POLICY ADVICE DIVISION

Tax policy report: Tax cut transitional measures

Date:	26 March 2010	**Priority:**	**High**
Security Level:		**Report No:**	T2010/473 PAD2010/52

Action sought

	Action Sought	**Deadline**
Minister of Finance	**Agree** to recommendations	30 March 2010
Minister of Revenue	**Agree** to recommendations	30 March 2010

Contact for telephone discussion (if required)

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26 March 2010

Minister of Finance
Minister of Revenue

Tax cut transitional measures

Executive summary

As we have previously indicated (T2010/362; PAD 2010/044 refers), there are two transitional matters to be considered that flow from any cuts in the company or individual tax rates. They concern adjustments to provisional tax and allowing a transitional period for companies to impute their dividends at the old company tax rate. Officials note that both measures:

- Have fiscal costs: the provisional tax measure is largely timing but results in a large reduction of revenue in the first year; the transitional imputation period results in a permanent fiscal cost.
- Given that these measures were part of the last round of tax cuts, they may be expected by taxpayers to accompany any future tax cuts.

This report considers these issues. In discussing these matters we have assumed that the company tax rate will decrease to 28%. If this does not proceed, then the individuals' provisional tax is the only part of this report in respect of which decisions will be required.

Provisional tax

Provisional tax can either be paid on the basis of earlier years' tax liabilities, or based upon an estimate. Provisional tax is a timing matter only – any under or over-payment of provisional tax is adjusted after year end when the tax return is filed. If provisional tax is paid by way of an estimate, an adjustment can be made for changes to tax rates, whereas the earlier year basis does not incorporate tax cuts effective in the current year. Generally, larger companies estimate their provisional tax obligations, whereas some smaller companies may not. Significantly less individuals estimate their provisional tax.

The provisional tax analysis for Budget 2010 is complicated by the other tax changes that are proposed - in particular, the depreciation measures. The impact of Budget 2010 on tax

liabilities will depend on each taxpayer's circumstances, but, tax rate cuts excepted, the tax measures in Budget 2010 will generally increase taxation obligations. Thus the grounds for adjusting provisional tax are not as strong as they previously have been. In cases where taxpayers have a net increase in tax liability as a result of the wider tax package, there is no justification for providing a reduction in provisional tax.

However, a number of taxpayers (individuals in particular) will be in a position where the main, if not only, effect on their taxation liability, will be the tax rate cut. Further, proportionately less individuals estimate their provisional tax liability. Accordingly, to ensure that individuals receive the benefits of the tax rate cuts at the same time as the GST increase is effective, Inland Revenue recommends that where provisional tax is paid based on earlier years, it be adjusted downwards from 1 October 2010 by the percentages in the Table 1 below. Inland Revenue also recommends that the company uplift basis also be adjusted.

Treasury does not consider that a reduction in provisional tax is warranted. This is on the basis that many taxpayers will, in fact, have an increase in tax liability due to other measures contained in the package (e.g. the depreciation measures). Given the context of the package as a whole, and the pressure on the fiscal situation, and the fact that taxpayers already have the option of estimating their tax liabilities downwards (in order to take account of the tax cuts), Treasury considers it prudent not to proceed with this measure. In terms of expectations, we further consider that taxpayers would likely understand the policy reasons why a blanket reduction in provisional tax does not automatically follow given the nature of the package as a whole.

In the event that a reduction in provisional tax is required by Ministers, Inland Revenue considers the following reductions should be provided[1]:

Table 1

	Year		
	2010/11	2011/12	2012/13
Companies' adjustment			
• last year basis decreases:		5%	
• previous year basis decreases:		5%	5%
Individuals' adjustment			
• last year basis decreases:	10%	10%	
• previous year basis decreases:	15%	15%	10%

This would apply to both the standard uplift method of paying provisional tax, and to the GST ratio method.

Providing a reduction in provisional tax would affect the timing of revenue costs over the forecast period although, other than financing costs of deferred revenue, revenue costs net to zero. The revenue profile over the forecast period of reducing provisional tax in relation to individuals is as follows (T2010/362; PAD 2010/044 refers):

[1] The Treasury has not considered the underpinning calculations.

	Increase/(decrease) in revenue $m				
	2009/10	**2010/11**	**2011/12**	**2012/13**	**2013/14**
Total Operating impact	**-**	**(240)**	**15**	**215**	**10**

There is no estimated revenue cost in respect of reducing provisional tax in relation to companies because it is assumed that they will estimate their provisional tax liabilities (factoring in all the changes arising from the tax package).

Transitional imputation crediting rule

If the company tax rate decreases, there is a transitional imputation credit ratio issue that, in particular, has implications for resident shareholders of companies (company tax is often a final tax for non-resident shareholders and therefore not relevant to this discussion). From 1 April 2010 the maximum imputation credit ratio will be 30/70 (imputation credits to cash dividend), so if the company rate changes to 28%, the ratio will automatically change to 28/72 from the date of the tax cut. Allowing this to happen automatically is the simplest solution from a compliance and administration perspective.

However, the claim could reasonably be made that this could result in double taxation as earnings that were taxed at 30% may carry a maximum imputation credit of 28%.

Allowing companies a transitional period to keep imputing at 30/70 to the extent they have imputation credits that arose from paying tax at 30% mitigates this, and officials agree this would be a principled approach. Grandparenting the 30/70 ratio for two years has an estimated revenue cost of a $125 million over the forecast period (T2010/362; PAD 2010/044 refers).

Please note that given Cabinet's decision to provide a tax reform package that is broadly revenue-neutral (Cabinet Minute (10) 3/2 refers), not adopting recommendation (e) would assist in achieving this goal.

Recommended action

It is recommended that, as part of the Budget 2010 tax package, you:

(a) **Agree** that:

EITHER:

i. provisional tax be reduced for taxpayers who pay provisional tax on the earlier year basis from 1 October 2010 for individuals and the commencement of the 2011/12 year for companies (Inland Revenue recommendation);

Agreed/Not agreed　　　　Agreed/Not agreed

OR

ii. provisional tax not be reduced for taxpayers who pay provisional tax on the earlier years basis (Treasury recommendation).

Agreed/Not agreed Agreed/Not agreed

(b) If (a)(i) is agreed, **Agree** that taxpayers should be allowed to decrease their provisional tax payments from 1 October 2010 based on the following table:

	Year		
	2010/11	2011/12	2012/13
Companies' adjustment • last year basis decreases: • previous year basis decreases:		 5% 5%	 5%
Individuals' adjustment • last year basis decreases: • previous year basis decreases:	 10% 15%	 10% 15%	 10%

Agreed/Not agreed Agreed/Not agreed

(c) **Note** that, if (a)(i) and (b) are agreed, in addition to an increase in government debt servicing costs, the revenue profile over the forecast period of reducing provisional tax in relation to individuals is as follows:

	Increase/(decrease) in revenue $m				
	2009/10	**2010/11**	**2011/12**	**2012/13**	**2013/14**
Total Operating impact	**-**	**(240)**	**15**	**215**	**10**

Noted Noted

(d) **Agree** to provide a two-year transitional period where companies can over-impute dividends at the present 30/70 ratio.

Agreed/Not agreed Agreed/Not agreed

(e) **Note** that, if (d) is agreed, the revenue profile over the forecast period is as follows:

	Increase/(decrease) in revenue $m				
	2009/10	**2010/11**	**2011/12**	**2012/13**	**2013/14**
Total Operating impact	**-**	**-**	**-**	**(145)**	**20**

Noted

Noted

(f) **Note** that, given Cabinet's decision to provide a tax reform package that is broadly revenue-neutral (Cabinet Minute (10) 3/2 refers), not adopting recommendation (e) would assist in achieving this goal.

Andrew McLoughlin
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. This report considers the transitional issues that arise from any decrease in tax rates.

2. This report presumes the following tax rate decreases:

- effective from 1 April 2011 or equivalent income year the company rate decreases from 30% to 28%; and
- effective from 1 October 2010 for individuals the rates are:

Band	Old rates	New Rates
$0 - $14,000	12.5%	10.5%
$14,001 - $48,000	21%	17.5%
$48,001 - $70,000	33%	30%
Over $70,000	38%	33%

3. If other tax rate changes are agreed upon, officials will provide further advice on transitional issues.

Provisional tax

4. Taxpayers whose income is not taxed at source (e.g. because they are in business) usually pay their income tax on an 'as-you-go' basis, similar to PAYE wage-earners. The system is called provisional tax and the payments can either be based on an earlier year's tax obligation or be estimated. Where they are based on an earlier year's tax obligation there is generally an uplift factor of 5% (if based on last year's obligation) or 10% (if based on the previous year's obligation) to allow for incomes to increase. These uplifts apply to the standard "three instalments" basis of paying provisional tax. The GST ratio method does not use uplifts, but uses earlier year's obligations in a similar fashion.

5. The recent decreases to both the company and individuals' tax rates were accompanied by adjustments to provisional tax so that the cuts were immediately reflected in the tax paid by provisional taxpayers, as it was in PAYE deducted from wage-earners. Given this history, there may be an expectation that such relief will be offered again.

6. However, on the basis that the tax package contains a number of elements - some of which decrease, and others which increase, tax liabilities for companies and individuals - and given the existing ability for taxpayers to estimate downwards their provisional tax liabilities, the Treasury believes that taxpayers would likely understand the policy reasons why a blanket reduction in the uplift does not automatically follow given the nature of the package as a whole. Inland Revenue does not agree with this belief.

7. Reducing provisional tax where it is based on earlier years taxation would affect the timing of costs over the forecast period although, other than financing costs of deferred revenue, revenue costs would eventually net to zero. The revenue profile over the forecast period of reducing the provisional tax uplift in relation to individuals is as follows:

	Increase/(decrease) in revenue $m				
	2009/10	**2010/11**	**2011/12**	**2012/13**	**2013/14**
Total Operating impact	**-**	**(240)**	**15**	**215**	**10**

Companies

8. A provisional tax adjustment for companies is simple – the percentage tax rate decrease is simply rounded to the nearest 5% and the uplift factor is adjusted. A change to a new company tax rate of 28% represents a 6.67% decrease from the existing rate of 30%, which rounds to 5%.

9. The revenue estimate for the company tax rate decrease assumes that it is effective immediately and factored into companies' provisional tax payments. Thus there is no additional fiscal cost of adjusting the provisional tax uplift to reflect the tax rate change.

10. However, there is a complication. Overall a number of companies may be paying more tax because of the other budget changes (e.g. the depreciation measures). Where this effect is significant, the "use-of-money" interest regime that buttresses companies' provisional tax will generally ensure that this is taken into account as provisional tax is paid, and the revenue estimate has also presumed this.

Individuals

11. For individuals, any change in provisional tax depends where they are on the variable tax scale so any adjustment would have to be somewhat arbitrary, or would require individual calculation. The latter is not reasonable from an administration perspective. However, an arbitrary adjustment will clearly present winners and losers.

12. Many individuals who pay provisional tax do not estimate. Thus, unless provisional tax is adjusted, they will be subject to the GST increase at 1 October 2010, but will not receive any explicit effect from the individuals' tax cuts until well into the 2011/12 year (or even the year afterwards) when they have filed their 2011/12 tax return. However, as taxpayers are already able to estimate their provisional tax payments downwards under current law, Treasury considers that individuals would be able to receive the value of the tax cuts through the making of lower provisional tax payments without the need for a change to the provisional tax uplift. Inland Revenue agrees that technically this is correct, but notes the proportionately higher compliance costs of individuals estimating provisional tax. Further, as noted below, there is a behavioural assumption that only some individuals will estimate, even to access the tax cuts earlier.

13. The assumptions that underpin the revenue estimate of tax rate changes assume that only some individual provisional taxpayers will adjust their provisional tax to reflect the tax rate change by way of an estimate. Thus there is a fiscal cost of adjusting provisional tax where individuals are paying it on the earlier years basis.

Conclusion

14. It is not clear-cut that the tax package would require a reduction to provisional tax given the divergent nature of the various elements contained in the package.

15. However, if Ministers require a reduction to provisional tax, and assuming the tax rate changes detailed in the background section of this report (company tax rate reduction to 28% from 1 April 2011; individuals: across the board decreases from 1 October 2010), Inland Revenue recommend the provisional tax uplift be adjusted downwards by the following percentages[2]:

	Year		
	2010/11	2011/12	2012/13
Companies' adjustment			
• last year basis decreases:		5%	
• previous year basis decreases:		5%	5%
Individuals' adjustment			
• last year basis decreases:	10%	10%	
• previous year basis decreases:	15%	15%	10%

Transitional imputation crediting issue

16. If the company tax rate decreases there is a transitional imputation credit ratio issue that, in particular, has implications for resident shareholders of companies (company tax is often a final tax for non-resident shareholders and therefore they are not relevant for this discussion). From 1 April 2010 the maximum imputation credit ratio will be 30/70 (imputation credits to cash dividend), and so if the company rate changes to say 28%, the ratio will automatically change to 28/72. Allowing the imputation ratio to change at the same time the company rate changes is the simplest solution from a compliance and administration perspective.

17. However, changing the imputation ratio at the same time as the company tax rate is likely to result in an adverse reaction from the tax community and some shareholders. This is because imputation credits would be passed out at 28% while the credits were earned at 30% and are likely to still be available. As a consequence, non-corporate shareholders (individuals, trusts and some savings vehicles) would pay an extra $2 of tax on each $100 of gross imputed dividends received, as the amount of credit they can deduct would fall by $2. The effect would be particularly notable for trusts that do not distribute their income as

[2] The Treasury has not considered the underpinning calculations.

beneficiary income and the 30% savings vehicles (e.g. PIEs and other super funds etc. that are not subject to the company tax regime).

18. In some circumstances there is the possibility that the opportunity to use some credits could be effectively lost. The claim could reasonably be made that this amounts to double taxation.

19. This is illustrated via a simple example:

	Grandparenting	No grandparenting
Shareholder's cash dividend from, say, the 2011 income year paid in the 2012 income year	700	700
Imputation credits	300	272
Taxable income	1,000	972
Taxation thereon – say at the trust rate	330	321
Tax credit	300	272
Balance to pay	30	49
Net tax-paid dividend	$670	$651

20. While the shareholder has to pay $19 extra tax, the company would have surplus imputation credits of $28 not matched against tax paid income. Note that unless the company has other untaxed income, the shareholders will not be able to access this $28. This is more likely to affect smaller companies.

21. The company has had underlying pre-tax profits of $1,000 – with no grandparenting the effective tax rate on this $1,000 is 34.9%. With grandparenting it is 33%, the trust tax rate.

22. An approach which would avoid the over taxation effects would be to allow companies a transitional period to keep imputing at 30/70 to the extent they have imputation credits that arose from paying tax at 30% (or 33%). Such a measure would be more complex than the moving immediately to a 28/72 imputation credit ratio.

23. The fiscal cost of doing this is more difficult to estimate because the company shareholder interface is not yet in a stable state following the last company tax cuts (the transitional over-imputation period finishes on 31 March 2010), and there is also the tax cuts for individuals which will further change dividend payment patterns, particularly in closely-held companies.

24. A further consideration that should be noted is that any bank of 30% credits will only have built up over three years (2008-09 to 2010-11 years), and therefore should be considerably smaller than the 33/67 bank of credits that had to be dealt with at the time of the last company tax rate cut. Also, the company tax take for these tax years has been less than usual because of the wider economic situation.

25. While there is only a three year build-up of 30% credits, from a tax policy perspective providing grandparenting for two years would reduce double-taxation and would therefore be a principled approach. Accordingly, officials again recommend that a two year transitional period be offered where companies can over-impute their dividends at the 30/70 ratio. Grandparenting the 30/70 ratio for two years has an estimated revenue cost of a $125 million over the forecast period (T2010/362; PAD 2010/044 refers).

26. Officials note that, given Cabinet's decision to provide a tax reform package that is broadly revenue-neutral (Cabinet Minute (10) 3/2 refers), not providing grandparenting would assist in achieving this goal.