POLICY ADVICE DIVISION

Tax policy report: Implementation of tax reform package

Date:	29 January 2010	**Priority:**	**High**
Security Level:		**Report No:**	T2010/73 PAD2010/08

Action sought

	Action Sought	Deadline
Minister of Finance	Agree to recommendations	5 February 2010
Minister of Revenue	Agree to recommendations	5 February 2010

Contact for telephone discussion (if required)

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29 January 2010

Minister of Finance
Minister of Revenue

Implementation of tax reform package

Executive summary

Subsequent to the final report of the Victoria University Tax Working Group, Ministers are currently considering a range of options that could form part of a tax reform package (T2010/36; PAD2010/02 refers).

You have asked officials to report to you on the logistics of implementing a number of these options from 1 October 2010 and 1 April 2011, or from the 2011-12 income year where appropriate (T2009/2765; PAD2009/238 refers).

This report outlines the legislative requirements of the various options, the lead times for transition and implementation, and associated risks where known at this stage of policy development. It also indicates whether consultation would be beneficial for each initiative. The proposals are still under consideration and this report does not assume that they will necessarily be implemented.

Ministers may wish to consider additional support for certain taxpayers (such as superannuitants, beneficiaries, and Working for Families recipients) to compensate for an increase in GST. This report provides preliminary comments on implementation issues for such compensation.

Most initiatives can be introduced on Budget night. This paper seeks your agreement on the legislative approach for these initiatives. Officials have identified two possible approaches. Under either approach, tranches of the fiscally negative initiatives may need to be phased in over a period of time so that their fiscal impacts are matched with fiscally positive initiatives.

Option 1: *Enact some initiatives on Budget night under urgency, with a subsequent select committee process for others.* The select committee process would be truncated if an application date of 1 April 2011 is desired. Under this approach, some initiatives (those requiring technical consideration) would be introduced on Budget night and referred to the

Finance and Expenditure Committee for a truncated select committee process (or, in the case of thin capitalisation, included in the International Tax bill scheduled for 2010, which would undergo the normal select committee process).

Under option 1, some consultation would be undertaken as part of the select committee process which may result in better quality reforms. However, there would be less consultation than would normally be undertaken under the Generic Tax Policy Process because of the truncated select committee process.

Option 1 also comes with the risk that the final package of initiatives will not be fiscally neutral given the possibility of amendments at select committee stage. For example, fiscally negative initiatives (such as personal tax cuts) would be enacted on Budget night, but initiatives with fiscally positive impacts (such as removal of depreciation loading) may not be enacted in the structure costed for Budget, and this could result in the fiscal impact of the total package being higher than that outlined in Budget 2010.

To mitigate this risk, officials consider that the group of initiatives passed under urgency, and the group of initiatives referred to a select committee, should each be a fiscally neutral package.

This means that initiatives enacted under urgency on Budget night should itself form a fiscally neutral package. This might be, for example, the GST rate increase and certain tranches of the personal tax rate cuts (such as a cut to the bottom personal tax rate). These could apply from 1 October 2010.

The final form of the remaining initiatives (for example, a tranche of the personal tax cuts, and changes to depreciation) will be less certain because of potential changes at the select committee process. Because of this uncertainty, officials recommend that those initiatives (or tranches of these initiatives) should be delayed until 1 April 2011.

Option 2: *Enact all initiatives on Budget night under urgency, no select committee process.* Limited pre-consultation would be undertaken on some technical initiatives.

Under option 2 the fiscal risk identified above would be mitigated, and application dates could be brought forward to 1 October 2010 (where appropriate). However, there is an increased risk of errors arising from the absence of consultation (even though these were subject to the transparent Victoria University Tax Working Group process). The lack of public consultation on significant measures is also likely to be criticised. This could be mitigated by limited pre-consultation on technical initiatives. Any errors could be rectified in future tax bills.

Officials consider that under option 2 the following initiatives could have a start date of 1 October 2010:

- personal tax cuts (with the possible exception of resident withholding tax and portfolio investment entity rates, and certain schedular payments and Māori authority rates); and
- a GST rate increase and associated compensation.

However, under this approach, tranches of the fiscally negative initiatives may still need to be phased in over a period of time so that their fiscal impacts are matched with fiscally positive initiatives.

Under either option, changes to the rules on capital contributions should apply from Budget night to prevent taxpayers gaining during the transition period.

The other initiatives could have a start date of the 2011-12 income year (generally a 1 April 2011 start date).

Some initiatives (such as reforming the loss attributing qualifying company rules, clarifying the capital/revenue boundary, and some Working for Families integrity issues and personal tax rate consequential issues) would require further work before introduction, but could be announced on Budget night.

Officials will report on the substantive policy aspects, fiscal impacts and administrative costs of each issue in February and early March.

Recommended action

We recommend (subject to final decisions on a tax package for Budget 2010) that you:

(a) **EITHER**

Option 1

(i) **Agree** that a tax package announced on Budget night could involve some initiatives enacted under urgency on Budget night, and that other initiatives could be referred to the Finance and Expenditure Committee for a truncated select committee process (or in the case of thin capitalisation, for inclusion in the International Tax bill scheduled for 2010).

Agreed/Not agreed Agreed/Not agreed

(ii) **Note** there may be significant fiscal risk associated with option 1.

Noted Noted

(iii) **Note** that, as a result of the potential fiscal risk associated with option 1, initiatives enacted under urgency on Budget night should form a fiscally neutral package in themselves, as should other initiatives that may be delayed until 1 April 2011 and subject to a truncated select committee process.

Noted Noted

OR

Option 2

(i) **Agree** to enact all initiatives on Budget night under urgency without a select committee process.

Agreed/Not agreed　　　　　　Agreed/Not agreed

(ii) **Note** that limited pre-consultation would be undertaken on certain specific matters such as depreciation on buildings and loss ring-fencing rules for rental property (as indicated in this report).

Noted　　　　　　Noted

(iii) **Note** that under option 2 the following initiatives could have a start date of 1 October 2010:

- Personal tax cuts (with the possible exception of resident withholding tax and portfolio investment entity rates, and certain schedular payments and Māori authority rates); and
- a GST rate increase and associated compensation.

Noted　　　　　　Noted

(b) **Note** the implementation issues discussed in this report.

Noted　　　　　　Noted

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Hon Bill English
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Background

1. Subsequent to the final report of the Victoria University Tax Working Group (TWG), Ministers are currently considering a range of initiatives that could form part of a tax reform package (T2010/36; PAD2010/02 refers).

2. The TWG has employed an open process in evaluating the various tax reform options, and the public has been able to follow this process and discuss the various measures openly with TWG members in a recent public conference. Accordingly, this open process has served to provide a significant level of public consultation.

3. You have asked officials to report to you on the logistics of implementing these initiatives from 1 October 2010 and 1 April 2011, or from the 2011-12 income year where appropriate (T2009/2765; PAD2009/238 refers).

Personal tax cuts

4. The tax cuts could be provided to salary and wage earners and superannuitants from 1 October 2010. For these taxpayers, this would apply for their first pay period beginning on or after 1 October 2010. Other taxpayers would receive their tax cut after filing their tax return at the end of their 2010-11 income year.

5. Inland Revenue will need to work with payroll providers after Budget in order to implement the new PAYE rates from 1 October. While these timeframes are tight, officials believe these timeframes are achievable given past experience with mid-year tax cuts in 2008.

6. Officials consider that changes can be made to RWT (resident withholding tax) and PIE (portfolio investment entity) rates on 1 October 2010 if changes are to existing rates only (that is, if there are no changes to thresholds or additional tax rates). However, if changes to thresholds or additional tax rates are introduced, officials consider that there is a high risk that RWT and PIE rate changes may not be able to be introduced by 1 October. This is because implementing these changes may create significant information technology systems and customer contact problems for some financial institutions and portfolio investment entities. If changes to thresholds or new rates are made, officials recommend that the start date for RWT and PIE rate changes should be 1 April 2011.

7. Current withholding taxes on distributions from Māori authorities and on company directors' fees and honoraria are in some instances not aligned to actual tax rates. Officials recommend that consultation should be undertaken on these rates, as it is not clear what the appropriate rate should be. These could be included in a future tax bill, with implementation from 2011-12 or later income years, depending on the outcome of the consultation.

Administrative costs

8. There would be some administrative costs for implementing tax rate changes, which are currently being analysed. The cost would be slightly higher if changes are made on 1 October 2010 instead of the beginning of an income year. Costs are expected to be similar to the personal tax rate changes in 2008 (which were approximately $8 million over five years).

Legislative process and consultation

9. Personal tax cuts can be enacted under urgency on Budget night. Officials recommend that, if Ministers choose a truncated select committee process, the RWT and PIE rate changes should be referred to the select committee. Pre-Budget consultation is not required.

GST rate increase

10. One of the initiatives to be considered by Ministers is an increase to the GST rate. Logistically, officials consider a GST rate increase could be implemented as early as 1 October 2010. This is because the changes involve small legislative amendments. Although this would be the first rate change in over 20 years, based on our recent experience with other rate changes, we consider a timeframe of four months is feasible.

11. Various legislative mechanisms are already provided in the GST Act to facilitate the administration of a rate change. These mechanisms deal with GST returns that straddle the rate change-date and transactions that have occurred before the rate change date but on which GST has yet to be paid. They also provide for adjustments to things such as the additional GST paid on any bad debts from earlier periods that are written off after the rate change.

12. Some taxpayers may try to take advantage of the standard GST rules around when a supply is recognised - for example, by prepaying or pre-invoicing services that may actually be provided subsequent to the rate change, so that the supply is charged at the previous lower rate[1]. The bigger the rate increase and the longer the time period between its announcement and implementation, the more likely it is that there will be more prepayments and pre-invoicing. This was recognised when considering the legislative mechanisms before the 1989 rate change, but it was ultimately decided to build on the existing known time of supply rules on compliance cost grounds.

13. The alternative would be to have special "time of supply" rules for transactions entered into in the run up to the rate change (the approach used when GST was introduced) that would directly target when goods are delivered or made available, or when a service is performed. This would require the valuation of work in progress and re-invoicing for services that spanned the rate change date to reflect any unexpired portion at that date. These rules would

[1] GST is payable on the earlier of the date an invoice is issued by the supplier or the date any payment in respect of that supply is received by the supplier. The recipient of the supply may avoid the higher rate of tax by making a pre-payment or requesting an invoice to be issued before the date of change. This could result initially in less additional revenue from the rate increase.

involve material additional compliance costs for taxpayers and our preference would instead be to follow the approach used in 1989.

14. The impact on pre-invoicing and consumption patterns would be reduced if the time span between the announcement and introduction date were kept to a minimum. However, some pre-announcement seems desirable to give taxpayers time to make systems changes and re-price their goods and services. An announcement in May and implementation on 1 October 2010 should provide adequate time for this. Inland Revenue would also need to work with accounting software providers after the Budget. While a 1 October timeframe may be tight for their making the necessary software changes, it should be achievable based on experience with changes to other rates in 2006.

Administrative costs

15. Our preference is for a 1 October implementation date as this has the least impact on GST return filers and other work flows. A GST rate change from 1 October 2010 would require only around 100,000 filers to prepare split returns for the period spanning the rate change date compared with over 500,000 if the rate were increased from either 1 September 2010 or 1 November 2010. The alternative date preferred for implementing a GST rate increase would be 1 April 2011 when the impact on GST return filers is also relatively low. There would be one-off administration costs associated with processing split GST returns, including manual data entry.

16. Educating taxpayers about the changes and the transition and amending information material would have resourcing implications. There would also be increased audit activity in relation to the transitional period to monitor, for example, the adjustments resulting from different accounting methods and the rate increase.

Legislative process and consultation

17. GST rate changes could be enacted under urgency on Budget night. Pre-Budget consultation is not required.

Support for some taxpayers to compensate for GST increase

18. Additional support for certain groups (such as beneficiaries, superannuitants and Working for Families recipients) could be provided to compensate for additional living costs that arise as a consequence of a GST rate rise. Compensation could coincide with the start date for the GST rate rise.

19. This could be done by bringing forward indexation for inflation from 1 April 2011 to 1 October 2010 (or otherwise increasing amounts on 1 October 2010).

20. Indexation for Working for Families was brought forward to 1 October in 2008. A mid-year increase is therefore feasible, but it is very complex to implement. This is largely because mid-year changes to Working for Families result in overpayments for families whose circumstances change during the year, which frequently leads to tax debt. As a result of the 2008 mid-year indexation, $100 of tax debt was unilaterally written off for every family who received Working for Families and had a tax debt for the 2008-09 income year, with higher amounts written off if debt could be attributed to the mid-year change. Writing off this debt had additional fiscal and administrative consequences which largely fell in the following year (fiscally this was costed at approximately $6 million over two years).

21. Due to Budget sensitivity, we have consulted with the Ministry of Social Development only in a limited manner in the preparation of this report. The following represents initial advice on areas where further work would be needed if a compensation package affecting beneficiaries and superannuitants were to be developed.

22. In principle, a delivery date of 1 October 2010 for a package of compensation for beneficiaries and superannuitants should provide sufficient lead time to be feasible for the Ministry of Social Development. This is however, dependent to a degree on the complexity of the package, and other calls on the Ministry of Social Development's systems, at the time. There are, however, a number of policy and delivery implications that will need to be worked through in developing a package.

23. Cabinet will shortly be considering a package of benefit reform (the "Future Focus" package). At this stage it is proposed that key parts of this package would be implemented from 4 October 2010, with legislation in House from March 2010. Included in the package is a proposal to legislate for CPI adjustments of main benefits. The interactions between Future Focus and any tax package will need to be carefully worked through both in terms of policy and delivery implications.

24. More generally, the interrelated nature of the welfare system means that the impacts of any compensation package on individuals' incomes are unlikely to be straightforward. For instance:

- an increase in benefit rates will be partially or fully offset by consequential reductions in supplementary benefits for many beneficiaries and low income working people;
- depending on the compensation mechanism, and the results of the New Zealand superannuitant adjustment formula, it is possible that an increase in New Zealand Superannuation from 1 October could result in a zero increase in some New Zealand Superannuation rates from the following 1 April; and
- a small minority of people, potentially including superannuitants, could be financially worse off due to the compensation package, as a result of increased income resulting in a loss of entitlement to other assistance (for example, the disability allowance or the Community Services Card)

25. A key consideration in the development of any compensation package is the extent to which it is acceptable to have individuals who receive less total income after the provision of compensation, and whether it is acceptable to have individuals who do not receive the full value of the compensation.

26. Over the last two decades supplementary assistance has come to form an increased proportion of beneficiaries' weekly income compared to the main benefit. In cases where supplementary assistance is paid for a specific cost that is subject to GST (for example, disability allowance or childcare subsidy), there is a case for increasing this assistance as part of a compensation package.

Company tax cuts

27. The headline company tax rate, which is currently 30%, can be changed in Budget night legislation by simple changes to the Income Tax Act 2007.

28. The consequential changes (refer below) can either be enacted in Budget night legislation or via a regular tax bill that goes through the select committee process. As we have the precedent of the recent decrease to the company tax rate in Budget 2007, either option is feasible.

29. Any rate change should take effect from the start of a taxpayer's income year, and not during an income year because of imputation credit account difficulties and other compliance and administration costs. Thus 1 April 2011 or a company's equivalent balance date is the earliest practicable application date.

30. No pre-Budget consultation is necessary as there are few technical aspects on which feedback is required - particularly given the recent precedent. This measure is taxpayer-friendly.

31. The major consequential issues include the following:

Provisional tax relief

32. Will provisional tax relief be necessary? At the time of the last company tax cut, 10% provisional tax relief was offered. However, officials consider that if the cut is less than 10%, such relief may not be necessary.

Imputation

33. A reduction in company tax rate will change the imputation credit ratio. Assuming a reduction in the company tax rate to 27%, the imputation credit ratio would change to 27/73

(from 30/70). However, the treatment of existing credits needs to be carefully considered. Possible options for this include:

- changing the ratio straight away, which would be criticised as double taxation in respect of New Zealand resident shareholders;
- giving a 'haircut' to the existing pool of credits so that the same amount of profits can be distributed fully imputed (which would be criticised as confiscation in respect of New Zealand resident shareholders);
- allowing a transition period for distributing pre-existing credits:
  - via a simplified two-bucket approach (this was the option chosen with the reduction to the 30% rate, and was buttressed by avoidance rules to reduce the scope to over impute current profits); or
  - via having pools of credits before and after the change (this is the purest approach but it would be compliance and administration intensive because of the two imputation credit accounts that would be necessary).

34. The last two options are more fiscally expensive than the first two.

Application to portfolio investment entities and other savings vehicles

35. There are a range of savings vehicles whose tax rate is presently 30% (based on the company rate). Consideration should be given as to whether this company tax rate alignment should be maintained if there is a further company tax rate decrease. The issues here include:

- the integrity issue that savings, especially short-term savings, can have a tax incentive if they are made through portfolio investment entities or similar entities;[2]
- the question as to whether the economic growth benefits of incentivised short term savings outweigh the integrity issue;
- whether a higher top rate for savings can be enforced given the actual and potential use of companies, and vehicles taxed as companies, for savings.

Related rates

36. Related rates such as RWT (resident withholding tax on interest) and FITC (foreign investor tax credits) will need to be amended.

[2] There is also an integrity issue, as income from a portfolio investment entity is generally not taken into account for Working for Families tax credits and similar purposes.

Legislative process and consultation

37. The new company tax rate could be enacted on Budget night with application from the 2011-12 income year. If Ministers choose option 1 (a truncated select committee process), consequential amendments could be referred to the select committee.

Removing depreciation loading from the annual depreciation rate calculation

38. A proposal to be considered by Ministers is whether depreciation loading should be removed from the annual depreciation rate calculation. Depreciation loading applies to New Zealand new depreciable property. It does not apply to some types of assets, including buildings, second-hand assets, or intangible depreciable property. Depreciation loading adds 20% to the economic depreciation rate for qualifying assets. Removing the loading would reduce depreciation rates on qualifying assets by 20%.

39. There are very few implementation concerns with this proposal. The amendment would be easy to draft, raises no significant systems issues for Inland Revenue and is relatively straightforward for taxpayers to apply. Any change could apply to existing assets or to newly acquired assets. In the case of existing assets, the change would require taxpayers to reduce the depreciation rates on the relevant assets in their tax asset registers. Taxpayers would likely raise concerns, calling the change retrospective. For newly acquired assets, the change would mean the new depreciation rates would be the Commissioner's published depreciation rates, without a loading.

40. The proposal may raise issues with provisional tax payments, which are relevant to decisions on the application date. The proposal, if implemented, would affect the level of deductions for provisional tax purposes. This feeds into the value of provisional tax payments. Taxpayers who underestimate their provisional tax payments are liable for interest on the shortfall. We are still working through these matters, in particular the administrative and compliance costs for provisional taxpayers.

Legislative process, consultation and application dates

41. Given there are no major implementation issues with this proposal and the need for Budget secrecy, we see no need for consultation. This proposal can be enacted without a select committee process.

42. The change could easily be implemented from the beginning of the 2011-12 income year.

Removing or reducing depreciation deductions from buildings

43. Depreciation deductions on buildings could be removed or reduced. There are numerous potential implementation and policy issues to work through with this proposal. The complexity arising from this proposal suggests that a limited period of consultation is desirable. Some of the important points to consider are:

- defining the set of non-depreciable buildings;
- should any changes apply to the existing stock of buildings or only to newly acquired buildings?;
- should losses realised on disposal be allowed for buildings that do not qualify for depreciation deductions? If so, we would need to consider rules to ensure that losses are correctly allocated between land and improvements; and
- the proposal may cause problems for provisional tax payments, which are relevant to decisions on the application date.

Legislative process, consultation and application dates

44. Officials recommend limited pre-Budget consultation with a small number of people. The complexity of the issues and potential provisional tax problems means that it might be sensible to apply the proposal from the beginning of the 2011-12 income year (which begins at the earliest from October 2010).

Working for Families – removing indexation of the abatement threshold

45. The Family Tax Credit (FTC) is the government's main form of financial support to parents with children. It is available on an income-tested basis to beneficiary and working parents regardless of whether they undertake any form of paid work.

46. The Income Tax Act 2007 requires that both the amount of the FTC and the income threshold at which the Working for Families tax credits begin to abate both be adjusted for inflation. The adjustment occurs once the cumulative increase in the Consumer Price Index (CPI) reaches 5% from the last adjustment (which was in October 2008). Currently, families with incomes greater than the abatement threshold of $36,827 benefit from both the indexation of FTC amounts and the indexation of the threshold.

47. Treasury forecasts indicate that the next adjustment will take place in time for increases to be paid from April 2012. However, there is a possibility that the 5% CPI accumulation may be breached before then, triggering an increase in payments from April 2011.

48. Removing the indexation of the amount of the FTC would mean that, in real terms, people would receive less assistance over time. In 2005, as part of the Working for Families

(WFF) package, the child component of the main benefit rates was removed and transferred to the FTC so that since then, the FTC has been the primary form of assistance to parents with children.

49. This proposal considers only removing the indexation of the abatement threshold and *not* the amount of the FTC.

50. Removing the indexation of the abatement threshold would mean that people would receive less assistance over time as incomes grow beyond the abatement threshold. Note that removing the indexation of the FTC income threshold would not affect families with incomes below the current $36,827 threshold.

51. The main WFF tax credits are added together and abated when a person's income exceeds $36,827 per annum. FTC is abated first followed by the in-work tax credit, the grandparented child tax credit and then the parental tax credit.

52. The Ministry of Social Development estimates that around three-quarters of families with children are now receiving WFF. The table below shows the annual income a family can earn before their tax credits are fully abated.[3]

Number of children	Income at which WFF is fully abated
One	$74,862
Two	$90,457
Three	$106,052
Four	$125,547
Five	$145,042
Six	$164,537

53. Removing indexation of the threshold alone would not lock-in these income levels because the amounts of FTC would continue to grow with indexation. However, maintaining the threshold would mean that WFF tax credits would increasingly be targeted to those lower down the income distribution.

Administrative and compliance issues

54. Removal of the indexation of the abatement threshold would require no significant changes to Inland Revenue systems or administrative procedures. Any changes would be incorporated into Inland Revenue's annual updating of systems.

[3] With children aged under 13 years, who are receiving the FTC and in-work tax credit but not the parental tax credit.

Legislative process and consultation

55. Removal of the indexation of the abatement threshold would require an amendment to the Income Tax Act 2007. If the cumulative inflation rate from October 2008 to September 2010 does not breach 5% then the next adjustment would not take effect until April 2012. (However, the HYEFU 2009 forecasts put the cumulative inflation rate for September 2010 at 4.8%, so there is a possibility that 5% inflation may be breached by then. In that case, legislation to prevent the adjustment taking place would need to be enacted by September 2010.)

56. An amendment could be introduced and enacted on Budget night or at any stage thereafter as long as enactment occurs before September 2010 to ensure there is no adjustment in April 2011.

57. Removing the indexation of the abatement threshold could take place without public consultation or consideration by a select committee.

Working for Families - integrity

58. Entitlement to the WFF tax credit is subject to an income test designed to fit within the scheme of the Income Tax Act 2007. However, some families are able to structure their financial affairs in ways that divert the incidence of tax away from the individual to other entities, such as trusts. The effect is to increase their entitlement to WFF tax credits. Similarly, families with privately owned rental properties can use rental losses to offset other income, increasing their entitlement to the WFF tax credits.

59. As a result, families may receive more social assistance than they would in the absence of these arrangements and beyond what their true economic circumstances justify.

60. A wider definition of income that would better reflect a family's economic situation could:

- treat distributions from trusts of amounts that have been previously taxed as trustee income as income of the beneficiaries for social assistance purposes;
- include income from portfolio investment entities or other superannuation schemes that are not locked-in;
- extend the attribution of profits from closely-held companies which are owned by family trusts;
- review whether losses from rental properties should be included in the definition of "income" given that business losses are excluded;
- treat fringe benefits which are closely substitutable with cash as income for social assistance purposes;

- treat payments of dividends, interest and wages to dependent children from associated family entities (for example, companies and trusts) as income of parents for social assistance calculation purposes (income of both parents is already currently taken into account);
- treat employer contributions beyond the normal range to superannuation schemes as income of employees for social assistance calculation purposes; and
- treat the offshore income of non-resident spouses as income of the parents of dependent children in New Zealand for social assistance calculation purposes.

61. This wider definition of "social income" could be used for the purpose of determining entitlements to social assistance programmes administered by other government departments as well as Inland Revenue. The income-tested social assistance programmes administered by Inland Revenue are WFF tax credits, child support and student loans. Income-tested social assistance programmes administered by other government departments include social security primary benefits, student allowances, rest home subsidies and health entitlement cards such as the community services card. This makes sense under a whole of government approach to problems and the fact that entitlements to most social assistance programmes are based on the Income Tax Act definition of "taxable income".

Administrative and compliance issues

62. At this stage there are no foreseeable operational impediments for widening the definition of "income" for WFF purposes. However, from an implementation perspective, a staged approach is preferable, with limited changes to be made effective from 1 April 2011.

63. The full administrative impact will need to be identified and confirmed during the consultation process.

Legislative process, consultation and application dates

64. Legislating to include some of the sources of income listed above is straightforward (for example, including PIE income) while for others it is not (for example, accounting for a non-resident spouse's income). A longer timeframe and consultation process is necessary for a comprehensive definition of "income" given the potentially far-reaching implications for other areas of social policy. Therefore, depending on the timing of the total fiscal package, there are two options to proceed with a comprehensive review of the definition of "income".

Option A - Staged approach: (officials' preferred approach)

65. Stage 1: Legislate for relatively straightforward items in May 2010 with an application date of 1 April 2011. Limited confidential pre-Budget consultation with relevant government agencies should be undertaken.

66. Stage 2: Expand on stage 1 by legislating for remaining items in 2011 with an application date of 2012. These items would be subject to full consultation (as per the Generic Tax Policy Process) and a select committee process.

Option B – Comprehensive approach

67. Legislate once a comprehensive review of the definition of income has been finalised. Legislate in 2011 with an application date of 1 April 2012. These items would be subject to full consultation (as per the Generic Tax Policy Process) and a select committee process.

Loss ring-fencing rules for rental property

68. Officials have been asked to report on the merits of ring fencing losses for residential rental properties so that those losses could not be offset against other income. Officials have concerns about ring-fencing, which will be outlined in a subsequent report. However, we note that if it were to be introduced, legislative changes to the Income Tax Act 2007 would be required to implement loss ring-fencing. These would not only cover the treatment of losses but also, where possible, buttressing rules to impede the use of vehicles and structures to avoid the loss ring-fencing rules.

69. Considerable policy development work would be required as part of designing ring-fencing rules. Decisions, for example, would need to be made on whether to restrict ring-fencing to only the losses of residential investment housing, or to apply loss ring-fencing also to commercial property and other types of rental investments, the treatment of mixed-use properties, and whether to allow any restricted losses on a subsequent sale of the property.

70. The tax treatment of pre-existing investments would also need to be considered. Possible approaches would include applying the new rules to all housing investment immediately, phasing in the new rules, or grand-parenting investments existing at the time of enactment so that the restriction would only apply to the next buyer of that property.

Administrative and compliance issues

71. Administrative and compliance costs would depend on the nature of the loss limitation and buttressing rules. For example, if losses were to be carried forward, there would need to be a process for subsequently recognising those losses. One option is for taxpayers to record their carry-forward losses on each return, which would mean making a minor amendment to the return. Alternatively, taxpayers could be relied upon to keep their own records of accumulated losses. Overall, however, there would be additional compliance costs for investors in property.

72. It would be preferable to apply any loss ring-fencing rules from the beginning of the income year, which for personal taxpayers would be 1 April 2011.

Legislative process and consultation

73. Officials recommend that, if Ministers choose option 1 (a truncated select committee process), this initiative should be referred to the select committee. This would provide the time needed to undertake policy development, and to put administrative systems in place.

74. If Ministers choose option 2 (no select committee process), loss ring-fencing rules could be enacted on Budget night. However, given the technical concerns of the proposal, officials advise limited pre-consultation with key stakeholder groups beforehand.

Capital contribution payments

75. A capital contribution is a payment to a person compensating them for undertaking some work/service and the payment is non-taxable. For example, to obtain a power supply, a farmer might be required to install power lines from the farmhouse to the farm boundary. The lines company may charge the farmer to install the new lines but as a condition of the power supply service contract, ownership of the newly installed powers lines may revert to the lines company for no consideration. These payments are currently non-taxable to the recipient, while being able to be capitalised and depreciated. This ability to depreciate could be removed in order to eliminate the asymmetry. The proposal is to reduce the depreciation cost base to the extent that this base is funded by way of capital contributions.

76. There are very few implementation problems with this proposal as officials assume any change would apply from the date of announcement. Any amendment would be reasonably simple to draft (there is precedent for this in current legislation), raises no significant system issues for Inland Revenue and is relatively straightforward for taxpayers to apply. Taxpayers would reduce the base value of the item of depreciable property by the amount of the payment and calculate depreciation deductions in the normal way.

Legislative process, consultation and application dates

77. Given the absence of implementation concerns with this proposal and the need for Budget secrecy we see no need for consultation. This proposal can be enacted without a select committee process.

78. The application date would ideally be on or after the date of announcement – otherwise taxpayers may accelerate expenditure to take advantage of the more generous treatment currently available. Depending on Ministers' decisions on the timing of the total fiscal package, the application date could therefore be from Budget night.

Thin capitalisation

79. Thin capitalisation rules apply to foreign-controlled entities in New Zealand. They limit the scope for a multinational group to load debt against its New Zealand operations to reduce tax paid here. The key rule is that some interest deductions may be disallowed if the debt percentage (essentially, the debt-to-assets ratio) of the New Zealand group exceeds 110% of the worldwide group's debt percentage. However, if the New Zealand debt percentage does not exceed a 75% "safe harbour", then the worldwide comparison is not needed and all of the interest may be deducted.

80. In its December 2009 report, the Capital Markets Development Taskforce noted that there was some justification for considering a reduction of this "safe harbour" threshold from 75% to 60%. The Victoria University Tax Working Group recommended, in its January 2010 report, that such a change be considered for introduction relatively quickly.

81. The maximum expected annual fiscal gain from reducing the "safe harbour" threshold from 75% to 60% is estimated at $177 million.

Administrative and compliance issues

82. Reducing the safe harbour as proposed would mainly affect corporate taxpayers rather than Inland Revenue systems.

83. The main impacts are likely to be as follows:

- a modest increase in legislative complexity. The change would mean that, in future, different thresholds applied to foreign-controlled entities in New Zealand and New Zealand-owned companies investing offshore;
- increased tax liabilities for some highly geared firms. Foreign-owned New Zealand companies with a New Zealand debt percentage that exceeds both 60% and 110% of the worldwide group's debt percentage would face partial denial of their interest deductions; and
- increased compliance costs for foreign-owned companies with significant levels of debt, even if they do not breach the new 60% safe harbour. A lower safe harbour would increase the need for such firms to monitor, and perhaps adjust, debt levels throughout the year.

84. Foreign-owned New Zealand companies with significant levels of debt may wish to revise their capital structure before the safe harbour is lowered, reducing debt to avoid denial of interest deductions. It may take some time and involve some cost for such firms to unwind existing financing arrangements.

Consultation and legislative process

85. As noted, the proposal to reduce the safe harbour was discussed by the Capital Markets Development Task Force and the Victoria University Tax Working Group. A detailed background paper on this issue was prepared for the Tax Working Group by officials and published on the Tax Working Group's website in October last year. Both the Task Force and the Tax Working Group subsequently discussed the proposal in their published final reports.

86. The proposed policy change has therefore already been the subject of some consideration by business/taxpayer representatives and academics, and has also been aired publicly, albeit that this falls short of formal public consultation. There has to date been no discussion or consultation with external parties on the detail of the necessary legislative amendments.

87. If Ministers choose option 1 (a truncated select committee process), the initiative could be announced on Budget night. The legislative changes would be made in the International Tax bill due to be introduced in 2010.

88. Under option 2 (no select committee process), the new thin capitalisation threshold could be enacted on Budget night. Any remedial or consequential amendments can be made in the International Tax bill due to be introduced in 2010.

89. Under either option, we would recommend that this change apply for the 2011-12 and subsequent income years. Taxpayers are likely to be very resistant to an earlier application date as this may not allow sufficient time for them to adjust their financing arrangements.

Reforming the loss attributing qualifying company rules

90. A loss attributing qualifying company (LAQC) can pass through its losses to its shareholders in proportion to their effective interest in the company. Officials agree that the present LAQC rules are no longer appropriate. Their original intention of approximating a partnership tax treatment is no longer effective because of the more recent increase in the top individual marginal rate. They create tax base integrity issues through the provision of arbitrage opportunities – losses at up to 38%, and income at 30% (or 33% if the family trust owns the LAQC once it has started making money - for example, forestry LAQCs).

91. However at this stage it has not been determined whether LAQCs should continue in a modified form (such as a "look-through" treatment) or whether some other option is appropriate (such as a standard company tax treatment). Further, the potential transitional issues may, depending on how LAQCs are to be dealt with, be quite complex.

Legislative process, consultation and application dates

92. If Ministers require work on qualifying companies and LAQCs, officials will report back on potential options. At this stage, officials consider that, at best, an announcement could be made at Budget 2010, with changes forthcoming. However, this might not be appropriate unless full information on what is happening and transition can also be released. Such a Budget 2010 announcement would benefit from some limited confidential pre-Budget consultation. Further, a select committee process would be ideal in order to achieve reforms of better quality.

93. Subject to the nature of the ultimate reform proposals, it may be possible to apply LAQC reform for income years beginning on or after 1 April 2011.

Clarifying the capital/revenue boundary

94. There can be uncertainty about whether gains on real and personal property sales are taxable. The Victoria University Tax Working Group and the Capital Markets Development Taskforce (CMDTF) noted concerns about the corresponding effects on investment.

95. As a possible means of addressing this problem, a time-based test has been floated, with gains being taxable only if the property is held for less than a given period (say, one or two years). However, the CMDTF noted that such an approach may introduce disadvantages and biases of its own. In particular, it may encourage investors to defer the realisation of gains (to avoid tax) and accelerate realisation of losses (to obtain relief).

Legislative process and consultation

96. Officials will report to Ministers during February on the possibility of reducing uncertainty around the taxation of real and personal property. Given the time available and the complexity and significance of the issues involved, this will be pitched at a high level. Any announcement in Budget 2010 would therefore likely be limited to whether the government intended to undertake further work in this area, in consultation with stakeholder groups.

Legislative process

97. Officials have identified two possible legislative approaches to implement the proposals outlined in this report. Under either approach, tranches of the fiscally negative initiatives can be phased in over a period of time so that their fiscal impacts are matched with fiscally positive initiatives.

Option 1

98. The first approach is to enact some initiatives on Budget night, with a truncated select committee process for specific matters. Other initiatives (those requiring technical consideration) could be introduced on Budget night and referred to the Finance and Expenditure Committee for a truncated select committee process.

99. The advantage with this approach is that some consultation would be undertaken as part of the select committee process, which could result in better quality reforms. However, there would be less consultation than would normally be undertaken under the Generic Tax Policy Process due to the truncated select committee process.

100. The main disadvantage with this approach is that there is a risk that the total package of initiatives will not be fiscally neutral, given the possibility of amendments at select committee stage. For example, fiscally negative initiatives (such as personal tax cuts) would be enacted on Budget night, but initiatives with fiscally positive impacts (such as the removal of depreciation loading) may not be enacted in the structure costed for Budget, and this could result in the fiscal impact of the total package being higher than that outlined in Budget 2010.

101. To mitigate this risk, officials consider that the group of initiatives passed under urgency, and the group of initiatives referred to a select committee, should each be a fiscally neutral package.

102. This means that the package of initiatives enacted under urgency on Budget night should itself form a fiscally neutral package. This might be, for example, the GST rate increase and certain tranches of the personal tax rate cuts (such as a cut to the bottom personal tax rate). These could apply from 1 October 2010.

103. The final form of the remaining initiatives (for example, a tranche of the personal tax cuts, and changes to depreciation) will be less certain because of potential changes at the select committee process. Because of this uncertainty, officials recommend that those initiatives (or tranches of these initiatives) should be delayed until 1 April 2011.

Option 2

104. The second approach is to enact all initiatives on Budget night with no select committee process. Limited pre-consultation would be undertaken on some specific matters.

105. The advantage of this approach is that the fiscal risk identified above is removed, and application dates could be brought forward to 1 October 2010 (where appropriate). However, there is an increased risk of errors arising from the absence of consultation. The lack of public consultation on significant measures is also likely to be criticised. However, this could be partially mitigated by limited pre-consultation on specific matters. Any errors could be rectified in future tax bills.

Next steps

106. Officials will report on the policy aspects, fiscal impacts and administrative costs of each issue in February and early March.