Inland Revenue
Te Tari Taake

POLICY ADVICE DIVISION

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: Additional base broadening measures – Budget 2010

Date:	19 March 2010	**Priority:**	High
Security Level:		**Report No:**	T2010/422 PAD2010/51

Action sought

	Action Sought	Deadline
Minister of Finance	**Agree** to recommendations	22 March 2010
Minister of Revenue	**Agree** to recommendations	22 March 2010

Contact for telephone discussion (if required)

Name	Position	Telephone	
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19 March 2010

Minister of Finance
Minister of Revenue

Additional base broadening measures – Budget 2010

Executive summary

Ministers are currently considering a number of options that could form part of a tax reform package. This report 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. We ask you to advise which items you would like to be included in Budget 2010.

We also seek a decision on the removal of the redundancy tax credit.

These additional base broadening measures and their estimated revenue implications are summarised in the table below. To the extent any of these measures are to be effective from or before 1 October, budget night legislation will be needed.

Additional base broadening measures	Revenue implications[1]
[information deleted in order to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials]	[deleted – confidentiality of advice]
Remove the transitional circumstances tax credit. This credit applies to full time earners who do not have deductions. Growth in incomes has, over time, meant that the credit's application no longer	$8 million

[1] Per annum in outyears. Based on 10.5%/17%/30%/33% personal tax scale including clawback effect. Other than the numbers in respect of bright line tests, these revenue estimates are provided by Inland Revenue.

reflects its original policy intention – it no longer applies to 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. It is appropriate to remove the transitional circumstances tax credit from 1 April 2011.	
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. We recommend that any change be effective from 1 April 2011.	$17 million
Increase totalisator duty. The totalisator concession provided several years ago to the New Zealand Racing Board (NZRB) could be removed. 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 which was the justification for the rate mis-alignment. This change could be effective from 1 April 2011.	$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. The main issues are refunds of GST to purchasers 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 and recommending that certain transactions (including land) be either zero rated or made subject to a domestic reverse charge (the effect is the same even though the mechanism is different). This would apply to transactions made on or after 1 April 2011.	$60 million

Five year bright line test for property disposals. The basic concept is that any profit from disposing of an item of property would be treated as income if the property had been owned for less than 5 years. This would be accompanied by loss ring-fencing rules to quarantine losses under the rules against future similar profits. If a bright-line test were to be introduced, officials prefer applying it to all business and investment assets (including shares). However, a rule not limited to real property would take some time to develop and could not be included in Budget night legislation. Treasury recommends that a 5-year rule for residential investment property only be included in Budget night legislation, applying to property bought and sold after Budget day. The revenue figure given in this table relates to that option in steady-state.	$75 million (once fully implemented)

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 *[information deleted. in order to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials]*

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.

In the time available there has been no opportunity for officials to consider likely distributional effects. Also, with the probable exception of the GST base maintenance item, the above will likely cause negative reaction from those affected as there has been no consultation.

Recommended action

It is recommended that as part of Budget 2010 you:

(a) **Agree** that the redundancy tax credit should be removed from 1 October 2010.

Agreed/Not agreed Agreed/Not agreed

(b) *[Information deleted in order to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials]*

Yes/No Yes/No

(c) **Decide** whether the transitional circumstances tax credit should be removed from 1 April 2011.

Yes/No Yes/No

(d) **Decide** whether the child tax credit should be replaced with an exemption for employment income received by children which is not taxed at source from 1 April 2011.

Yes/No Yes/No

(e) **Decide** whether totalisator duty should be increased from 1 April 2011.

Yes/No Yes/No

(f) **Decide** whether to proceed at this time with GST base maintenance effective from 1 April 2011.

Yes/No Yes/No

(g) **Decide** whether a 5-year bright line test for property disposals should be introduced.

Yes/No Yes/No

(h) If a bright-line test for property disposals is to be introduced, **decide** whether:

i) rules for residential investment property disposals should be included in Budget-night legislation with immediate effect, and that officials should report back after the Budget on the inclusion of other real property and equities in the bright-line test at a later stage.

Yes/No Yes/No

OR

ii) rules for real property (other than owner-occupied property) and equities should be developed for post-Budget consultation and enactment.

Yes/No Yes/No

(i) If a bright-line test for residential investment property is to be included in Budget night legislation, **decide** whether the bright-line test should be grandfathered.

Grandfather/don't grandfather Grandfather/don't grandfather

(j) **Note** that officials will be reporting separately on options for improving GST neutrality.

Noted Noted

Andrew McLoughlin
for Secretary to the Treasury

Carolyn Palmer
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Hon Bill English
Minister of Finance

Hon Peter Dunne
Minister of Revenue

Background

1. Ministers are currently considering a number of options that could form part of a tax reform package. This report 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. We seek your advice as to which, if any, of these you would like to be included in Budget 2010.

2. The discussion on each of these items is of necessity brief and will report in more detail in the immediate future on any of these items that you include in Budget 2010. However, given the timelines, the decision to include any of these items needs to be made now.

3. This report also recommends that you agree to the removal of the redundancy tax credit.

4. Given the time available, we have not considered the distributional effects of any of the items on the menu.

Removing the redundancy tax credit

5. The redundancy tax credit was introduced several years ago. Its purpose was to ensure that a redundancy receipt itself did not cause a redundant person to move up a tax threshold, and to the 39% rate in particular. It works by providing a refund of 6 c/$ for the first $60,000 of redundancy receipt.

6. If the top individual rate (now 38%) is abolished there is no obvious need for the tax credit and we recommend that it be repealed as part of the budget night legislation, with regard to redundancy receipts on or after the date of the individual's tax cut, 1 October 2010. Given the way the personal tax rate adjustments have been costed, there is no actual fiscal savings of this change (although there will be a small administration saving), rather, there is a cost of retaining the credit of $19 million per annum.

7. Alternatively, the rebate could be reduced from 6c per $ (which was the difference between the 39% and the 33% tax rates) to 3c per $ (being the difference between the new 30% and the new 33% tax rates). This would reduce the cost to $10million per annum.

[Information deleted in order to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials]

Removing the transitional tax credit

8. The transitional circumstances tax credit is available to a full-time earner (a person engaging in at least 20 hours' of remunerative work per week) who does not have dependent children. The full year's maximum credit is $728. This abates at a rate of 20 cents for each dollar of net income in excess of $6,240. The credit therefore terminates when income reaches $9,880.

9. This credit was introduced in October 1986, at the same time as the introduction of GST in New Zealand, in order to compensate full time low wage taxpayers for the extra tax payable as a result of the introduction of GST.

10. Growth in incomes has, over time, meant that the credit's application no longer reflects its original policy intention – it no longer applies to the full time low wage taxpayers it was designed for. To illustrate this point, a full time taxpayer working at least 20 hours at the minimum wage for 48 weeks in the year will not qualify at all for the transitional circumstances tax credit because they would earn net income in excess of $9,880.

11. Instead, the credit is mostly claimed by taxpayers who do not work the full year. Although the quantum of the credit is apportioned when the claimant does not work the full year, taxpayers only working part of the year can still claim the credit. Examples of claimants will therefore include students who work during vacations. In excess of 41,000 taxpayers claimed nearly $8 million in transitional circumstances tax credits in 2008 (on average, $190 per claim).

12. The transitional circumstances tax credit is also a significant driver of refunds, and therefore personal tax summaries and income tax returns, which increases contacts and other administration costs for Inland Revenue.

13. Thus there is significant justification for removing the transitional circumstances tax credit as part of Budget 2010. However, for administrative reasons this should be effective from 1 April 2011, rather than 1 October 2010.

Revenue implications

14. Removing the transitional circumstances tax credit is estimated to result in revenue savings of $8 million per annum in outyears. This is based on the new personal tax rates (base case) and takes into account the impact of the clawback.

Replacing the child tax credit

15. The child tax credit is available to children (under 19 years old) who attend school at any time during a tax year and who also earn employment income. The credit is a maximum of $292.50 per annum, allowing children to earn up to $45 a week ($2,340 per annum) without paying tax. In the year to 31 March 2008, the tax credit was claimed by 86,763 children and a total value of $25 million was claimed. The average claim was $288.50.

16. Over and above this a number of other children will also have effectively derived the credit directly through their employment income not being taxed. Such children then have no need to correspond with Inland Revenue.

17. 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. Despite being able to access the tax credit during the year, just over 70% of the 2008 claimants requested a personal tax summary and claimed the rebate at year-end as a lump sum.

18. 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.

19. The child tax credit should be replaced with an exemption for services income received by children which is **not taxed at source** up to $2,340. This income exemption is desirable to prevent children having to file.

Revenue implications

20. Removing the child tax rebate is estimated to result in revenue savings of $17 million per annum in outyears. This is based on the new personal tax rates (base case) and takes into account the impact of the clawback. This does not allow for a behavioural response from children and employers moving to income which is not taxed at source.

21. Replacing the child tax credit with an income exemption would also drive down contacts, thereby reducing both compliance and administrative costs, and therefore is consistent with Transform IR. If this is agreed, to we recommend that it be effective from 1 April 2011 so as to allow for a smoother transition.

Increase totalisator duty

22. The Totalisator Agency Board (TAB) is exempt from income tax as it is part of the New Zealand Racing Board (NZRB). The TAB is subject to totalisator duty, which is a duty of 4% of TAB income, less money paid out in winnings.

23. 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. As such, there is policy rationale for increasing the rate of duty payable by the NZRB back to the original rate of 20%.

Revenue implications

24. Implementing these measures is estimated to result in revenue savings of $50 million per annum in outyears. This change could be effective from any arbitrary date, but we recommend 1 April 2011.

GST base maintenance

25. In November 2009, the Government released the discussion document *GST: Accounting for land and other high-value assets*, which suggested a number of options that would attempt to resolve certain business-to-business neutrality concerns and improve the operation of GST in general. This would have the effect of addressing GST base risks, especially refunds of GST to the purchaser with no offsetting payment by the supplier (known as phoenix fraud) and avoidance of the mortgagee sales provisions.

26. Officials are reporting separately on a proposal to either zero rate major transactions or introduce domestic reverse charging (in effect they produce the same result, even though the mechanism is different.

Revenue implications

27. Implementing these measures is estimated to result in revenue savings of $60 million per annum in outyears. This could be made effective to transactions occurring on or after 1 April 2011.

Bright line test for property disposals

28. Officials were asked to design a bright-line test of 3 or 5 years for property disposals.

29. 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.

30. 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 purchased after Budget day. Treasury would also support investigating post-Budget whether other property, particularly shares, should also be included in the bright line test.

31. 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

32. 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.

33. 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.

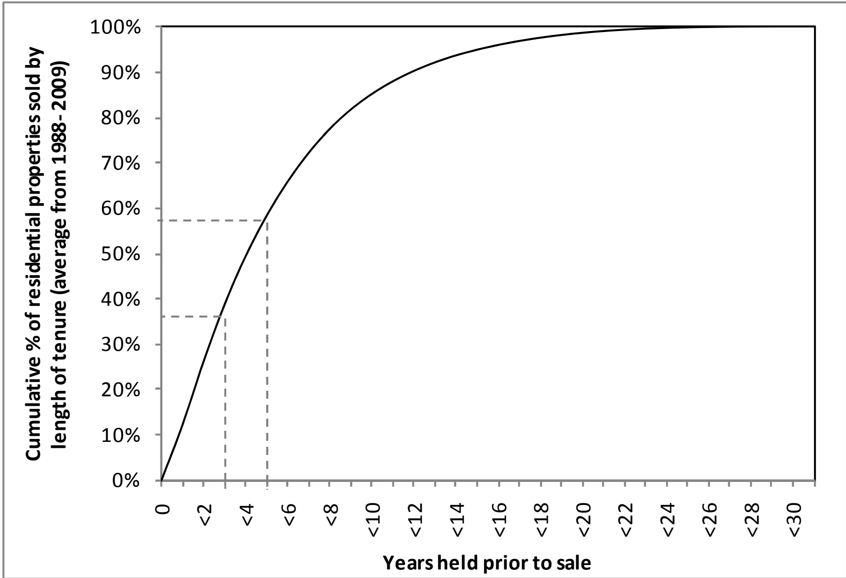
Property covered

34. 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.

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

36. 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.

37. 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.



38. 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 address 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.

39. 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

40. 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.

41. 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.

42. 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.

43. 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

44. 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 per year. These costs mainly relate to loss ring-fencing.

Fiscal impact

45. 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.

46. The revenue estimates 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.

47. 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.

48. Treasury estimates, subject to the caveats above about behavioural changes and appreciation rates, that revenue from a brightline 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

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

49. 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.

50. 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 recommended that the test only apply to residential 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.

Administration impacts

51. Excluding the Bright line test (discussed above) and the GST neutrality options (to be covered in the separate report on this issue), the burden of administrating any or all of the options covered in this paper is slight and would not prevent Inland Revenue from implementing any of the proposed budget package configurations.

Other potential base broadening measures

52. As well as the specific base broadening options outlined above, there are also a number of other base maintenance and base broadening projects that could form part of the normal tax policy work programme, post-Budget.

53. These all require further policy development and most will require consultation. As such, they are not suitable options for Budget night legislation. It is expected that there will be a post-Budget tax policy work programme report that will take the work programme out to the end of next year. This can be discussed in the context of that work programme report.