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

From: Minister of Finance and Minister of Revenue

Re: Ministers' Sub-Group on Tax Meeting on 22 March 2010

Date: 19 March 2010

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

- An agenda; and
- Summary papers on each of the issues to be discussed:
  - Appendix 1 – Composition of the final package
  - Appendix 2 – The company tax rate
  - Appendix 3 – Compensation issues
  - Appendix 4 – Bright line test for property disposals
  - Appendix 5 – Other revenue raising options
  - Appendix 6 – Working for families integrity
  - Appendix 7 – Tax rates for PIEs and other savings vehicles – further information

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

Ministers' Sub-Group on Tax
Agenda for meeting 3 – 22 March 2010

1. **Base package** – Appendix 1 (10 minutes)

   - Outline of base package.
   - What it does.
   - What is its focus?
   - Revenue shortfall.
   - Outline of 4 alternative personal tax rate structures.
   - Alternatives include applying the 33% rate to the $48-70K bracket and lowering the 10.5% rate to 10% (as requested by Ministers).

   a. Briefing by officials (Angela Mellish).
   b. Sub-group discussion and key decisions on whether the base package should be rebalanced.

2. **If base package to be rebalanced to provide relief to companies – how should this be done? -** Appendices 1 & 2 (10 minutes)

   - Departmental views on how corporate relief to be provided:
     - Treasury recommend company tax rate be reduced to 28%.
     - Inland Revenue recommend the rate be maintained at 30% and relief be provided by scaling back depreciation changes.
   - Integrity measures.

   - Treasury/IRD outline their preferred packages.

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

3. **Follow-up from sub-group meeting two** (10 minutes)

   - *Capital/Revenue boundary*: "bright-line" test – practical implications, possible time period and scope (Appendix 4).

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

   - PIEs/savings vehicles – further advice on the issues associated with raising rate (aligning to top personal tax rate) and lowering rate (aligning with company tax rate) – Appendix 7.

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

- *Working for Families*: inclusion of student allowances and other relevant social assistance programmes that use the Income Tax Act definition of "income" as part of the review of Working for Families (Appendix 6).

a. Briefing by officials (Robin Oliver/Andy Mcloughlin).
b. Sub-group discussion.

4. Other Base Broadening – Appendix 5 (10 minutes)

Per Base Broadening report:

- *Redundancy Tax Credit*
- *[deleted – confidentiality of advice]*
- *Transitional Circumstances Tax Credit*
- *Child Tax credit*
- *Independent Earner Tax Credit*
- *Totalisator Duty*
- *GST Base Maintenance*

a. Briefing by officials (Robin Oliver/Andy Mcloughlin).
b. Sub-group discussion and key decisions

5. Compensation package – Appendix 3 (5 minutes)

- General rate of compensation for Budget 2010: 2.02%. Actual impact on prices reflected in Annual General Adjustment to welfare payments from 1 April 2011.
- Compensation payments equivalent to 2.02% brought forward to 1 October 2010 for recipients of:
  - Main benefits
  - Student allowances (including changes to regulations)
  - NZ Super + Veterans
  - Working for Families – Family Tax Credit and Minimum Family Tax Credit (excluding the in-work tax credit and parental tax credit)
  - Disability allowance, child care assistance and child disability allowance
- Accommodation Supplement – propose not to increase payments in Budget 2010 (rents do not attract GST), but report back on impacts of tax package on housing affordability, and wider issues relating to the accommodation supplement and income related rents before Budget 2011.
- Student loans – propose not to bring-forward the indexation of the student loans living cost component.
- Whether Ministers wish to bring forward the CPI adjustment for GSF and National Provident Fund annuities.
- Contingency fund.

a. Briefing by officials (Oliver Valins/[deleted – privacy]).
b. Sub-group discussion and key decisions on compensation.

6. Agenda for meeting 4, 29 March 2010

- Final recommendations on the final tax package.

APPENDIX 1

Composition of the final tax package

Key observations and decisions

- Confirm that the rate of GST be increased to 15% as part of the 2010 Budget tax package.
- Confirm the preliminary decisions already made on the specific base-broadening and integrity measures previously considered.
- Note that the current base scenario package that is being considered results in a revenue shortfall of approximately $690m in 2010/11 and $245m in outyears.
- Note that other revenue raising measures can be included in the Budget 2010 tax package that could raise up to an additional $595m.
- Indicate whether the Budget 2010 tax package should be rebalanced to provide relief to the corporate sector. Note that this decision is inextricably linked to decisions on what personal tax rate structure is preferred and any additional revenue raising measures.
- If Ministers decide to rebalance the tax package as above, decide whether this should be achieved by:

  (i) reducing the company tax rate to 28%; or

  (ii) scaling back the existing base-broadening measures affecting companies.
- Indicate which of the following personal tax rate structures is preferred:

  (i) 10.5%/17.5%/30%/33% (the base package); or

  (ii) 10%/18%/30%/33% (alternative 1); or

  (iii) 10.5%/18.5%/30%/33% (alternative 2); or

  (iv) 10.5%/17.5%/33% (alternative 3); or

  (v) 10.5%/18.5%/33% (alternative 4).
- Note that Treasury and Inland Revenue outline their preferred packages below.

Current base scenario package

The following table shows the funding shortfall that exists in the current base scenario package.[1] This shortfall can be filled by identifying other base-broadening measures,

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[1] Based on HYEFU2009 forecasts

by altering the proposed rate schedule in the current base scenario package, or a combination of the two.

$ million	*2010/11*	*2011/12*	*2012/13*	*2013/14*
Personal Tax (10.5, 17.5, 30, 33)	-2370	-3565	-3890	-4080
Net NZS	-220	-310	-330	-335
Net main benefits	-75	-105	-105	-105
WFF Compensation	-45	-60	-65	-65
Other compensation	-40	-60	-60	-60
GST (including clawback)	1960	2715	2845	2965
WFF de-indexation	0	25	95	95
WFF Integrity Measures	5	15	15	15
Building Depreciation (all buildings)	0	720	725	730
Depreciation Loading (with grandfathering)	140	260	330	370
LAQCs (incl. closing remission loophole)	0	75	65	55
Thin Cap 60%	0	210	210	210
Depreciation - capital contributions	5	5	5	10
Contingency	-50	-50	-50	-50
Net cost of base scenario	***-690***	***-125***	***-210***	***-245***

Other revenue raising measures that might be considered

Other revenue raising measures (discussed further in Appendices 4 and 5) that could be included as part of the 2010 Budget include:

- increasing tobacco excise ($160m);
- increase totalisator duty on racing ($50m);
- changes to improve GST neutrality ($60m);
- remove the transitional circumstances tax credit ($8m);
- replace the child tax credit with an exemption for income received by children which is not taxed at source ($17m);
- [deleted - confidentiality of advice]
- introduction of a bright line test (Treasury preferred option - $75m in steady state). [2]

There is also a question of whether or not a reduced contingency might be used to balance the package.

Other personal income tax rate structures considered

Officials have considered four alternative personal tax scenarios, which differ only by the marginal tax rates. These are shown in the table below:

Reduced cost compared to base scenario (10.5/17.5/30/33): $ million					
Scenario		**$0 – $14,000**	**- $48,000**	**- $70,000**	**$70,000+**
Base case		10.5%	17.5%	30%	33%
Alt. 1		10%	18%	30%	33%
Alt. 2		10.5%	18.5%	30%	33%
Alt. 3		10.5%	17.5%	33%	33%

[2] Note that Inland Revenue has not had the opportunity to review this costing in detail.

Alt. 4		10.5%	18.5%	33%	33%

The estimated reduction in cost of the alternatives over the forecast period, compared to the cost of the base scenario, is shown below[3]:

Reduced cost compared to base scenario (10.5/17.5/30/33): $ million					
Scenario		**2010/11**	**2011/12**	**2012/13**	**2013/14**
Alt. 1	10/18/30/33	30	45	50	55
Alt. 2	10.5/18.5/30/33	305	420	440	455
Alt. 3	10.5/17.5/33	235	335	365	390
Alt. 4	10.5/18.5/33	540	755	800	845

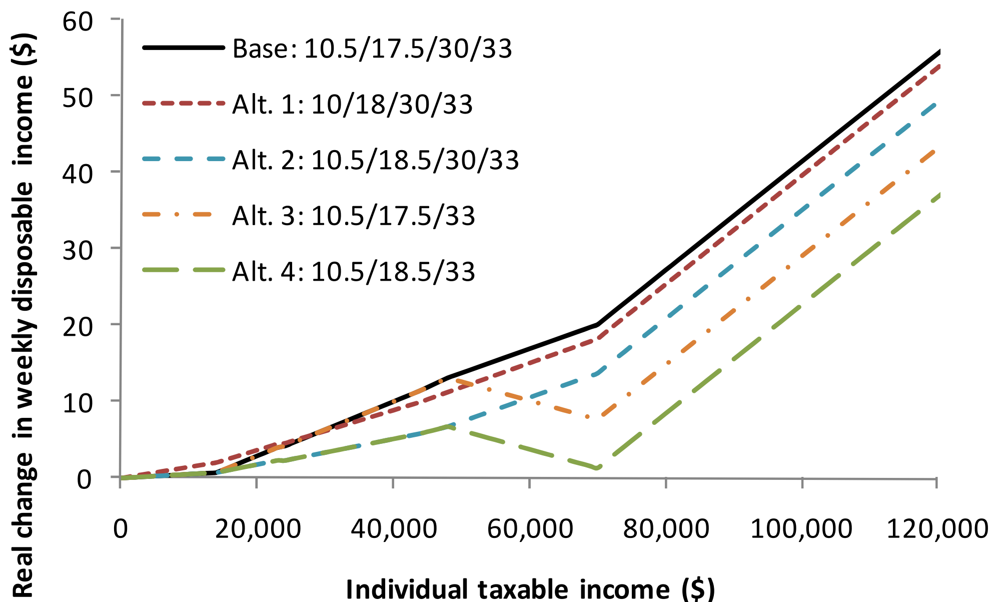
Distributional effects of alternative scenarios

The information captured in the following table, for individuals with different levels of income, shows the increased amount (on an annual basis) that a taxpayer who was previously consuming all net income could now save (although clearly only a fraction of this will be saved). The calculations are indicative only and are provided by Inland Revenue for Ministers' attention. In contrast to the previous distributional analysis Ministers have received from officials, the following figures are expressed in post-GST change dollars, rather than pre-GST change dollars. In the time available, Treasury was not able to confirm the accuracy of the calculations.

Increase in net real annual disposable income: $					
Taxable Income	**Base Scenario**	**Alternative 1**	**Alternative 2**	**Alternative 3**	**Alternative 4**
10,000	27.29	77.29	27.29	27.29	27.29
20,000	154.88	194.88	94.88	154.88	94.88
30,000	338.84	328.84	178.84	338.84	178.84
40,000	533.30	473.30	273.30	533.30	273.30
50,000	733.11	633.11	393.11	673.11	333.11
60,000	901.81	801.81	561.81	541.81	201.81
70,000	1,070.51	970.51	730.51	410.51	70.51
80,000	1,449.31	1,349.31	1,109.31	789.31	449.31
90,000	1,828.11	1,728.11	1,488.11	1,168.11	828.11
100,000	2,206.91	2,106.91	1,866.91	1,546.91	1,206.91

The chart below shows another representation of the distributional effects of the scenarios on an individual's weekly real disposable income.

[3] These figures are indicative only, and do not properly account for the interaction with the welfare system, or changes to FBT, ESCT, PIEs and timing of provisional and terminal tax. Figures are based on June years and include clawback of 17.3%.



The base scenario provides some relief to taxpayers on lower income levels. At income levels in excess of $14,000 this relief increases steadily through all income bands.

Alternative 1, compared to the base scenario, shifts the balance slightly between the bottom two tax rates. Gains are very slightly higher (up to $1.35/wk) for those earning less than $28,000 per annum, while very slightly lower (up to $1.92/wk) for those earning over $28,000. This alternative has little impact on the overall fiscal package.

Alternative 2 makes all taxpayers earning more than $14,000 worse off compared to the base scenario. The amount of reduction increases until the top of the second rate band ($48,000) where people would be $340 per annum worse off. This alternative would balance the current package without requiring any further revenue raising measures to be considered.

Alternative 3 would also fill the base scenario revenue gap. Reductions of benefit relative to the base scenario would impact taxpayers starting at $48,000, reaching a maximum at the top threshold of $70,000 after which they would be constant at $660 per annum. Compared to Alternative 2 it would concentrate the impact of reducing fiscal costs on higher income taxpayers. This alternative would also balance the current package without requiring any further revenue raising measures to be considered.

Alternative 4 combines these changes to give the greatest cost reduction (compared to the base scenario) of around $800 million per annum over the forecast period. While no taxpayer is worse off compared to the present system, taxpayers at $70,000 have little benefit. This alternative would fill the base scenario revenue gap and also allow relief to be provided to companies.

Officials' preferences

Inland Revenue

Inland Revenue considers that it is critical for the final package to attain a high level of public support. For this reason we would counsel considerable caution before abandoning the personal tax reductions envisaged in the base case scenario. Any of

the alternatives which raise significant amounts of money (namely, alternatives 2, 3 and 4) would provide substantially less assistance to lower income individuals. For example, alternative 2 would more or less cut in half the gains to individuals on $30,000 or $40,000.

We believe that the package that Ministers have preliminarily agreed to is coherent. The switch from personal income taxation to GST will reduce biases between different forms of saving and encourage saving. This will promote efficiency and growth. While company tax collections will rise, the thin capitalisation change is likely to result in an important offset. Higher taxes in New Zealand will tend to be offset by lower taxes overseas. Moreover, companies and their shareholders will benefit from lower personal taxes on New Zealand shareholders. Lower personal taxes will also tend to make it easier and less costly for firms to acquire and retain highly-skilled and mobile workers. The one area of concern we have is with the proposed removal of depreciation from industrial buildings.

We believe that the empirical evidence for removing depreciation deductions on industrial buildings is weak and that this move will be seen to be unfair. If firms are denied valid deductions for assets which do fall in value, this is likely to decrease the efficiency of investment decisions. A number of members of the Tax Working Group have argued quite forcibly that some buildings do depreciate and that to deny depreciation deductions in these circumstances would be unreasonable. We also note that Treasury has voiced concerns about the effects of the package on aggregate investment. In our view, continuing to allow depreciation deductions on industrial buildings is likely to increase both the efficiency of investment and aggregate investment.

While reducing the company tax rate would also boost investment, we are concerned that it would be a relatively cost ineffective way of doing so relative to continuing to allow depreciation on industrial buildings. A particular concern with cutting the company tax rate is that to the extent that companies are earning economic rents, reducing the company tax rate will provide a windfall to investors. This can be particularly costly from the point of view of New Zealand as a whole when such rents are earned by foreigners. Reducing company tax rates in a way which provides a windfall to non-resident shareholders and leaves New Zealanders to pick up the tab can make New Zealand as a whole worse off.

Reducing the company tax rate will also reintroduce incoherence into the taxation of savings vehicles. Savings would be subject to a 33 percent rate if held directly, 30 percent if held by a PIE and 28 percent if held in a unit trust. Resolving these issues would be very complex and would need intensive consultation. This incoherence would be opposed to the explicit recommendations of the TWG for greater coherence in the tax treatment of savings.

For all of these reasons we do not believe that it is desirable for a reduction in personal tax rate cuts to be used to finance a cut in the company tax rate.

We believe that it is possible to make the tax package broadly revenue neutral while at the same time continuing to allow depreciation on industrial buildings (costing, after the first year, about $180 million per annum) without paring back on personal tax rate cuts. This involves using a number of base broadening measures, revenue from the tobacco excise and a reduced contingency allowance, as follows:

	2010/11	2011/12	2012/13	2013/14
Current net cost of base scenario package	**-690**	**-125**	**-210**	**-245**

Tobacco excise	160	170	160	150
Increase in totalisator duty	10	50	50	50
GST phoenix schemes	10	60	60	60
Child tax credit	0	7	17	17
Transitional circumstances tax credit	0	4	8	8
Reduced contingency	45	45	45	45
Less, allowing depreciation on industrial buildings	0	-180	-180	-180
Total net cost of Inland Revenue preferred package	**-465**	**31**	**-50**	**-95**

Treasury

In Treasury's view, the final tax package should reflect a strategic approach to tax policy that is growth-oriented, fiscally prudent and consistent with a savings, investment, and growth-themed budget. We also recognise the government's preference to meet the constraints of making the vast bulk of taxpayers better off. The base scenario provides a strong message around personal work incentives and a shift from consumption to saving, with significant personal tax rate cuts and the increase in tax on consumption through the rise in GST. However, to produce a broadly revenue neutral package, it involves a switch in the burden of tax from personal taxes to taxes on business, particularly companies.

The base scenario is therefore weak around creating corporate incentives to invest and only partially tackles the bias towards property investments. If the government wants a package which promotes investment as well as savings and work (as Treasury recommends), we need measures to promote corporate investment and profitability – with the favoured option being a cut in the rate of company tax. Large base broadening measures for targeting property have been ruled out. However, moving to a bright line test for investment property would give the package more credibility in respect of targeting identified gaps in the taxation of property.

The base scenario package includes a number of measures aimed at broadening the base (reducing tax deductions in this case) which fall on business. A cut in company tax would rebalance the package, offsetting some of the increased tax burden on business, and promote incentives for business investment in New Zealand.

We consider that a reduction in the company tax rate, alongside base broadening measures is worth pursuing as:

- High corporate rates discourage investment and productivity improvements.
- Economies are increasingly open and average tax rates can influence global investment decisions; statutory rates can influence where profits are declared.
- A tax reform package without incentives for business investment is not consistent with the Budget theme of savings, investment and growth.

To enable a broadly revenue neutral package, if a company tax rate cut (to 28%) is included, further principled base broadening measures can be introduced to provide

revenue for personal tax rate cuts. These would make affordable across the board personal rate cuts which ensure that most individual New Zealanders are better off.

The Treasury option below achieves this by slightly reducing the generosity of the personal tax cuts (reducing the current 21c lower middle rate to 18.5c instead of 17.5c), reducing the company tax rate to 28c and introducing a number of additional tax initiatives that have merit in themselves and also raise revenue. These measures include initiatives to improve the neutrality of the GST rules, an increase in totalisator duty, and clarification of the capital revenue boundary around certain property.

The revenue profile of the Treasury-preferred option is as follows:

$ million	***2010/11***	***2011/12***	***2012/13***	***2013/14***
Personal Tax (10.5, 18.5, 30, 33)	-2040	-3085	-3375	-3555
Net NZS	-215	-305	-325	-330
Net main benefits	-75	-105	-105	-105
WFF Compensation	-45	-60	-65	-65
Other compensation	-40	-60	-60	-60
GST (including clawback)	1875	2595	2720	2835
WFF de-indexation	0	25	95	95
WFF Integrity Measures	5	15	15	15
Company tax 28%	-30	-410	-375	-395
Building Depreciation (all buildings)	0	685	690	695
Depreciation Loading (with grandfathering)	135	245	315	355
LAQCs (incl. closing remission loophole)	0	75	65	55
Thin Cap 60%	0	195	195	195
Depreciation - capital contributions	5	5	5	10
Tobacco Excise	160	170	160	150
5 year Brightline Test (grandfathered)	0	0	10	30
GST Phoenix Schemes	15	60	60	60
Increase Totalisator Duty on Racing	10	50	50	50
Contingency	-50	-50	-50	-50
Net revenue of Treasury recommended package	***-290***	***45***	***25***	***-15***

The changes compared to the base scenario are shown below:

$ million	***2010/11***	***2011/12***	***2012/13***	***2013/14***
Personal Tax (10.5, 18.5, 30, 33)	330	480	515	525
Net NZS	5	5	5	5
Net main benefits	0	0	0	0
WFF Compensation	0	0	0	0
Other compensation	0	0	0	0
GST (including clawback)	-85	-120	-125	-130
WFF de-indexation	0	0	0	0
WFF Integrity Measures	0	0	0	0
Company tax 28%	-30	-410	-375	-395
Building Depreciation (all buildings)	0	-35	-35	-35
Depreciation Loading (with grandfathering)	-5	-15	-15	-15
LAQCs (incl. closing remission loophole)	0	0	0	0
Thin Cap 60%	0	-15	-15	-15
Depreciation - capital contributions	0	0	0	0
Tobacco Excise	160	170	160	150
5 year Brightline Test (grandfathered)	0	0	10	30
GST Phoenix Schemes	15	60	60	60
Increase Totalisator Duty on Racing	10	50	50	50
Contingency	0	0	0	0
Net revenue compared to base package	***400***	***170***	***235***	***230***

APPENDIX 2

The company tax rate

This appendix discusses whether the company tax rate should be reduced to 28 percent. Decisions about the level of company taxes will be made in the context of the wider tax package.

Key decisions

- **Decide** the extent to which company tax collections should be increased to fund personal tax rate reductions.

If the burden on companies is to be reduced relative to the base scenario, whether:

- to maintain the company tax rate at 30 percent and relax some base broadening measures affecting companies; or
- reduce the company tax rate to 28 percent.

Company tax in the overall package

The overall goals of the tax reform package are to improve efficiency and growth and deal with current integrity issues in a manner which is fair. The cornerstone of the tax reform is a shift in the balance of government tax revenues from income taxes to GST. This shift is expected to increase the growth potential of the New Zealand economy.

However, increasing consumption taxes raises concerns about fairness. The reform will therefore contain across the board reductions in personal income tax rates and other measures to ensure that most individual New Zealanders are no worse off.

Base-broadening measures will be required to achieve this goal. Base-broadening can be efficiency enhancing in its own right. For example, increasing taxation of the property sector is intended to reduce existing tax preferences and shift investment to more efficient uses.

Reductions in personal tax rates will increase the incentives for New Zealanders to work, save and invest and encourage productive skilled workers to remain in New Zealand. The alignment of the trust and top personal tax rates also deals with concerns about the integrity of the tax system expressed by the TWG and others.

However, the package is also to be broadly revenue neutral. Achieving the desired degree of fairness in the personal tax system will imply base-broadening that impacts the company sector and will have an impact on their incentive to invest.

The extent to which the burden of taxation should be shifted from individuals to companies focuses on the trade-off between supporting the fairness of the tax system with across the board personal tax rate reductions versus raising taxes on investment.

The package of reforms could be rebalanced either by finding additional base-broadening measures that affect individuals or by modifying the base scenario of personal tax rates. If sufficient funds can be released through these means, it would be possible to reduce the impact of the package on companies.

This relief, relative to the base scenario, could be accomplished by either reducing the company tax rate to 28 percent or by scaling back some of the base-broadening initiatives in the base scenario.

The Treasury is of the view that this would be best accomplished by reducing the company tax rate to 28 percent. The IRD believes that the rate should remain at 30 percent and relief be provided by scaling back certain base-broadening measures. These two views are outlined below.

The Treasury position

The current package being considered by Ministers is broadly consistent with a growth, savings and investment theme, with a re-weighting from income tax to GST, reducing tax preferences on property, and integrity measures such as thin capitalisation and LAQC changes.

The stark potential inconsistency is the company tax rate. In the absence of a reduction in this rate, the base broadening measures will increase the total tax burden on companies, equivalent to returning to a 33% company tax rate.

The primary policy motivation for these base broadening measures is to reduce tax preferences for particular forms of investment. Reducing these preferences causes capital to flow to investments that are more productive for the economy as a whole. However, in the absence of rate reductions, these measures do push up average tax rates on investment. The solution is to use base-broadening revenues to lower tax rates. This redirects capital to more productive uses and reduces tax on fully-taxed activities. These two policy “wins” are the logic behind the “broad-base low-rate” approach.

Treasury also considers that a reduction in the company tax rate would encourage increased foreign investment in New Zealand, which is likely to deepen the capital stock and improve productivity. While foreign investment consists of a combination of inframarginal investments (economic rents) and marginal investments, clearly some new marginal investment would take place.

Concerns with distortions caused by a 5c gap between the company and top personal tax rates need to be kept in perspective. A 5c gap would be an improvement on the status quo. It is less than the current 8c gap, and less than the historic 6c gap between the 33c company and 39c personal tax rate.

From a strategic perspective, we see risks in New Zealand, as a capital-shallow investment-seeking economy, having a statutory tax rate for companies that is increasingly out of step with OECD comparators, then driving the effective tax rate even higher through base broadening measures without offsetting tax rate reductions.

The IRD position

Compared to other countries, New Zealand has unique economic, location and tax system features. Unlike countries in Europe and North America, New Zealand is not competing for tax sensitive investments as part of a large continental market, we have an imputation system and the small difference between our company and top personal tax rate means that we can capture the efficiency and simplification benefits of having alignment of tax rates. Taking these features into account, the IRD is of the view that reducing the company tax rate would be inconsistent with a number of the objectives of the tax reform.

To the extent that companies are earning rents, reducing tax rates provides windfall gains to investors. This is particularly costly from the point of view of New Zealand as a whole when such rents are earned by foreigners.

When considering the tradeoffs between reducing depreciation and reducing tax rates in a revenue neutral manner, the reduced taxes on rent earning sectors implies taxes are likely to increase in capital intensive sectors. Thus reducing the company tax rate, funded by less depreciation, is likely to have the perverse effect of reducing incentives to invest in New Zealand. Scaling back on depreciation measures is likely to be more cost-effective than reducing the company tax rate as a way of promoting investment.

Reducing the company tax rate will also reintroduce incoherence into the taxation of savings vehicles. Savings would be subject to a 33 percent rate if held directly, 30 percent if held by a PIE and 28 percent if held in a unit trust, life insurance plans and other special instruments. Resolving these issues would be very complex and would need intensive consultation. Such incoherence would move away from explicit recommendations of the TWG for greater coherence in the taxation of savings.

Aligning company and personal tax rates is itself efficiency enhancing as well as dealing with integrity issues in the simplest possible manner.

If Ministers wish to reduce the impact on companies as part of a rebalancing of the overall package, the IRD would recommend that this be accomplished by scaling back on the depreciation changes rather than reducing the company tax rate.

Fiscal impact

The headline cost of a 2% company rate is $395 million in outyears. However, there will be an additional fiscal cost in that the revenue raised from base broadening measures will decrease. This impact can be determined by comparing the differences in

the 30% and 28% base broadening tables and is approximately 65 million per year in total.

Cutting the company tax cut will also require a number of transitional measures including dealing with imputation credits. If an imputation window to use credits at the old rate is provided, as was the case with the last company tax cut, there will be an additional fiscal cost of $125 million over the forecast period.

The alternative option of scaling back on base broadening by continuing to allow depreciation on industrial buildings is estimated to cost, after the first year, about $180 million per annum.

APPENDIX 3

Compensation issues

Key decisions

- That main benefits, Student Allowances, Family Tax Credit, Minimum Family Tax Credit, NZ Super and Veterans Pensions be increased by a payment equivalent to 2.02% of these amounts from 1 October 2010.
- That increases in Disability Allowance, Childcare Assistance and Childcare Disability Allowance be brought forward from 1 April 2011 to 1 October 2010.
- That the Accommodation Supplement *not* be increased at this time; that the Student Loan Living Cost component *not* be brought forward from 1 April 2011 to 1 October 2010; that Budget 2010 tax cuts should *not* further increase net Student Allowance amounts (i.e. prevent 'double dipping').
- Whether to bring forward cost of living increases to the Government Superannuation Fund and National Provident Fund.

The recommended compensation package is comprehensive, and compares favourably with the package that accompanied the introduction of GST. However:

- While we can design a compensation package to prevent people being worse off *on average*, we cannot guarantee this for all people in all circumstances. Circumstances that *might* lead to some people being worse off include: if they are currently spending more than they are earning, if they are beneficiaries spending less than 8% of their income on housing costs, or if they have a significant portion of their income from non-taxable sources. In these cases there are good reasons why additional compensation is not required.
- The dynamic effects of the tax package – together with the *Future Focus* benefit reforms – will incentivise many people to earn more and thus benefit in time from the new tax system.

The proposed compensation package has the following estimated total costs (these are not final and will be updated using preliminary Budget forecasts and final tax package parameters):

	2010/11	2011/12	2012/13	2013/14
Estimated cost of compensation package, *including effects of tax cuts on NZ Super and Veterans Pension* (rounded to $5m).	$380m	$535m	$560m	$565 m

The following table summarises the main components of the proposed package:

Group	Recommended Option	Rationale
Main benefits	Provide a payment equivalent to 2.02% of benefits from 1 October 2010	Beneficiaries would otherwise have to wait 6 months for their benefit to reflect a GST-induced price rise.
Student Allowances	Provide a payment equivalent to 2.02% of Student Allowances from 1	Maintain the Student Allowance rate at the same level as Unemployment Benefits (avoids

	October 2010 Agree to change regulations to avoid rates further increasing Student Allowances as a result of the personal tax cuts	incentives to switch between the benefit and student allowance system). Changing regulations will prevent Student Allowances from further increasing due to the tax changes (i.e. prevents double-dipping).
NZ Super + Veterans	Personal tax cuts will automatically increase rates of NZ Super by an average 2.5% Provide a further payment equivalent to 2.02% of NZ Super from 1 October 2010	The Prime Minister has announced that super-annuitants will benefit twice from the tax package.
Working for Families	Increase Family Tax Credit (FTC) and Minimum Family Tax Credit (MFTC) by 2.02% on 1 October 2010	FTC is the main source of support for children for beneficiary and low income families. Increasing the MFTC will ensure these low income working families continue to be better off working than being on a benefit.
	No change to the In-work Tax Credit (IWTC) or Parental Tax Credit (PTC)	The IWTC is designed to make work pay, rather than subsidise costs of children. Hence, this rate is not subject to CPI increases. The PTC is paid to some parents upon the birth of a child. Neither payment is adjusted for inflation, but both are considered as part of a triennial review process.
Supplementary benefits	Increase the rates of the most significant forms of supplementary assistance, but not Accommodation Supplement, by 2.02% from 1 October 2010 to 31 March 2011 (i.e. Disability Allowance, Child Disability Allowance and Childcare Assistance)	Apart from the Accommodation Supplement (which does not attract GST: see also below), these are the most significant supplementary benefits. Increases in these payments are needed to help ensure that beneficiaries are not worse off from a GST-income tax switch.
	Increase on 1 April 2011 by an estimated 2.02% the rates and income thresholds of all supplementary assistance normally subject to the Annual General Adjustment	Increasing these payments will help to compensate beneficiaries and super-annuitants for a GST rise. Note you can choose to defer this decision. However, any later decision to increase payments by 2.02% would be a charge on the Budget 2010 contingency or Budget 2011.
	Direct officials to examine possible impacts of the tax package on housing affordability and wider issues relating to Government housing support	There are a range of outstanding policy issues with the benefit system, especially relating to housing assistance. Tax reform is not the place to resolve these issues. Any additional costs would be a charge on future Budgets.

Other groups	Indicate preference for whether or not to bring forward to 1 October 2010 a 2.02% cost of living increase for Government Superannuation Fund and National Provident Fund payments	These payments will, by legislation, increase in April 2011. Bringing these payments forward to October 2010 would increase payments at the same time as GST is raised, but raises fairness issues compared with the treatment of non-Government (private) pensions. Final agreement will depend on the technical feasibility of making payments early – we are currently investing this matter and will provide further advice to Ministers.
	Agree not to bring forward indexation of the Student Loan Living Cost Component	This is not an entitlement and will increase on 1 April 2011 by CPI. There are broader issues with student support that cannot be resolved here.

APPENDIX 4

Bright line test for property disposals

Key decisions

- **Decide** whether a bright line test for property disposals should be introduced and, if so, how long the period should be.
- If a bright line test for property disposals is to be introduced, **decide** whether rules for residential investment property should be included in Budget-night legislation.

Officials were asked to design a bright line test of 3 or 5 years for property disposals. A possible approach is outlined below.

A short test would be easily planned around. Officials consider that a 3 year test should not be pursued as it is likely to yield very little revenue while generating significant behavioural distortions.

Treasury considers that a five year period would be the minimum at which the gains of taxing the income outweighs the costs that the test would incur through behavioural changes. Therefore, Treasury favours a 5 year (or longer) test, as outlined below, on the basis that it would bring some investment property gains into the tax net. If the test is to be applied from Budget day, Treasury would recommend that losses are ring-fenced, and that the test apply only to residential investment property. If the test were to be applied at a later date, Treasury would support investigating post-Budget whether other property, particularly shares, should also be included in the bright line test.

Inland Revenue does not support a 5 year (or longer) test on the grounds that it would still generate significant behavioural distortions and raise similar issues to a general capital gains tax, without really resolving capital/revenue boundary problems.

Basic rule

The basic rule would be that any profit from disposing of an item of property is treated as income if the property has been owned for less than the specified period.

There is a choice about how gains from disposals are treated outside the period. The true bright line approach would be to exempt all such gains, but this would involve exempting some transactions that are currently within the base and could be costly; it may become a safe harbour to avoid tax by deferring sales. Therefore, if a bright line test is to be introduced, officials consider disposals outside the period should be dealt with under existing rules (so speculative gains would still be taxed). The downside is that existing boundary issues would remain for these transactions.

Property covered

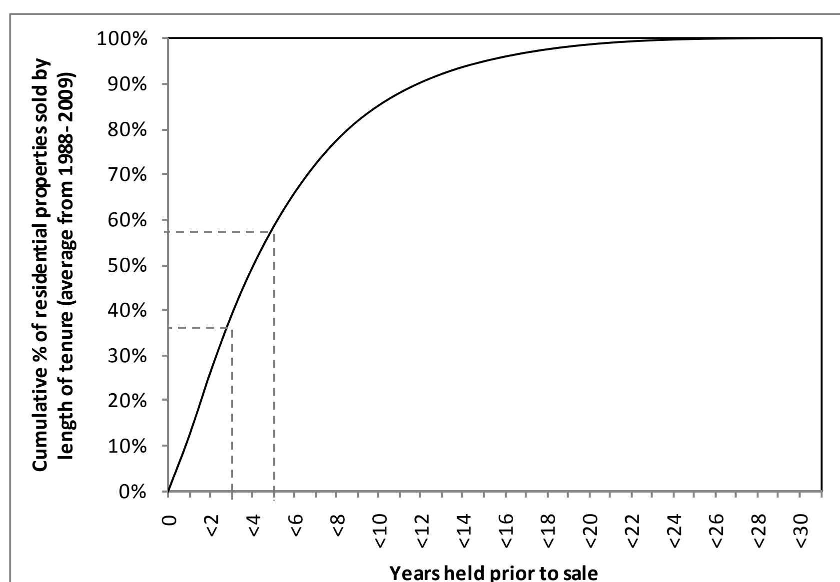
If a bright line test were to be introduced, officials prefer applying it to all business and investment assets (including shares), rather than restricting it to real property. That said, Treasury considers that a 5 year rule applying only to investment real property would still be preferable to the status quo.

If a bright line test were introduced for real property, we envisage there would be exemptions for owner-occupied housing, business premises and farmland.

Restricting a bright line test to real property would target a type of investment (specifically, residential investment property) that is perceived to be tax favoured and

which is currently generating substantial tax losses. However, this would mean inconsistent treatment of investments according to asset type. It would also invite tax planning, with taxpayers owning real property through companies and selling the shares in the company if there is a gain (but selling the property itself if there is a loss). Rules would be necessary to counteract this, which would add complexity, probably without being completely effective.

The length of time properties sold were held prior to sale over the period from 1988 to 2009, is shown below. We would expect this to change if a bright line test were introduced.



Applying the rule to all business and investment assets, including listed and unlisted shares, would be more principled than targeting real property only and would also prevent the use of real-property holding companies without the need for specific anti-avoidance rules. To address current investment biases, the rule would need to apply to shares owned by PIEs as well as to directly-owned shares. We may also want to cover shares in foreign companies.

Applying the test to PIEs would not be straightforward. We would probably have to tax them on all gains within the period regardless of whether shares were actually sold (accrual basis). This would not be welcomed by providers as it will put shares owned through PIEs on a worse footing that those owned directly, although it is consistent with the general PIE timing provision that income and expenditure should be recognised at the time they are reflected in the unit prices. If shares are covered, rules will be needed to cater for business restructuring (mergers, acquisitions, etc.) and these could be complicated.

Handling losses

Property holders may bring forward the sale of loss-making assets to obtain deductions. This could lead to significantly reduced or even negative revenues. Accordingly, officials consider that rules would be needed to address this.

The safest and most straightforward option would be to continue to deal with loss-making disposals under existing rules, regardless of when they occur. This effectively disallows all capital losses, even though capital gains within the bright line period had been brought within the tax base. This is likely to be criticised as unprincipled and punitive.

Therefore, on balance, officials favour allowing capital losses incurred within the period, but ring-fencing them so that they can only be applied against current or future gains taxed under the rule, not against general income. We consider that such ring-fencing should only apply to losses that are newly taxed as a result of the bright line rule, so losses that are allowed under current rules without ring-fencing would continue to be dealt with on that basis.

Note that ring-fencing rules do have certain drawbacks. They increase complexity and mean that capital/revenue boundary issues continue to be relevant, even within the bright line period. They also significantly increase the administration costs associated with a bright line test.

Administrative costs

While Inland Revenue has not had time to fully assess the impacts, a high-level estimate is that a bright line test would involve one-off implementation costs of around $600,000 to $800,000, with on-going administrative costs of around $200,000. These costs mainly relate to loss ring-fencing.

Fiscal impact[4]

Although we have tried to allow for behavioural changes in our methodology, the numbers below should still be interpreted with caution and with a margin of error. Behavioural changes are difficult to predict and will to some extent depend on the detailed design of the rules, but they are likely to be large and could impact significantly on these estimates. In addition, the numbers assume historical patterns of appreciation continue at a steady rate, whereas in practice capital gains and losses are highly volatile and actual revenues could fluctuate significantly from year to year.

The costings are for two scenarios. (Note that these scenarios may not reflect the actual implementation timetable. See discussion below.)

- Application of the test from Budget day announcement for real property, and from the beginning of the 2011/12 income year for other property (if included), with no grandfathering (i.e. gains from purchases before the relevant start date will also be taxed if the property is sold within the period)

- Application of the test to properties that are bought and sold after budget day (real property) or the first day of the 2011/12 income year (for other property, if included). This "grandfathered" option would delay the revenue gains significantly for real property, although not so significantly for equities due to their more rapid turnover and the fact gains would be recognised on accrual in PIEs.

A third option would be to tax gains from Budget day (but not before) and to apply the test immediately. Officials do not recommend this option as it has practical difficulties around valuation and increases compliance costs.

Treasury estimates, subject to the caveats above about behavioural changes and appreciation rates, that revenue from a bright line test would be:

Without grandfathering

Residential property only:

$ million	2010/11	2011/12	2012/13	2013/14
3 years (1 year basis)	0	12	13	13
5 years (3 year basis)	0	71	73	75

[4] Note that Inland Revenue has not had the opportunity to review this costing in detail.

Residential property and shares (post Budget implementation):

$ million	2010/11	2011/12	2012/13	2013/14
3 years (1 year basis)	0	237	243	253
5 years (3 year basis)	0	336	348	355

With grandfathering

Residential property only:

$ million	2010/11	2011/12	2012/13	2013/14
3 years (1 year basis)	0	2	2	2
5 years (3 year basis)	0	2	11	30

Residential property and shares (post Budget implementation):

$ million	2010/11	2011/12	2012/13	2013/14
3 years (1 year basis)	0	202	222	242
5 years (3 year basis)	0	227	266	310

Possible implementation options

A properly designed, comprehensive regime, not limited to real property, would take some time to develop. Therefore, if the idea of a bright line test is to be pursued, Inland Revenue officials recommends a budget announcement on the idea with the development of the rules post-budget in consultation with stakeholders, with implementation from the start of the 2011/12 income year.

Treasury recommends that a 5-year bright line test for residential investment property be included in Budget-night legislation. Timeframes mean the rule would have to be simple, with no anti-avoidance rule for selling companies that own real property. Loss ring-fencing rules could be included. It is recommend that the test only apply to real property bought and sold after Budget day (a grandfathered option). The rule could be refined in subsequent legislation after Budget night. This could include developing an anti-avoidance rule for property-holding companies, and looking at whether the scope of the rule should be extended beyond residential investment property.

APPENDIX 5

Other base broadening options

Key decisions

- **Agree** that the redundancy tax credit should be removed from 1 October 2010.
- [deleted – confidentiality of advice]
- **Decide** whether the transitional circumstances tax credit should be removed as part of Budget 2010.
- **Decide** whether the child tax credit should be replaced with an exemption for employment income received by children which is not taxed at source as part of Budget 2010.
- **Decide** whether totalisator duty should be increased as part of Budget 2010.
- **Decide** whether options for GST base maintenance should be included as part of Budget 2010.

Ministers are currently considering a number of options that could form part of a tax reform package. This appendix presents a menu of additional base broadening measures that could be used to fund changes to the mix and type of taxes as part of a wider tax reform package.

These additional base broadening measures and their revenue implications are summarised:

Additional base broadening measures	Revenue implications[5]
[information deleted in order to maintain the constitutional conventions protecting the confidentiality of advice tendered by ministers and officials]	*[information deleted in order to maintain the constitutional conventions protecting the confidentiality of advice tendered by ministers and officials]*
Remove the transitional circumstances tax credit. Growth in incomes has, over time, meant that the credit's application no longer reflects its original policy intention – it no longer applies to	$8 million

[5] Per annum in outyears. Based on 10.5%/17%/30%/33% personal tax scale including clawback effect.

the full time low wage taxpayers it was designed for. The transitional circumstances tax credit is also a significant driver of refunds, which increases administration costs for Inland Revenue. If reductions are made to the lower personal tax rates, there is significant justification for removing the transitional circumstances tax credit from 1 April 2010.	
Replace the child tax credit with a limited exemption for employment income received by children which is not taxed at source. The child tax credit is available to children (under 19 years old) who attended school at any time during a tax year and who also earned employment income. The credit was originally intended to be a compliance cost reduction measure for employers of children by allowing them to not deduct PAYE up to the $45 a week cap. Most employers of children deduct PAYE from wages without reducing it to account for the child tax credit, so as a compliance cost reduction measure, the child tax credit is largely ineffective.	$17 million
Increase totalisator duty. Remove the totalisator concession provided to the New Zealand Racing Board (NZRB). In 2006, the duty payable by the NZRB was aligned with the rate of duty paid by casinos. Casinos pay income tax which justifies having a lower rate of duty. NZRB does not pay income tax.	$50 million
GST base maintenance. In November 2009, the Government released the discussion document *GST: Accounting for land and other high-value assets*, which suggested a number of options for addressing GST base risks – especially refunds of GST with no offsetting payment by the supplier (known as phoenix fraud) and avoidance of the mortgagee sales provisions. Officials will be reporting shortly on submissions to the discussion document.	$60 million

The Treasury and Inland Revenue agree that it would be appropriate to move on any or all of the above items, with the exception that Inland Revenue is opposed to the bright line test.

[deleted - confidentiality of advice]

Officials will report back in more detail in the immediate future on any of the additional base broadening options that Ministers indicate they want as part of the taxation package for the 2010 Budget.

Also, given the changes in the individuals' marginal tax rates, it is appropriate to remove the redundancy tax credit (6c per $ for the first $60,000 of redundancy pay). The tax credit was designed to ensure that redundant taxpayers would not be pushed into the 39% tax rate by the occasion of redundancy.

APPENDIX 6

Working for Families integrity

Key decision

- **Note** that it is not feasible to include in Budget night legislation an amendment to disregard investment losses for determining entitlements to student allowances.
- **Agree** that the post-Budget review addressing integrity concerns relating to social assistance programmes cover Working for Families tax credits, student allowances and health entitlement cards.

The Ministers' tax subgroup on 8 March 2009 agreed to announce in the Budget a review of what should be the measure of income for determining Working for Families (WFF) entitlements, and that a Budget night amendment should exclude investment losses (including rental property losses) for WFF purposes. The Ministers' subgroup queried whether the scope of the post-Budget review should be widened and sought further advice from officials.

Scope of review

The review would consider further adjustments to the income definition used for determining a household's entitlement to WFF tax credits. Possible adjustments could include, for example, counting payments from trusts as income of the beneficiaries, and counting the income from non-locked in portfolio investment entities (PIEs).

There are other types of social assistance that use the Income Tax Act definition of income that would be appropriate to include in the review. These are student allowances and health entitlement cards. The review would consider whether there are integrity concerns relating to these other forms of assistance and whether the Income Tax Act provides the appropriate measure of income for determining entitlements. For example, the review could consider whether rental losses should be disregarded in calculating parental income for student allowance purposes.

The review could also consider whether Inland Revenue should provide information to the Ministry of Social Development (MSD), which administers student allowances.

The review would be completed in 2010 with a view to developing solutions for legislation potentially in 2011.

Data sharing

Recipients of benefits are required to report any changes in their income so their benefit entitlements can be adjusted accordingly. The government-wide data sharing component of the Transform Inland Revenue project may help to address this. The disclosure of Inland Revenue-collected information, such as PAYE details, to MSD would assist to validate a person's eligibility for benefits.

Scope of Budget night legislation

The Government has agreed to enact as part of Budget night legislation an amendment so that investment losses (including those from residential rental properties) will be excluded from the calculation of income for WFF tax credit purposes. This amendment will apply from 1 April 2011.

It is not feasible to include in Budget night legislation an amendment to disregard investment losses for determining entitlements to student allowances. This is because MSD, which administers student allowances, does not have access to the required information. In contrast, Inland Revenue has information about rental losses from IR3 returns filed by individuals, and can adjust a person's entitlement to WFF tax credits accordingly.

APPENDIX 7

Tax rates for PIEs and other savings vehicles – further information

Key decisions

Given the complexity of the issues it is recommended that you:

- **Agree** not to increase the top PIE tax rate as part of Budget 2010
- **Agree** that officials report to Ministers after the Budget as a matter of urgency with further advice on setting the top PIE tax rate.

At the Ministers' Tax Sub-group meeting of 8 March Ministers considered the issue of whether the top PIE tax rate should be changed to align with the top personal tax rate (likely to be 33%) as part of the Budget. Officials indicated that the appropriate tax rate for PIEs and other savings vehicles was a complex issue and recommended that this be considered as a matter of urgency after the Budget. Ministers sought further information on what the main complexities with changing the PIE rate as part of the Budget may be. This appendix outlines these issues – with and without a company tax rate cut - and seeks agreement not to change the PIE tax rate as part of the Budget.

Top tax rate for PIEs

The 30% top PIE tax rate is a final tax. This provides a tax advantage to investors that have a marginal tax rate of 33% or 38% as investment income is taxed at 30% at the PIE level and there is no further tax when the investor sells their units in the PIE or receives distribution.

The 30% capped PIE rate causes integrity and coherence issues as it creates artificial biases for people to use PIEs ahead of direct investments or investments through non-PIE vehicles. It also causes equity issues as the tax advantage is only available to people that have a marginal tax rate of 33% or 38%. The Tax Working Group recognised these integrity and coherence issues and recommended that PIEs and other widely-held savings vehicles be taxed at the marginal tax rate of investors.

Officials agree that, ideally, the PIE tax rate structure should mirror the personal tax rate structure – with the top PIE rate being increased to the top personal tax rate (likely to be 33%).

Complexities

There are, however, a number of complex issues that would need to be addressed if the top PIE tax rate were to increase to 33%. The complexity arises because the company tax rate would remain at 30% or be reduced (depending on final Budget decisions).

PIEs uncompetitive without integrity measures

If the PIE tax rate were higher than the company tax rate, investment vehicles that were taxed as companies would gain a competitive advantage over PIEs. Such vehicles include non-PIE unit trusts that are taxed as companies and listed investment

companies. The tax advantage would arise because the investment income would be taxed at the lower company tax rate. While the investor would have to pay tax at their marginal tax rate on any dividends earned, there are various mechanisms available to ensure that the investor can receive the investment income with no additional tax – essentially resulting in the company tax being a final tax. These mechanisms include redeeming units in a unit trust directly with the investment manager for a capital gain rather than receiving a dividend (so-called 'manager buyback') and the sale of shares in a listed investment company for a tax-free capital gain.

The competitive advantage that these vehicles would have over PIEs (if PIEs were taxed at the top personal tax rate) may be able to be addressed by various integrity measures designed to ensure that investors in such vehicles were taxed at their marginal tax rate. However, the design of a comprehensive set of integrity measures would require careful consideration and consultation.

Without the adoption of a comprehensive set of integrity measures there is a real risk that a number of PIEs would elect out of the PIE rules in order to access the lower company tax rate. This could have adverse consequences on PIE investors that have PIE tax rates below the company tax rate.

KiwiSaver issues

In addition, when considering whether the top PIE tax rate should be increased to the top personal tax rate, it would be necessary to decide whether the higher rate should apply to savings that were in KiwiSaver PIEs (and other locked-in superannuation funds). While there is an argument that investment income from KiwiSaver funds should be taxed at investors' marginal tax rates, an increase in the top PIE rate applying to KiwiSaver funds is likely to be perceived as discouraging saving and disadvantaging savers who have made locked-in contributions expecting a capped tax rate to apply.

Other issues if company tax rate is cut

There are a number of other forms of savings entities (e.g. life insurance, certain group investment funds and bonus bonds) that are presently linked to the company tax rate. If the company tax rate were reduced to 28% as part of Budget 2010 it would be necessary to consider whether the cut should flow through to these entities.

Officials recommend in general that the tax rate for these other savings entities be reviewed as part of the wider review on the PIE rate. However, as outlined below, the lower company tax rate will automatically (or through necessity) flow through to certain savings entities as part of the Budget. This will result in a somewhat complex and arbitrary set of tax rules for savings entities until such time as these issues can be resolved.

Savings entities that would be taxed at 28% after the Budget

The tax rate for companies that are in economic terms savings or investment vehicles and unit trusts (which are taxed as companies) would change automatically as part of Budget 2010.

Category A GIFs (group investment funds) are currently taxed as companies. It would be necessary for the tax rate on Category A GIFs to follow the company rate down as part of the 2010 Budget. If it did not it would create major problems in respect of imputation.

Thus – if the company rate were cut - the following savings and investment entities that would be taxed at the lower company rate as part of the 2010 Budget:

- Companies that are savings and investment vehicles;
- Unit trusts; and
- Category A GIFs;

Under present tax law and practice this will often be a final tax.

Savings entities that would remain at 30% after the Budget

The following rates/entities would remain at 30% pending the post-Budget review:

- Maximum rate of PIEs (portfolio investment entities);
- An approved unit trust (Post Office Bonus Bonds which because of an exemption from the unit trust regime is taxed as a trust);
- Policyholder income of life insurance companies;
- A widely held (non-Category A) GIF; and
- A widely held super fund.

Savings that would be taxed at 33% after the Budget

Savings income (dividends and interest) derived directly by individuals is taxed at their marginal rate (presuming a maximum of 33% after the budget cuts). Similar income derived by trusts is also taxed at this rate.