POLICY ADVICE DIVISION

Tax policy report: Potential tax base broadening and maintenance measures

Date:	3 December 2009	Priority:	High
Security Level:		Report No:	T2009/2514 PAD2009/229

Action sought

	Action Sought	Deadline
Minister of Finance	Note contents and discuss with officials	15 December 2009
Minister of Revenue	Note contents and discuss with officials	15 December 2009

Contact for telephone discussion (if required)

Name	Position	Telephone	
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3 December 2009

Minister of Finance
Minister of Revenue

Potential tax base broadening and maintenance measures

Executive summary

The purpose of this report is to outline a list of potential options for tax base broadening (Appendix 1) and tax base maintenance opportunities (Appendix 2), to inform Ministers' thinking on potential tax reform packages, and on managing future fiscal challenges. The report does not purport to contain detailed analysis and description of each measure, rather it seeks to inform Ministers of the potential range of measures and make some comment on their attributes so that Ministers can discuss which measures they want to further consider. Much more analysis would be required before decisions should be made.

Appendix 1, which deals with tax base broadening, provides a list of key measures with an estimated revenue profile for each, and an indication of each measure's expected impacts in terms of the following fundamental tax principles:

- Efficiency;
- Equity;
- Integrity; and
- Administration and compliance costs.

The measures discussed in Appendix 1 are predominantly those considered by the Tax Working Group. The agencies involved in the preparation of this report express no view on the merits of these measures at this early stage, and some of these are not likely to be recommended by either or both agencies. Any disagreements between the agencies about the impacts of the principles enunciated above are noted as appropriate in this Appendix.

Appendix 2 provides a list of tax base maintenance ideas that may be worthy of further investigation for the purposes of both protecting the tax base and generating revenue to fund tax reforms. Should you require, officials can report to you in more detail on these matters.

More generally, we note that over recent years other pressures have meant that there has not been a high emphasis in the tax policy work programme on maintaining and reinforcing the existing tax base, although a small number of GST and income tax measures have been or are being addressed. Some items in this area are long standing and, from an integrity perspective, addressing them would be beneficial to the longer-term sustainability of the tax system.

Very few of the ideas on both of the attached Appendices are on the existing tax policy work programme. Given the full devotion of existing resources to the current work programme, adoption of any of these measures would require a reprioritisation of policy resources.

Officials recommend meeting with Ministers to discuss and elaborate on the contents of this report once you have had time to consider it.

Recommended action

We recommend that you:

(a) **Note** this report and discuss it with officials.

Noted

Noted

Bill Moran
for Secretary to the Treasury

Jim Gordon
Policy Manager
Inland Revenue

Hon Bill English
Minister of Finance

Hon Peter Dunne
Minister of Revenue

Background

1. As noted in the *Long Term Fiscal Statement* (LTFS) issued by the Treasury in October this year, the fiscal outlook has significantly deteriorated since 2006 (when the first LTFS was released). Based on the most recent fiscal projections, net public debt is projected to reach over 220% of gross domestic product by around 2050. Clearly this is unsustainable.

2. While taxation and debt can be used to assist in the management of these long term fiscal pressures, they can also both contribute to them. As noted in the LTFS, achieving higher economic growth will not, on its own, resolve these fiscal challenges.

3. While taxes are generally damaging to efficiency and economic growth, some are more damaging to growth than others. Further, where tax rates are high and tax bases are not comprehensive, distortions to economic decision-making may occur, creating inefficiencies and reducing growth prospects. In these circumstances a strategically designed tax package involving a combination of changes in the tax mix, broadening of the tax base, and lowering of marginal tax rates could potentially reduce the growth-damaging effects of the tax system and therefore have significant growth-enhancing potential.

4. As you are aware, it was in this context that the Tax Working Group (TWG) was established by Victoria University, in conjunction with the Treasury and Inland Revenue, in May 2009. The TWG's objectives were to consider the direction of New Zealand's medium-term tax policy and the best mix of tax settings that are sustainable, and which will promote growth, fairness, and simplicity within the tax system.

5. This report does not contain detailed analysis of each specific item discussed in it. Rather it sets out to inform at a high level what measures might be considered and provides some discussion about each one. This is to allow Ministers to indicate which ideas they believe may be worthy of further investigation.

Tax base broadening options – Appendix 1

6. This Appendix aims to highlight a number of potential areas for tax base broadening for the purposes of informing Ministers' thinking on possible future tax reform packages, and on managing future fiscal challenges. In doing so it provides a list of key measures with an estimated revenue profile for each which, unless otherwise stated, do not assume grandparenting. It also provides an indication of each measure's expected impacts in terms of the following fundamental tax principles:

- Efficiency
- Equity
- Integrity
- Administration and compliance costs

7. The list of measures is located at Appendix 1. The TWG is presently considering a range of options for its final report. Information on the specifics and impact of many of the options in this report have previously been provided to you and the TWG, although this list is more comprehensive.

8. It is important to note that some of the options in Appendix 1 are either mutually exclusive or incompatible. For example, a broad-based CGT and RFRM can be viewed as being mutually exclusive. In addition, were RFRM selected, loss ring-fencing in respect of rental property would not be required as the losses would already be denied under RFRM. Accordingly, care should be taken when considering a potential package and in adding together the revenue profiles of different measures.

9. We note that the agencies involved in the preparation of this report express no view on the merits of these measures at this early stage, and that some of these are not recommended by either or both agencies. Any disagreements between the agencies about the impacts of the principles enunciated above are noted as appropriate in this Appendix.

Base maintenance opportunities – Appendix 2

10. Over recent years there has not been a high emphasis in the tax policy work programme on maintaining and reinforcing the existing tax base, although a small number of GST and income tax measures have been or are being addressed. Some of the unaddressed items in this area are long standing and, from an integrity perspective, addressing them would be beneficial to the longer-term sustainability of the tax system.

11. Appendix 2 outlines a number of areas that have been identified by tax policy officials as being threats to the tax/welfare base, or that might constitute potential opportunities for making coherent improvements to the existing tax system. It is possible that addressing these areas will assist both in terms of reducing tax/welfare base risks, and in generating revenue.

12. Most of these items have not been assigned a place on the tax policy work programme because of resource constraints. Given the full devotion of existing resources to the current work programme, adoption of any of these measures would require a reprioritisation of policy resources. Appendix 2 also indicates officials' initial views as to the fiscal effect of each item and our analysis of the degree of difficulty/resource in completing each item. Examples of these items are:

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Next steps

13. When Ministers have had time to consider these measures, officials recommend a meeting to discuss them further with you with a view to determining which, if any, measures you would like further information and advice on.

APPENDIX 1

Base Broadening Option	Description	Affected Taxpayers	Efficiency	Equity	Integrity	Compliance & Admin	2010/11	2011/12	2012/13	2013/14	2014/15	Steady State	Comments
CGT (No Exemptions; Accrual Basis)	A CGT would generally tax the nominal increase in value of assets and be taxed at marginal tax rates. It could either include or exempt a taxpayer's primary dwelling. The first two revenue estimates are on an accrual basis. The third option is on a realisation basis. IRD view: Not viable so irrelevant	Home owners, rental property owners, investors, businesses	Treasury view: Significant improvement	Uncertain due to level of owner-occupied housing held by low-middle income earners	Significant improvement	Net increase	0	9538	9941	10361	10800	Increasing to 17107 in 2024/25	An accrual estimate of revenue based on QVNZ data. It uses an assumed rate of real appreciation (average rate based on 30 years of historical data), plus inflation, for a number of property bases (owner-occupied and rental property, shares, and commercial, industrial, and rural property); & applies an average marginal tax rate for each base to the estimated gain on that base, to derive the revenue estimate. This CGT model applies to the entire taxable base on introduction, but only taxes the value increment from a valuation date (a form of grand-parenting)
CGT (Excludes Owner Occupied Housing; Accrual Basis)	IRD view: Not viable so irrelevant	Rental property owners, investors, businesses	Treasury view: Improvement	Significant improvement but increase in rents	Significant improvement	Net increase	0	4706	4906	5115	5333	Increasing to 8511 in 2024/25	An accrual estimate of revenue based on QVNZ data. It uses an assumed rate of real appreciation (average rate based on 30 years of historical data), plus inflation, for a number of property bases (owner-occupied and rental property, shares, and commercial, industrial, and rural property); & applies an average marginal tax rate for each base to the estimated gain on that base, to derive the revenue estimate. This CGT model applies to the entire taxable base on introduction, but only taxes the value increment from a valuation date (a form of grand-parenting)
CGT (Excludes Owner Occupied Housing; Realisation Basis)		Rental property owners, investors, businesses	Treasury view: Improvement. IRD view: Reduction	Tax paid mostly by high income earners subject to increase in rents	Significant improvement	Net increase	0	29	172	501	738	Increasing to 5543 in 2024/25	The estimate is realisation-based. The steady state estimate is expressed in 2009/10 dollars based on QVNZ data. However, the estimates assume that property will continue to appreciate at the historical 30 year average. QVNZ data was used to determine the profile of historical realisation rates. This CGT model is based on property entering the base on the first sale of the property after the CGT is introduced, & gains on subsequent sales are then taxed (i.e. the first sale is not taxed). This is a form of grand-parenting
RFRM (on Rental Property)	Total net rental and capital gain income is deemed to be replaced by a 6% risk free rate of return (applied to the level of net equity in rental property). Rental income would not be separately taxed and no associated deductions would be allowed	Rental property owners	Treasury view: Decrease. Distorts investment decisions. IRD view: Mixed. Increases tax on rental housing	Tax paid mostly by high income earners subject to increase in rents	Treasury view: Decrease. IRD view: Mixed	Increase	175	700	700	700	700	700	Based on a nominal RFRM rate applied immediately to all rental housing (excluding that owned by the state), assuming average net equity of 30%. This effectively operates as an accrual tax. Estimates are sensitive to net equity & RFRM rate assumptions. Estimate does not allow for increase in rental housing stock
Land Tax (No Exemptions, Deductibility Included, Immediate at 1% rate)	A land tax would apply annually to the value of land (excluding improvements) at a specific rate (e.g. 0.25%, 0.5%, or 1%). It would generally tax the entire land base without specific land-type exemptions. It would leverage off the Rating Valuation system. There are a number of land tax variants that can assist in managing equity issues (e.g. the disproportionate burden borne by land intensive industries).	Landowners (especially the agriculture sector & superannuitants); banks	Efficient tax	Broadly proportional, but a wealth loss for existing land owners	Few integrity concerns	Increase	810	3240	3240	3240	3240	3240	Based on $461.1 bil land value base (2006 QVNZ RV data), average tax rate for deductions of 30%, and rate of land tax of 1%, applying to all of base from first year (except conservation forestry and "other" - which includes public buildings and public land). Assumes no increase in land value over time. No account is taken of increase in values since 2006. Includes reduction in land values from tax based on Coleman and Grimes (2009)
Land Tax (No Exemptions, Deductibility Included, Immediate at 0.5% rate)		Landowners (especially the agriculture sector & superannuitants); banks	Efficient tax	Broadly proportional, but a wealth loss for existing land owners	Few integrity concerns	Increase	438	1750	1750	1750	1750	1750	Based on $461.1 bil land value base (2006 QVNZ RV data), average tax rate for deductions of 30%, and rate of land tax of 0.5%, applying to all of base from first year (except conservation forestry and "other". "Other" includes public buildings and public land). Assumes no increase in land value over time. No account is taken of increase in values since 2006. Includes reduction in land values from tax based on Coleman and Grimes (2009)
Land Tax (No Exemptions, Deductibility Included, Immediate at 0.25% rate)		Landowners (especially the agriculture sector & superannuitants); banks	Efficient tax	Broadly proportional, but a wealth loss for existing land owners	Few integrity concerns	Increase	228	910	910	910	910	910	Based on $461.1 bil land value base (2006 QVNZ RV data), average tax rate for deductions of 30%, and rate of land tax of 0.25%, applying to all of base from first year (except conservation forestry and "other". "Other" includes public buildings and public land). Assumes no increase in land value over time. No account is taken of increase in values since 2006. Includes reduction in land values from tax based on Coleman and Grimes (2009)
Land Tax (No Exemptions, Phased Rate)	The phased rate option involves an initially low land tax rate that rises over time to a maximum rate of 1%	Landowners (especially the agriculture sector & superannuitants); banks	Efficient tax	Broadly proportional, but a wealth loss for existing land owners	Few integrity concerns	Increase	47	373	554	733	909	3240	Based on $461.1 bil land value base (2006 QVNZ RV data), average tax rate for deductions of 30%, and rate of land tax applying at 0.05% and increasing in annual increments (of 0.05%) until it reaches 1%. Applying to all of base from first year (except conservation forestry and "other". "Other" includes public buildings and public land). Assumes no increase in land value over time. No account is taken of increase in values since 2006. Takes into account reduction in land values based on Coleman & Grimes (2009)
Land Tax on Incremental Increase in Value	The land tax on incremental value applies land tax at 1% only to the incremental increase in land value from period to period. The increase is assumed to be 2% per annum	Landowners (especially the agriculture sector & superannuitants); banks	Efficient tax	Broadly proportional	Few integrity concerns	Increase	0	0	93	186	282	3240	Based on $461.1 bil land value base (2006 QVNZ RV data), land tax applying at the rate of 1% only to the incremental increase in land value. Land value increase assumed to be 2% per annum. No allowance is made for reduction in land value from the tax or for the deductibility of the land tax. Applying to all of base from first year (except conservation forestry and "other". "Other" includes public buildings and public land). Assumes no increase in land value over time. No account is taken of increase in values since 2006

Base Broadening Option	Description	Affected Taxpayers	Efficiency	Equity	Integrity	Compliance & Admin	2010/11	2011/12	2012/13	2013/14	2014/15	Steady State	Comments
Loss Ring-Fencing (Losses Released Upon Sale)	Loss ring-fencing would restrict the ability to offset rental property losses against other forms of taxable income. Rental losses could be allowed on sale or permanently disallowed	Rental property owners	Treasury view: Mixed. Increases efficiency where it offsets bias elsewhere. IRD view: Reduction	Uncertain - depends on impact on rents	Reduction	Marginal increase	10	55	95	130	165	Declining	Assumes restriction is transitioned in over 5 yrs (20% p.a.) and losses are released on sale. Turnover is assumed to be 10% of rental stock p.a. Over a longer period, additional revenue declines as losses released from sale offset losses restricted on new rental housing. Possible that estimate is understated as it is based on 2004 data
Loss Ring-Fencing (Losses Permanently Disallowed)		Rental property owners	Reduction in efficiency	Uncertain - depends on impact on rents	Reduction	Marginal increase	10	55	100	145	195	195	As above but losses are permanently disallowed on sale and therefore the govt receives a permanent benefit. Because of this permanent benefit revenue does not decline in later years. Possible that estimate is understated as it is based on 2004 data
60% Thin Capitalisation Threshold	Reducing the acceptable level of debt capitalisation for foreign-owned NZ companies for tax purposes (reducing the total debt/total assets percentage down from 75%). This will reduce the level of interest deductions taken in NZ	NZ companies owned by non-residents	Improving where it reduces tax bias for debt. Reducing where it raises cost of capital for NZ	No impact for Nzers	Significant improvement	Increase	44	177	177	177	177	177	Estimates are based on data showing foreign-controlled/owned non-bank NZ companies sourced from IR10s. A taxable income proxy has been used to establish asset amounts for those companies without asset data. Information on world-wide debt/assets ratios is not available. Takes no account of on-lending concession. Likely to be at upper-end of fiscal saving
67% Thin Capitalisation Threshold		NZ companies owned by non-residents	Improving where it reduces tax bias for debt. Reducing where it raises cost of capital for NZ	No impact for Nzers	Significant improvement	Increase	23	92	92	92	92	92	Estimates are based on data showing foreign-controlled/owned non-bank NZ companies sourced from IR10s. A taxable income proxy has been used to establish asset amounts for those companies without asset data. Information on world-wide debt/assets ratios is not available. Takes no account of on-lending concession. Likely to be at upper-end of fiscal saving
Reducing Depreciation Loading	Reducing the accelerated depreciation concession for new assets from 20% to 15% . This means an asset that can currently be depreciated at 48% (40% x 1.2) would be depreciated at 46% (40% x 1.15)	Rental property owners, investors, businesses	Improvement if considered with lower depreciation rates on buildings	Improvement	Marginal improvement	Marginal increase	15	105	133	145	149	149	Assumes loading reduced from 120% to 115% from 1 April 2011. Key assumption used is gross capital formation less buildings with a 5% growth rate projected (consistent with BEFU2009 Treasury forecasts). A weighted average depreciation rate is also assumed based on data from SNZ. The company tax rate of 30% is assumed
Removing Depreciation Loading	Removing accelerated depreciation (meaning assets will only be depreciated at their core economic depreciation rates)	Rental property owners, investors, businesses	Significant improvement if considered with lower depreciation rates on buildings	Improvement	Marginal improvement	Marginal increase	62	428	550	612	637	637	Assumes loading removed from 1 April 2011. Key assumption used is gross capital formation less buildings with a 5% growth rate projected (consistent with BEFU2009 Treasury forecasts). A weighted average depreciation rate is also assumed based on data from SNZ. The company tax rate of 30% is assumed
Removing Depreciation on all Buildings	Eliminating the ability to claim depreciation in respect of buildings on the basis that the empirical evidence shows they are not in fact depreciating	Rental property owners, investors, businesses	Improvement where a building is actually appreciating. Significant decrease where a building is depreciating	Improvement generally but penalises building intensive industries	Improvement (subject to treatment of losses) and structuring activity to get access to losses	Reduction (subject to treatment of losses)	310	1245	1266	1293	1326	1326	There are significant caveats around this revenue estimate. A number of key assumptions are not based on clear evidence. Further, this estimate does not take into account the allowance of tax losses (which should arguably be allowed on disposal if depreciation is not allowed). If the allowance of tax losses on buildings is factored in, the revenue increase is only one of timing
Excise taxes - increase by 10%	Raise excise taxes on both alcohol and tobacco by 10%	Smokers & drinkers	Improvement	Regressive overall	No change	No change	35	140	140	140	140	140	The estimate shows the expected increase in excise revenue from a 10% increase in the excise rate on tobacco and alcohol (based on 2008 excise rate data). It is based on elasticity assumptions in respect of beer, wine, and spirits that reflect empirical work
Excise taxes - align rates on low and high volume alcohol	Raise excise rate for low volume alcohol by 82%, to match the rate on high volume alcohol	Beer and wine drinkers	Significant improvement	Mildly regressive	Improvement	Improvement	395	395	395	395	395	395	Estimate is based on framework used above, but instead the excise rate for low volume alcohol is increased by 82%, to match the rate on high volume alcohol
Totalisator Duty	Remove the totalisator concession provided to NZ Racing Board (NZRB) in 2006 (where the rate of duty paid 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	NZ Racing Board	Uncertain	Uncertain	No change	No change	13	50	50	50	50	50	Assumes reversal of 2006 alignment of totalisator duty to duty paid by casinos (where it was reduced from 20% to 4%). Difference justifiable as casinos pay income tax but NZRB is tax exempt. The estimate is based on an increase in the duty from the current rate of 4% to 20%, and is also based on the average gross totalisator for the 2008 & 2009 fiscal years

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General Notes

Estimates are on a static basis & do not take into account behavioural changes (due to information constraints). Accordingly, the revenue estimates are unlikely to be exact
The basis of comments on impacts varies. Some are made relative to the status quo; others (e.g. land taxes) assume there is a shift in tax mix from income taxes to other taxes
Amounts are expressed in $NZ millions and based on fiscal years (year ending 30 June)
Some estimates are based on HYEFU forecasts which will not be public until mid-December 2009
Steady state amounts are indicative. In many cases, over time the steady state revenues will increase

Grand-parenting is not assumed unless specifically stated. Grand-parenting will reduce the speed (possibly significantly) of revenue genration
Estimates are produced on a "best-endeavours" basis given information constraints
Comments on impacts are indicative only & require further explanation & elaboration. Most impacts are critically dependent on design issues
Commencement dates will require review once detailed proposals are developed. Most measures could commence in 2011/12
CGT measures would take longer to design, consult on, and implement

Base maintenance opportunities

Officials' initial views as to the fiscal effect and our analysis of the degree of technical difficulty/resource in completing each item are noted at the end of each item. However, some of the issues described as technically easy might be strongly contested.

Enforce marginal rates if tax rates are not aligned

At present the interface between individuals' marginal tax rates, particularly the 38% rate, the trust and PIE tax rates, and the company tax rate lacks coherency. Alignment of tax rates would address this, but if alignment is not immediately achievable, the 38% tax rate should be enforced. This will involve consideration of some or all of:

- Changing the trust tax rules so as to prevent income being passed to beneficiaries having been finally taxed at the 33% trust rate.

- Ensuring that personal services income (e.g. income of certain professionals from their practices) is taxed to the person providing the personal services.

- The PIE tax rates which are presently capped at 30%.

- Other opportunities to shelter income.

In particular, business people who can alienate their business to a trust or a company can use these opportunities (although anyone with savings can take advantage of PIEs). As an aside, increasing integrity in this area could also increase income subject to ACC levies and be of assistance to more properly targeting social measures (see next item below).

Over $100m per annum	Difficult

Working for families definition of income

Presently the definition of family income for entitlement to Working for Families (WfF) focuses on the taxable income of the parents, with some amendments. In broad terms this definition is also used for child support, student allowance purposes, and other means testing. Because of this definition, PIE income and fringe benefits are ignored, as is income paid out by trusts as tax paid income (i.e. at 33%). Further, there are issues with the taking into account of tax losses, including tax losses from rental properties. Consideration could be given to changing the definition of income for these purposes.

Tax rate alignment does not address this.

Over $10m per annum, could be over $100m per annum	Difficult

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Increase transparency of loss-attributing qualifying companies (LAQCs)
LAQCs are companies that pass their losses to their shareholders (who are often on the 38% tax rate), but whose profits are taxed at the company rate of 30%. Thus they are a hybrid, and from a tax policy perspective, this is inappropriate due to the tax arbitrage that occurs. Tax rate alignment would solve this issue.

While they are not necessarily an essential part of many tax avoidance arrangements, they do feature in a number of these arrangements. However, it is important to note that generally losses are not created by LAQCs per se. Rather, they arise from the operation of underlying law, e.g. the treatment of rental houses or forestry.

There are also some specific base issues associated with LAQCs that ideally should be addressed, but it would seem better to address the underlying problem, rather than do these in isolation. However, tax rate alignment would not solve these.

Up to $100m per annum	Easy-medium

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Capital contribution payments

New consumers (typically clients of energy companies) have to make a contribution to the energy companies' costs of reticulation. At present these companies are treating the income as capital gain (non-taxable) and depreciating the gross cost of the associated assets (even though the energy company did not incur this cost). Economically this outcome is inappropriate, and, at least on the face of it, the contribution should reduce the cost base of the assets for depreciation purposes.

Between $10m per annum and $100m per annum	Easy

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