:

- investors in the PIE being able to elect a tax rate with the PIE that reflects their marginal tax rate (although this is currently capped at a maximum of 30%); and
- not taxing the PIE on any profits from selling shares in New Zealand companies or Australian listed companies (thereby approximating the tax treatment of a direct investor holding those shares on capital account).

The tax advantages associated with portfolio investment entities (PIEs) mean that they are the preferred structure for managed fund investments. Also, all default KiwiSaver funds are required to be PIEs.

Key decisions

- That given the complexity of the issues, the top PIE tax rate should not be adjusted as part of Budget 2010. Instead officials should report to Ministers after the Budget with further advice on setting the top PIE tax rate
- That if reductions are made to the personal tax rates below 30%, that the PIE rates below 30% should be reduced to reflect these reductions.

30% top PIE tax rate

PIEs are designed so that peoples' investment income is taxed at a rate that reflects their own personal tax rate. Importantly, however, the top PIE tax rate is capped at 30% - which provides a tax incentive for investors on the 33% and 38% tax rates to invest using a PIE.

The top PIE rate was capped at 30% when the company tax rate was reduced from 33% to 30%. If the top PIE rate had not been reduced at that time there would have been incentives for managed funds to structure themselves as unit trusts or investment companies rather than PIEs. While sound reasons existed for capping the PIE tax rate at 30%, it has resulted in coherence and integrity issues as high income earners can use PIEs to shelter investment income and have it taxed at a 30% final rate.

The Tax Working Group recommended that the top PIE tax rate should be aligned with the top personal tax rate. Under this approach, if the top personal tax rate were increased to 33% to align it with the trustee tax rate, the top PIE tax rate would be increased to 33%. The issues associated with how the top PIE tax rate should be set are complex. For example, it would be necessary to consider the effect any change would have on KiwiSaver investment and other forms of saving. Also, Ministers may also wish to consider whether an approach that aligns the top PIE rate with the

company rate (even if the company rate were reduced) is better than the approach of aligning it to the top personal tax rate.

Alignment with lower rates

The lower PIE rates (12.5% and 21%) are generally aligned with the lower personal tax rates. Regardless of what is done with the top PIE rate, if the lower personal tax rates are changed the lower PIE rates should be aligned with them. This could be done effective from 1 October 2010 (if personal tax rates change then) if the number of lower personal tax rates and their thresholds does not change (only the rates change), but if the number of lower rates or the thresholds change, then it should be done effective from 1 April 2011 to give managed funds more time to adjust their systems.

Officials estimate that, based on the tax rate structure that has been discussed, reducing the PIE rates below 30% would decrease revenues by $20 million in the 2010/11 year and $24 million in future years.

APPENDIX 5

THIN CAPITALISATION CHANGES

This proposal looks at lowering the 75% safe harbour in the inbound thin capitalisation (interest allocation) rules applying to the NZ operations of foreign multinationals.

Key decision

- Whether the 75% safe harbour in the inbound thin capitalisation (interest allocation) rules applying to the NZ operations of foreign multinationals should be reduced to 60% as part of Budget 2010, with application from the 2011/12 income year.

Background

These rules limit the scope for foreign multinationals to reduce taxable profits by over-allocating debt to New Zealand. Interest deductions are disallowed to the extent that the debt-percentage (essentially, the debt-to-asset ratio) of the NZ group exceeds a 75% "safe harbour" and also exceeds 110% of the worldwide group's debt percentage.

There is no objectively "correct" level at which to set the safe harbour. Lowering it involves conflicting considerations:

- It will mean that some existing debt investment is replaced with equity, increasing revenue at no economic cost. This is likely to be the case, in particular, when the foreign investor is earning economic rents or is able to claim credits at home for tax paid in New Zealand.

- But it will also mean that some marginal investments cease to be economic and are no longer undertaken. In this case, there is a cost to New Zealand as the change will increase the cost of capital.

Reducing the safe harbour to 60%

The Capital Markets Development Task Force and the Victoria University Tax Working Group recommended lowering the safe harbour from 75% to 60%. The maximum expected annual revenue gain from reducing the safe harbour to 60% is estimated at $210 million (based on a 30% company tax rate; a lower rate would reduce this gain). On balance, officials support this recommendation.

Reducing the safe harbour to 50%

Reducing the safe harbour to 50% increases the maximum expected annual revenue gain to an estimated at $373 million, although this estimate needs to be treated with caution. As the safe harbour is further reduced, the 110% threshold will come into play more often. This is likely to significantly reduce the revenue gain in practice.

A change of this magnitude is not recommended because of the potential drawbacks.

- It increases the risk that the national income forgone from discouraging inward investment will exceed the benefits of increased tax revenue.

- It may be too low to accommodate legitimate financing arrangements. The average debt percentage of NZ companies is probably within the range of 50-60%.

- It will increase compliance costs for business, monitoring and perhaps adjusting debt levels throughout the year. There will also be a larger number of firms that have to calculate their worldwide debt percentage to apply the 110% threshold.

Effective tax rates

If the safe harbour is significantly higher than "natural" levels of external debt, then there is an opportunity for foreign-owned firms to reduce their effective NZ tax rate. The 2001 McLeod Review noted that, with a natural debt percentage of 50% and a safe harbour of 75%, a non-resident direct investor could basically "help themselves" to an effective NZ tax rate of around 20%.[4] Applying the same methodology, a safe harbour of 60% gives an effective rate of 26%. A safe harbour of 50% gives an effective rate of 30%.

International comparisons

Overall, New Zealand's current 75% safe harbour is probably not out of line with comparable thresholds in other countries. A 60% safe harbour would be low by international standards but may nevertheless be justified. A 50% safe harbour would be well below international norms.

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[4] With an external debt-equity ratio of 50:50, the non-resident can capitalise the company with 50 percent external debt, 25 percent related party debt and 25 percent equity. Ignoring yields, the weighted average effective tax rate on the non-resident's investment is (.5 x 10%) + (.5 x 30%) = 20%. The effective rate cited in the McLeod Review was actually 21.5%, based on a 33% company tax rate.

Budget 2010 tax package – base scenarios (as at 4 March 2010)

Scenario outline:

Black text indicates potential changes already discussed by the Tax Group, with preliminary preferences made. Red text indicates potential changes currently being considered by the Tax Sub-Group. Blue text indicates potential changes still to be considered by the Tax Sub-Group at a future date.

Tax changes	Existing	Option	From	Notes (see individual papers for further assumptions)
Personal tax rates				
0 – 14,000	12.5%	10.5%	1 October 2010	Costings include consequential changes to FBT and ESCT, and now include impact of alignment of lower PIE rates with proposed lower personal rates.
14,001 – 48,000	21%	17.5%		
48,000 – 70,000	33%	30%		
70,000 +	38%	33%		
GST	12.5%	15%	1 October 2010	Costings include increased revenue from additional spending due to other tax changes.
GST compensation for NZS/benefits/WfF				Costings assume indexation (including bring-forward) based on 2.22% assumed price increase (excludes WFF abatement threshold adjustments and other welfare assistance). Initial draft costings may be revised after comparison with MSD modelling.
Deny building depreciation			2011/12 income year	Costings assume no losses on sale allowed and no grandparenting.
Remove 20% depreciation loading			20 May 2010	Costings assume removal of depreciation loading for purchases on or after budget day
Reduce thin capitalisation threshold	75%	60%	2011/12 income year	Based on assumptions about worldwide group debt percentage
PIE rates	Lower 2 rates aligned with personal rates above, top rate of 30% from 1 April	Lower 2 rates aligned with personal rates above		Costings are included within personal tax changes in tables on right-hand side.
Company tax rate	30%	30% or 28%	2011/12 income year	Costings will vary depending on policy decisions taken and transitional issues
WFF de-indexation of abatement threshold only			Next indexation	Next indexation currently forecast 1 April 2012

No change to company tax rate

$ million	2010/11	2011/12	2012/13	2013/14
Personal tax	-2345	-3560	-3890	-4080
Net NZS	-235	-330	-350	-370
Net Benefits	-80	-110	-110	-110
WFF compensation	-50	-70	-75	-70
GST (including clawback)	1935	2615	2735	2850
Building depn (all buildings)	0	720	725	730
Depn loading (with grandfathering)	140	260	330	370
Thin cap 60%	0	210	210	210
WFF de-indexation	0	25	95	95
Net	**-635**	**-240**	**-330**	**-375**

Reduction of company tax rate to 28%

$ million	2010/11	2011/12	2012/13	2013/14
Personal tax	-2345	-3560	-3890	-4080
Net NZS	-235	-330	-350	-370
Net Benefits	-80	-110	-110	-110
WFF compensation	-50	-70	-75	-70
Company tax	-30	-410	-375	-395
GST (including clawback)	1935	2620	2745	2855
Building depn (all buildings)	0	685	690	695
Depn loading (with grandfathering)	135	245	315	355
Thin cap 60%	0	195	195	195
WFF de-indexation	0	25	95	95
Net	**-670**	**-710**	**-760**	**-830**

- Numbers for NZS, Benefits & WfF compensation are Treasury numbers; these are being worked through with MSD and will increase slightly when flow-on compensation measures to supplementary assistance are included.
- For thin cap figures in the tables are maximums based on an assumption that worldwide group debt percentages do not allow for deductions if the safe harbour is breached. To the extent that assumption does not hold (more likely for a 50% safe harbour), these figures will be overstated.
- Corporate tax numbers do not include transitional costs- these are being finalised.

Other potential measures (based on 28% company rate, excluding clawback):

$ million	2010/11	2011/12	2012/13	2013/14
Tobacco excise	170	170	165	165
Depn loading on existing assets (no grandparenting)	0	600	330	150
Continuing depn on industrial buildings	0	-175	-175	-180
Gains & losses on depreciation	0	-15	5	45
Loss ring-fencing (including interaction effect with LAQCs)	55	260	265	265
LAQCs	0	65	55	45
Capital revenue boundary	0	0	0	0
WFF integrity measures	5	15	15	15
Thin cap threshold to 50%	0	155	155	155

For excise figures: revenue estimates are highly sensitive to the behavioural responses of consumers & producers; estimates will be reduced substantially by automatic inflation compensation for beneficiaries & superannuitants.

- All costings are provisional and are sensitive to taxpayer behaviour
- Deprn loading and continuing depn on industrial buildings on existing assets are in addition to the figures in the bottom RHS table
- Capital revenue boundary assumes zero revenue due to uncertainty of this costing
- LAQC costing is heavily sensitive to taxpayer behaviour and long-term profitability assumptions, and is therefore costed at a 30% company rate. It does not include approx $7 million from the remission income loophole.

Indicative costs on marginal changes

		Base scenario	Change	$million (2011/12)
Personal tax rates				
0 – 14,000		10.5%	± 1%	± 400
14,001 – 48,000		17.5%	± 1%	± 510
48,000 – 70,000		30%	± 1%	± 135
70,000 +		33%	± 1%	± 170
Personal tax thresholds	$	14,000	+ 1,000	-170
	$	48,000	+ 1,000	-110
	$	70,000	+ 1,000	-50

Note no interaction with NZS and benefits accounted for in these rough marginal estimates

All costings are provisional only and are based on HYEFU 2009 macroeconomic forecasts.