Inland Revenue
Te Tari Taake

POLICY ADVICE DIVISION

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: Implementing tax and KiwiSaver election commitments

Date:	28 November 2008	**Priority:**	**High**
Security Level:		**Report No:**	T2008/2179 PAD2008/208

Action sought

	Action Sought	**Deadline**
Minister of Finance	Agree to recommendations	1 December 2008
Minister of Revenue	Agree to recommendations	1 December 2008

Contact for telephone discussion (if required)

Name	**Position**	**Telephone**	
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28 November 2008

Minister of Finance
Minister of Revenue

Executive summary

In its election manifesto, the National Party announced its intention to introduce a number of tax changes. Urgent legislation will need to be enacted before Christmas to deliver some of these changes. This report seeks decisions from you on the following key issues so that development of a pre-Christmas taxation bill can proceed:

- Changes to the personal tax rate structure
- Introduction of an independent earner rebate
- Changes to the key high-level design of KiwiSaver
- Removal of the research and development (R&D) tax credit

This report also outlines the next steps that will take place to implement the following election manifesto tax changes where Ministers' decisions are not yet sought:

- Repealing the recent Employment Relations Act amendment that affects KiwiSaver
- [deleted – not relevant to Taxation (Urgent Measures and Annual Rates) Act 2008]
- [deleted – not relevant to Taxation (Urgent Measures and Annual Rates) Act 2008]

Officials also seek ministerial direction on the following urgent matters:

- [deleted – not relevant to Taxation (Urgent Measures and Annual Rates) Act 2008]
- Overpayments of Working for Families tax credits caused by Budget 2008 mid-year changes
- [deleted – not relevant to Taxation (Urgent Measures and Annual Rates) Act 2008]

Recommended action

We recommend that you:

Personal tax cuts

(a) **Agree** that the income tax rates and thresholds in the Income Tax Act be amended in three phases to provide the following personal tax rate structure:

From 1 April 2009

$0 - $14,000	12.5%
$14,001 - $48,000	21%
$48,001 - $70,000	33%
$70,001 +	38%

From 1 April 2010

$0 - $14,000	12.5%
$14,001 - $50,000	21%
$50,001 - $70,000	33%
$70,001 +	37%

From 1 April 2011

$0 - $14,000	12.5%
$14,001 - $50,000	20%
$50,001 - $70,000	33%
$70,001 +	37%

Agreed/Not agreed Agreed/Not agreed

(b) **Agree** to the consequential amendments required to implement the personal tax cuts outlined in appendix 1.

Agreed/Not agreed Agreed/Not agreed

(c) **Agree** that the personal tax cut changes be included in a taxation bill that is enacted before Christmas 2008.

Agreed/Not agreed Agreed/Not agreed

Independent earner rebate

(d) **Agree** that the Income Tax Act be amended to include an independent earner rebate (IER) that would, from the tax year starting on 1 April 2009, deliver $10 per week or $520 per year to individuals earning between $24,000 and $44,000 of income for the year and who do not receive a benefit, Working for Families tax credits or New Zealand superannuation.

Agreed/Not agreed Agreed/Not agreed

(e) **Agree** that the amount of the IER should increase to $15 per week or $780 per year for the tax year starting on 1 April 2010 and subsequent tax years.

Agreed/Not agreed Agreed/Not agreed

(f) **Agree** that the IER would be abated at 13 cents for every dollar of income earned from $44,001 and above.

Agreed/Not agreed Agreed/Not agreed

(g) **Agree** that the IER be referred to in legislation as the 'independent earner tax credit' (IETC)

Agreed/Not agreed Agreed/Not agreed

(h) **Agree** to deliver the IETC to salary and wage earners through the PAYE system on a pay period basis and to other individuals through an end-of-year claim process.

Agreed/Not agreed Agreed/Not agreed

(i) **Agree** that a person should be resident in New Zealand for tax purposes in order to be eligible for the IETC, and that the amount that they receive will be reduced on a pro-rata basis for periods that the person is not a New Zealand tax resident.

Agreed/Not agreed Agreed/Not agreed

(j) **Agree** that the income eligibility criterion for the IETC be based on a person's total net income.

Agreed/Not agreed Agreed/Not agreed

(k) **Agree** that the types of income which would make a person ineligible for the IETC for a year or part of a year are:

- “Income-tested benefits” as defined in the Income Tax Act;
- Working for Families tax credits;
- New Zealand superannuation; and
- The veteran’s pension

Agreed/Not agreed Agreed/Not agreed

(l) **Agree** that if a person's spouse or partner receives Working for Families tax credits, then the person should also not be eligible for the IETC for a year or for part of a year.

Agreed/Not agreed Agreed/Not agreed

(m) **Agree** that a person receiving a foreign pension or benefit that is equivalent to an ineligible form of income should not be eligible for the IETC for a year or part of a year.

Agreed/Not agreed Agreed/Not agreed

(n) **Agree** that the IETC should be reduced on a pro-rata basis for the number of periods a person receives any ineligible income.

Agreed/Not agreed Agreed/Not agreed

(o) **Agree** that the IETC amendments to the Income Tax Act be included in a taxation bill that is enacted before Christmas 2008.

Agreed/Not agreed Agreed/Not agreed

KiwiSaver

Minimum employee contribution rate of two percent

(p) **Agree** that the new minimum contribution rate for employees be two percent of gross wages from 1 April 2009.

Agreed/Not agreed Agreed/Not agreed

(q) **Agree** that existing employees and members retain their current contribution rate but be able to elect the lower rate on or after 1 April 2009.

Agreed/Not agreed Agreed/Not agreed

(r) **Agree** that the default rate for employees who become members on or after 1 April 2009 be two percent.

Agreed/Not agreed Agreed/Not agreed

(s) **Agree** that employees who are currently contributing two percent under the current transition rules continue to contribute at this rate.

Agreed/Not agreed Agreed/Not agreed

Minimum employer contribution rate

(t) **Agree** that the minimum employer contribution (the compulsory contribution) be two percent from 1 April 2009.

Agreed/Not agreed Agreed/Not agreed

Discontinuing the employer tax credit

(u) **Agree** to repeal the employer tax credit from 1 April 2009 in respect of employer contributions that relate to employee contributions made on or after this date.

Agreed/Not agreed Agreed/Not agreed

Employer superannuation contribution tax exemption

(v) **Agree** that the exemption from employer superannuation contribution tax for employer matching contributions to KiwiSaver and complying superannuation funds be capped at the compulsory employer contribution of two percent.

Agreed/Not agreed Agreed/Not agreed

Member tax credit

(w) **Agree** that the member tax credit operate on a dollar-for-dollar basis up to an annual cap.

Agreed/Not agreed Agreed/Not agreed

(x) **Indicate** whether the member tax credit will be capped at either:

(i) $20 a week;

Yes/No	Yes/No

OR

(ii) $15 a week

Yes/No	Yes/No

If $15 a week is chosen, then

(y) **Agree** that the annual member tax cap is based on 52 weeks at $15 rather than on the number of days in the year.

Agreed/Not agreed	Agreed/Not agreed

(z) **EITHER**

(i) **Agree** that the new annual member tax credit cap apply from 1 April 2009;

OR

(ii) **Agree** that the new annual member tax credit cap apply from 1 July 2009 (Officials' preference).

(aa) If recommendation (z)(i) is chosen, **agree** to a composite annual cap for the 2008/09 member tax credit year of $975 ($18.75 a week).

Agreed/Not agreed	Agreed/Not agreed

(ab) **Indicate** whether the kick-start contribution should be discontinued.

Yes/No	Yes/No

(ac) **Indicate** whether the fee subsidy should be discontinued

Yes/No	Yes/No

(ad) **Agree** that changes to the kick-start contribution and fee subsidy would apply from the date of introduction of the bill or announcement if earlier.

Agreed/Not agreed	Agreed/Not agreed

(ae) Agree that a person will be entitled to the kick-start contribution and fees subsidy if before the repeal date that person:

- Was subject to automatic enrolment rules, (that is commenced new employment); or
- Provided their employer with a KiwiSaver deduction notice (that is a notice requiring contributions to be deducted from their salary or wages); or
- The Scheme provider received a valid application from membership.

Agreed/Not agreed Agreed/Not agreed

(af) Agree that for existing members the discontinuation of the fee subsidy should occur on the date that the member is paid the full fee subsidy for the current year of membership.

Agreed/Not agreed Agreed/Not agreed

Repealing recent Employment Relations Act amendment

(ag) Note that the proposed changes to the Employment Relations Act are outside the scope of the December Tax Bill.

Noted Noted

(ah) Note that the Department of Labour will provide the Minister of Labour with further advice on the employment relations implications of these proposals and implementation options.

Noted Noted

Compliance with securities legislation

(ai) Agree that officials consult with provider organisations such as ASFONZ and ISI on the issue.

Agreed/Not agreed Agreed/Not agreed

(aj) Note that officials will report back next week on the outcome of those discussions and a way forward.

Noted Noted

(ak) Agree that the KiwiSaver amendments be included in a taxation bill to be enacted before Christmas 2008.

Agreed/Not Agreed Agreed/Not agreed

Research and development tax credit

(al) Agree that the research and development tax credit be repealed.

Agreed/Not Agreed Agreed/Not agreed

(am) Agree that the repeal should be effective from the 2009-10 income year.

Agreed/Not Agreed Agreed/Not agreed

(an) Agree that the amendments repealing the research and development tax credit be included in a taxation bill enacted before Christmas 2008.

Agreed/Not Agreed Agreed/Not agreed

(ao) Agree that the timeframe that claimants have for making adjustments to claims for the credit should remain unchanged at two years from the date on which their tax return is filed.

Agreed/Not agreed Agreed/Not agreed

(ap) Agree that work should progress on remedial and administrative changes that have been publicly signalled, with a view to including any required amendments in the first tax bill next year.

Agreed/Not agreed Agreed/Not agreed

Working for Families overpayments

(aq) Note that the mid-year change to Working for Families, implemented in Budget 2008, causes a number of families to be overpaid their weekly or fortnightly amounts of Working for Families tax credits in the 2008-09 income year.

Noted Noted

(ar) **Note** that the previous government agreed to amend legislation to provide that Inland Revenue will write off up to $100 of Working for Families tax credit overpayments for the 2008-09 income year.

Noted Noted

(as) **Note** that the previous government agreed to amend legislation giving Inland Revenue the discretion to write off overpayments of Working for Families tax credits over the $100 threshold agreed above if the Commissioner of Inland Revenue is satisfied that an overpayment is a result of the mid-year changes to Working for Families caused by Budget 2008.

Noted Noted

(at) **Agree** to confirm the previous government's decisions regarding overpayments caused by the mid-year change to Working for Families implemented in Budget 2008.

Agreed/Not agreed Agreed/Not agreed

(au) **Agree** to include the above amendments relating to Working for Families overpayments in a taxation bill to be enacted before Christmas 2008.

Agreed/Not agreed Agreed/Not agreed

[deleted – not relevant to Taxation (Urgent Measures and Annual Rates) Act 2008]

Next steps

(aac) Direct officials to draft a paper for Cabinet on behalf of the Minister of Finance reflecting the above recommendations.

Directed/Not Directed Directed/Not Directed

(aad) Direct Inland Revenue to draft a bill reflecting the above recommendations.

Directed/Not Directed Directed/Not Directed

(aae) Note the fiscal consequences of the policy change options contained in this report, if you agree to the new annual member tax credit cap to apply from 1 July 2009, are:

($ million) - cost/(saving)	**2008/09**	**2009/10**	**2010/11**	**2011/12**	**2012/13**	**5-year total**
Tax, IER, Full R&D, and Kiwisaver Option 1	114	175	5	(191)	(171)	**(68)**
Tax, IER, Full R&D, and Kiwisaver Option 2	114	42	(142)	(348)	(333)	**(666)**
Tax, IER, Full R&D, and Kiwisaver Option 3	114	(10)	(132)	(294)	(275)	**(597)**

(aaf) Note that a further $31m will be saved in 2008-09 if you agree to the new annual member tax credit cap to apply from 1 April 2009.

Noted Noted

(aag) Note that there would be combination of administrative savings and costs and officials will report on these next week.

Noted Noted

(aah) Refer a copy of this report to the following Ministers:

- Minister of Commerce, Hon Simon Power
- Minister of Education, Hon Anne Tolley
- Minister of Social Development and Employment, Hon Paula Bennett
- Minister of Labour, Hon Kate Wilkinson

Referred Referred

Bill Moran
for Secretary to the Treasury
Manager

David Carrigan
Policy Manager
Inland Revenue

Hon Bill English
Minister of Finance

Hon Peter Dunne
Minister of Revenue

Background

1. In its election manifesto, the National Party announced that it intended to introduce a number of tax and KiwiSaver changes. Urgent legislation will need to be enacted before Christmas to deliver some of these changes. This report seeks decisions from you on key issues so that development of a pre-Christmas taxation bill can proceed.

2. This report also outlines the next steps that are necessary in order to implement election manifesto tax announcements.

Personal tax cuts

Announced policy

3. Before the election the National Party announced it would reduce personal taxes through a combination of increasing thresholds, reducing rates, and adding an independent earner rebate for some taxpayers. The reasons for these tax reductions are to provide a short-term economic stimulus and, over the longer-term, to encourage people to invest in their own skills and to seek better jobs that make more use of their skills. The announced tax proposal would result in the following personal tax rate structure:

From 1 April 2009

$0 - $14,000	12.5%
$14,001 - $48,000	21%
$48,001 - $70,000	33%
$70,001 +	38%

From 1 April 2010

$0 - $14,000	12.5%
$14,001 - $50,000	21%
$50,001 - $70,000	33%
$70,001 +	37%

From 1 April 2011

$0 - $14,000	12.5%
$14,001 - $50,000	20%
$50,001 - $70,000	33%
$70,001 +	37%

4. Officials seek confirmation that you wish to change the personal tax rate structure to that outlined above.

Pre-Christmas legislation

5. For the announced personal tax cuts to take place from 1 April 2009 legislation would need to be enacted by Christmas. Officials seek your agreement that legislation giving effect to the tax cuts be enacted before Christmas.

6. Officials seek your agreement that all three phases of the personal tax cuts be enacted in pre-Christmas legislation. This tax cut package will replace the tax cuts enacted in Budget 2008 by the previous Parliament from 1 April 2009.

Consequential changes

7. In addition to the new rates and thresholds, a number of consequential changes to tax legislation will also have to be enacted in pre-Christmas legislation so that tax cuts flow through the tax system appropriately. Officials seek your agreement to these consequential changes, as outlined in appendix 1 to this report.

Independent earner rebate

8. As announced the independent earner rebate (IER) would, from 1 April 2009, deliver $10 per week to individuals who earn between $24,000 and $44,000 and do not receive a benefit, Working for Families tax credits (WfF) or New Zealand superannuation. The IER would be abated at 13 cents for every dollar of income earned between $44,001 and $48,000. The amount of the IER would increase to $15 per week from 1 April 2010 and would be abated at 13 cents for every dollar of income earned between $44,001 and $50,000.

9. It is recommended that you agree to the IER as described above.

10. Officials estimate that around 630,000 people will qualify for the rebate in its first year.

Independent Earner Tax Credit (IETC)

11. Due to the rewrite of the Income Tax Act, tax rebates are now referred to in legislation as ‘tax credits’. Under this approach, the independent earner rebate would be referred in the law as the ‘independent earner tax credit’ (IETC). We seek Ministers’ agreement to this approach.

Delivery of the IETC

12. Officials considered two ways in which the IETC could be delivered:

1. Through the PAYE system for salary and wage earners and an end-of-year claim process for other individuals; or

2. Through an end-of-year claim process for all qualifying individuals.

13. It is our understanding that Ministers prefer that the IETC be delivered through the PAYE system for salary and wage earners. This would require a new tax code in the PAYE system.

14. A new tax code would be made available so that people could receive the IETC through their main source of salary and wage income. The person would self-assess their eligibility for the new tax code. The tax tables associated with this tax code would be calculated to deliver the benefit of the IETC on a pay period basis, based on a person's annualised earnings (from their main source of earnings).

15. A person's entitlement to the IETC can only be finally determined at the end of the tax year. This is because it is only at the end of the year that it is certain whether a person's total taxable income falls within the entitlement range and whether or not the person received an ineligible payment or benefit. Therefore, for some people the tax code approach would not deliver the correct amount of IETC during the year.

16. Non-salary and wage earners such as the self-employed and salary and wage earners who do not use the new tax code would receive the IETC at the end of the year by filing a tax return or requesting a personal tax summary.

17. The PAYE system will not deliver an accurate amount of IETC to some people. This group includes:

- People who earn non-salary income which either takes their total income above the threshold where they qualify for the credit, or takes their total income into the range where it is being phased out.

- People whose circumstances change during the year. For example, a person could apply for the new tax code at the beginning of the year on the basis that their estimated income is within the eligible income range and they do not receive WfF, an ineligible benefit or New Zealand superannuation. If the person's circumstances change during the year – making that person ineligible - the person is likely to receive an overpayment of IETC during the year that may need to be repaid at the end of the year.

[information deleted in order to not prejudice the maintenance of a law]

IETC – additional issues

22. Officials seek your agreement on the following key issues with the IETC.

Regressive effect of the IETC

23. As announced, there is a minimum level of annual income - $24,000 - that a person needs to earn in order to qualify for the IETC, from which point they would receive the whole rebate. This means that people who earn between $21,523 and $23,999 pay the same amount of tax as people who earn $2,476 more than them in the 2009-10 income year, so the IETC would have some regressive effect. Also, some people earning less than $24,000 per year would pay more tax than some people earning more than $24,000 per year, so the effect is regressive.

Taxpayer eligibility - requirement to be New Zealand resident for tax purposes

24. We recommend that a person must be resident in New Zealand for tax purposes for at least part of the tax year in which they are claiming the IETC. The credit should be reduced a pro-rata basis for periods that the person is not a New Zealand resident for tax purposes. This treatment ensures that the credit is appropriately targeted at recipients who meet the income criteria. These rules would be consistent with the rules for other similar credits, such as the transitional tax allowance and the (now repealed) low income earner rebate.

Income criterion

25. We seek confirmation on what type of income should be used to determine whether a person is within the income thresholds of the IETC.

26. We envisage that eligibility to receive the IETC would be based on a person's net income (gross income minus allowable deductions, before losses carried forward). This approach would mean that the IETC would apply to labour income, such as salary and wages, and non-labour income, such as directly earned investment income.

27. It should be noted that, for most salary and wage earners, the IETC would in practice generally be based solely on their salary and wage income, because many taxpayers are not required to square up even when the amount of the credit calculated through PAYE is inaccurate.

What is a 'benefit' for the purposes of making someone ineligible for IETC?

28. We seek confirmation on how a "benefit" should be defined for the purposes of making the recipient ineligible for the IETC.

29. We seek confirmation that the statutory definition of "income-tested benefits" in the Income Tax Act is that which was envisaged for determining what benefits would make a person ineligible for the IETC. This would mean that receipt of the following benefits would make a person ineligible for the IETC:

- domestic purposes benefit
- emergency benefit
- independent youth benefit
- invalids' benefit
- sickness benefit
- unemployment benefit
- widows' benefit

30. The rationale for targeting these benefits would be that they are not related to current employment (like certain ACC payments) and are designed to provide the recipient with sufficient income to meet their basic day to day needs, rather than supplementing a person's income.

31. It should be noted that the definition of "income-tested benefits" does not include student allowances, ACC payments, paid parental leave or income support such as accommodation allowances. Therefore recipients of these payments would be eligible for the IETC. This would be inconsistent with the treatment for WfF tax credits, where student allowances are treated as equivalent to income-tested benefits. At this stage we do not consider that receiving these payments should make someone ineligible for the IETC. Student allowances are only available to students during their term of study, and they can be distinguished from benefits in that they are designed to allow students to earn additional income through employment. Paid parental leave can be distinguished from "income tested benefits" as it is universal (i.e. not income-tested) and is only paid for a limited period after the baby is born. Work-related ACC payments can also be distinguished as they can be viewed as a regular insurance payout.

32. We therefore recommend that the statutory definition of "income-tested benefit" contained in the Income Tax Act 2007 is used for the purpose of defining which benefits make a person ineligible for the IETC.

Recipients of Working for Families tax credits

33. WfF is a family-based entitlement, whereas the IETC would be an individual entitlement. Although a person may not personally receive WfF, their partner might on behalf of their family.

34. We therefore recommend that if a person's spouse or partner receives WfF then the person should not be eligible for the IETC.

New Zealand superannuation and veteran's pension

35. Under the pre-election announcement, receipt of New Zealand superannuation would make a person ineligible to receive the IETC. The veteran's pension is similar to New Zealand superannuation in its amount and nature. (Around 10,000 people received the veteran's pension in 2007. Around 300 of these were under the age of 60.)

36. We therefore recommend that receipt of a veteran's pension should also make a person ineligible to receive the IETC.

Foreign pensions and benefits

37. We recommend that receipt of pensions and benefits that are paid by overseas governments under their social security legislation (where these payments are similar in nature to New Zealand Superannuation, the veteran's pension, WfF tax credits or income-tested benefits) should make the person ineligible for the IETC. This ensures equity of treatment between people who are receiving income assistance from the New Zealand government and those receiving assistance from overseas governments.

Receipt of small amounts of ineligible income

38. An issue therefore arises around what happens when a person receives a small amount of ineligible benefit, WfF or New Zealand superannuation. For example, a person receives a benefit for only one week in the year, but would otherwise qualify for the IETC. Should they be ineligible for the entire amount of the IETC?

39. We have considered two main approaches to dealing with this issue. These are:

1. Any amount of ineligible income that a person receives during a year makes that person ineligible for any payment of IETC for that year; or
2. A person's IETC entitlement is reduced on a pro-rata basis for the number of periods a person receives any ineligible income.

The first approach is simple, but may be viewed as inequitable.

40. The second approach adds some complexity to the entitlement, but may be viewed as more equitable if the IETC is intended to be a weekly, rather than a strictly annual concept. We understand that Ministers prefer the second approach. We therefore seek Ministers' agreement to the second approach.

Pre-Christmas legislation

41. If the IETC is not enacted before Christmas, it is likely that Inland Revenue or employers would not be able to deliver it by 1 April 2009.

42. We therefore seek confirmation that you wish to include the IETC in pre-Christmas tax legislation.

Administration Issues

43. [*information deleted in order to not prejudice the maintenance of a law]*

44. Inland Revenue has estimated the costs of administering the IETC through the PAYE system. This is outlined in the table below. The costs are high level and will be refined further before a formal request for funding is made.

	$ million			
	2008-09	**2009-10**	**2010-11**	**2011-12**
Operating				
One-off operating	2.216	0.534	0	0
Ongoing operating	0.616	5.959	8.42	8.42
Total operating	2.832	6.493	8.42	8.42
Capital				
One-off capital	0.835	0.553	0	0
Total (lower range)	3.667	7.046	8.42	8.42
Contingency (25%)	0.917	1.762	2.11	2.11
Total (upper range)	4.584	8.808	10.53	10.53

45. Treasury has not yet reviewed Inland Revenue's administrative cost estimates.

46. You have signalled your intention to amend three aspects of the scheme's high-level policy design as follows:

- From 1 April 2009, the minimum contribution rate for employees in KiwiSaver will be two percent of gross salary;
- Employers will also be required to make minimum contributions of two percent of gross salary or wages for each of their employees who are KiwiSaver members; and
- From 1 April 2009, the employer tax credit will be discontinued.

47. We have provided some preliminary advice on the cost and potential impact of these proposals. (Note that these changes will also apply to complying superannuation funds.1)

48. You have also indicated your intention to repeal the recent amendment to the Employment Relations Act that affects KiwiSaver. The Clerk of the House considers that these proposals are outside the scope of the tax bill. The Department of Labour will provide advice to the Minister of Labour on the employment relations implications of the proposed changes and implementation options.

Minimum contribution rate for employees of two percent

49. The introduction of a new minimum contribution rate raises transitional issues in respect of existing employees/members and employees who become members on or after 1 April 2009 as to whether the new two percent rate becomes the default rate. (The current default rate is four percent.)

50. For existing employees/members it is considered that these persons should retain their existing deduction rate but have the option to elect the lower rate from 1 April 2009. This approach minimises the compliance costs on employers in having to change deduction rates, except where an employee elects to do so. Informal discussions with a few employer organisations have indicated a preference for this approach as it is simple for employers to manage.

51. There is a group of employees already contributing a two percent rate (a transition rule applied enabling employees to contribute two percent if their employer was also contributing at least two percent). It is recommended that the contribution rate for this group remain at two percent.

52. In respect of employees who become members on or after 1 April 2009, you have indicated that the new minimum rate of two percent will be the default rate. This rate will apply unless the member elects a higher rate.

[1] A complying superannuation fund is an existing superannuation scheme that has established a separate fund that has rules similar to KiwiSaver such as lock-in and portability.

53. It is recommended that the new two percent contribution rate for employees be implemented as follows:

- That existing employees/members will retain their existing contribution rate but have the option to elect the two percent rate or a higher rate; and
- That for employees who become members on or after 1 April 2009 the default contribution rate will be two percent. Such members will be able to elect a higher rate if they choose.

Minimum contribution rate for employers of two percent

54. We seek your agreement that the minimum compulsory employer matching contribution will be two percent from 1 April 2009.

Discontinuing the employer tax credit

55. We seek your agreement that the employer tax credit of up to $20 a week per employee is to be discontinued from 1 April 2009. It is considered that repeal of the employer tax credit should apply to employer contributions made on or after this date in relation to employee contributions made from that date. This will mean employers will still be entitled to the employer tax credit in respect of employer contributions made during the tax year April 2008 to March 2009.

Impact on Crown as employer

56. The implication for State sector employers is that they will no longer receive tax credits to offset the costs of their KiwiSaver employer contributions. . Preliminary costings indicate that the costs associated with the removal of the employer tax credit will be approximately $6million in the June quarter and $25million in 09/10. However these figures are indicative only and will need to be re-assessed when all of the final design decisions are confirmed.

Employer superannuation contribution tax exemption

57. We seek your agreement that the employer superannuation contribution tax (ESCT) exemption will be capped at the employer minimum contribution rate of two percent from 1 April 2009. At present, the exemption is capped at the lesser of the employee's contributions or four percent of the employee's salary or wages. Because of the dual test for the current cap, the current rules require a rolling annual balance of contributions to be maintained. Moving to a cap of the employers' minimum contribution rate allows the current provisions to be simplified so that the cap refers only to the employer compulsory contributions.

Member tax credit

58. At present the member tax credit operates on a dollar for dollar matching principle up to a cap of $20.00 a week ($1042.86 a year). It should be noted that there is 52 weeks and one day in each year (excluding leap years). This is why the current maximum member tax credit of $20 per week works out to be an unusual amount – $1,042.86. This has created

some communications difficulties. This allows members to either make contributions up to the cap or top up contributions to the cap if regular contributions deducted from salary or wages is insufficient.

59. You have indicated in discussions with officials that the member tax credit will operate on a dollar for dollar matching principle rather than matching contributions at the minimum contribution rate of two percent, up to a maximum of $1042.86 a year. You asked officials to cost two options. You have asked for a $20 a week cap (Option 1) and a $15 a week cap (Option 2). A $15 a week cap would result in a maximum member tax credit entitlement of $780 per year.

60. The fiscal cost of a $15 a week cap and the current $20 a week cap is estimated as follows:

	2009-10 $(m)	2010-11 $(m)	2011-12 $(m)	2012-13 $(m)
Prefu08 member tax credit forecast	765	846	895	929
Option 1: Member tax credit matches contributions up to $20 per week. With a default contribution rate of 2% those earning over $52,000 get full credit. An average contribution rate of 3% assumed for those earning less than $52,000	742	821	869	902
Option 2: Member tax credit is capped at $780 annually ($15 per week)	609	673	712	740

Changes from Prefu08 forecasts

Option 1 savings $(m)	23	25	26	27
Option 2 savings $(m)	156	173	183	189
Cost difference between option 1 and 2 $(m)	-133	-148	-157	-162

61. The fiscal savings from the member tax credit proposal outlined in the National manifesto is estimated as follows. This proposal is based on matching contributions at the minimum contribution rate of two percent, up to a maximum of $1042.86.

	2009-10	2010-11	2011-12	2012-13
All MTC drop to 2% $(m)	566	626	662	688

62. You have also asked us to assess the level of savings that may accrue from withdrawing the $1,000 kick-start contribution and $40 fee subsidy from 1 April 2009. The savings are estimated as follows:

	2009-10 $(m)	2010-11 $(m)	2011-12 $(m)	2012-13 $(m)
Kick-start removal	-140	-86	-49	-47
Fee subsidy removal	-45	-51	-54	-57

63. The following table provides full costing for all options for implementing the KiwiSaver changes:

Cost of Kiwisaver options*	2008-09	2009-10	2010-11	2011-12	2012-13	5-year total
Option 1 - Union MTC proposal	-86	-640	-763	-839	-870	-3198
Option 2 - MTC capped at $780 per annum	-86	-772	-911	-996	-1032	-3797
Option 3 - Union MTC proposal with no kickstart or fee subsidy	-86	-825	-900	-942	-974	-3727

* all include ESCT exempt up to 2% and removal of ETC

64. The above numbers are Prefu 08 forecasts of the kick-start payment and fee subsidy. This data is based on a number of take-up assumptions that will need to be re-visited once final policy decisions are made. For example, the removal of the kick start payment may have flow-through impacts on the cost of the member tax credit. The reduction in enrolment incentives will probably result in fewer members joining the scheme and the cost of the member tax credit will reduce accordingly. There is also a possibility that there will be a significant behavioural response to the decision to withdraw the kick-start, with non-members seeking to join before the payment is withdrawn. This will inject some instability in to the costings. For example the savings in 09/10 and 10/11 are likely to be overstated. One means of managing the magnitude of the behavioural response is to withdrawal the kick-start from the date of the Bill's introduction, or announcement if earlier.

65. We understand that you are not seeking further advice on the option to remove ESCT. We therefore seek your direction on the following:

- The level of the member tax credit cap - $20 a week or $15 a week;
- Whether the kick-start contribution is to be discontinued; and
- Whether the fee subsidy is to be discontinued.

Transitional Issues

66. Transitional issues will arise if the member tax credit cap is reduced and the kick-start contribution and fee subsidy is discontinued.

Member tax credit cap

67. If a tax credit of $15 per week was calculated on the same basis as the current tax credit, the maximum credit per year would be $782.14. For communications purposes, however, it would be simpler to calculate the maximum yearly entitlement based on a 52 week year. It is therefore recommended that the maximum member tax credit entitlement be $780 per year.

68. If the cap is reduced to $15 a week, a transitional issue arises as to whether the new cap applies from 1 April 2009 or the commencement of the 2009/10 member tax credit year (that is July 2009). Members may have already contributed up to $1042.86 for the current member tax year on the basis that they would be entitled to a matching tax credit. The introduction of new cap part way through the member tax credit year is in effect a retrospective change to the scheme offer. From Inland Revenue's perspective, it would be simpler if the change commenced from 1 July 2009. A change from this date would also be simpler for providers to administer and is not a retrospective change to the scheme offer.

69. If the member tax credit is capped at $15 per week from 1 April 2009 this would result in savings of $31 million in the 2008/09 fiscal year.

70. If the new cap is to apply from 1 April 2009, it is recommended that a composite cap apply for the 2008/09 member tax year of $18.75 a week ($975 a year based on 52 weeks rather than the number of days). The composite cap consists of 9 months of the $20 a week cap plus three months of the $15 a week cap.

Discontinuation of the kick-start contribution and the fee subsidy

71. As noted above, officials recommend that the withdrawal of the kick-start payment should apply from the date of the Bill's introduction, or announcement if earlier.

72. In addition rules will be required to provide certainty as to what is membership so that there is clear boundary as to who is entitled to the kick-start contribution. Officials

recommend a person will be entitled to the kick-start contribution if before the repeal date that person:

- Was subject to automatic enrolment rules, (that is commenced new employment); or
- Provided their employer with a KiwiSaver deduction notice (that is a notice requiring contributions to be deducted from their salary or wages; or
- The Scheme provider received a valid application from membership.

73. In relation to the fee subsidy, the current rules provides for the subsidy to be paid six monthly in advance. The first payment is made about three months after joining KiwiSaver along with the kick-start contribution. The same membership rules as discussed in the above paragraph should apply in respect of the fee subsidy. In respect of existing members the discontinuation of the fee subsidy should occur on the date that the member is paid the full fee subsidy for the current year of membership. This avoids the discontinuation being a retrospective change to the scheme offer. For ease of administration the discontinuation of fee subsidy should apply from the same date as the kick-start.

74. As discussed below under the heading of compliance with securities legislation, these changes will impact on the validity of current investment statements.

Repeal of Employment Relations Act amendment

75. The Clerk of the House considers that the proposed changes to the Employment Relations Act are outside the scope of the December Tax Bill. The Department of Labour will provide the Minister of Labour with further advice on the employment relations implications of these proposals and implementation options.

Compliance with Securities legislation

76. The proposed changes will amend a number of the scheme's high level policy features and therefore result in current documentation such as prospectuses and investment statements being incorrect and misleading. If documentation is materially misleading a fund is required to close until the documentation is updated.

77. In past an exemption for a limited period has been provided so that documentation does not become invalid as a result of legislative changes. However, previous exemptions have allowed for changes that are beneficial to the members. That is the actual offer to members will be of higher value than the offer in the documentation. However, with the proposed changes the current offer in the documentation will be of higher value that the actual offer to be confirmed by legislation and the documentation will be misleading in a way that is to the disadvantage of the new member.

78. Officials have discussed the implications of this with the Ministry of Economic Development and the Securities Commission who consider that in general no exemption be afforded in this case. A very limited exemption may be necessary to allow amendments to a

prospectus to be registered with the Companies Office and an amendment statement to be included in the investment statement to be prepared.

79. Furthermore, it is recommended that an exemption be given to issuers from the Securities Regulations requirements in respect of an investment statement so that an amendment statement can be inserted into the investment statement identifying the changes rather than the investment statement having to be withdrawn and reprinted. Such an exemption allows providers to use existing stocks of investment statements and thereby minimises compliance costs.

80. Officials seek your approval to consult with provider organisations such as ISI and ASFONZ on the proposed exemption to Securities Regulations to ensure that they are aware of what will be required and also test whether a limited exemption may be needed. We consider that such an exemption should apply in respect of any existing investment statements on issue or in the course of being printed and expire on 30 April 2009.

Research and development tax credit

81. The National Party announced in its election manifesto that it intended to remove the R&D tax credit. If the government wishes to proceed with repealing the credit Ministers will have to make two preliminary decisions. The first is which tax bill should contain the amendments repealing the R&D tax credit. The second is what the application date of the repeal should be. This report seeks a decision on these two issues and outlines the tax impacts of repealing the R&D tax credit. Appendix 2 outlines subsequent issues of detail that also require decisions.

Bill process

82. The two options are, to either include the draft amendments to repeal the R&D tax credits in the pre-Christmas tax legislation, or to introduce them in an SOP to a reinstated Taxation (International Taxation, Life Insurance, and Remedial Matters) Bill. We recommend that they be included in the pre-Christmas tax legislation. Doing so would mitigate retrospective effects, reduce uncertainty for claimants and Inland Revenue and smooth planning for Budget 09.

83. The urgent bill is expected to be enacted in December. Enacting the repeal through this bill will mean that it is retrospective (of around two months) for a very small number of claimants with early balance dates. It will not be retrospective for those with standard balance dates.

84. The Taxation (International Taxation, Life Insurance, and Remedial Matters) Bill, if reinstated, is expected to be enacted around May or June next year and including the repeal of the R&D tax credit in this bill would require a SOP to the Bill at the Committee of the Whole House stage. The repeal would be retrospective by up to nine months for claimants with

early balance dates and up to three months for those with a standard balance date. Similarly, the longer the delay in implementing the repeal the greater the uncertainty for those it affects, including Inland Revenue. Delay would reduce the assistance Inland Revenue could provide to taxpayers because Inland Revenue would be required to apply the current law until it is amended.

85. Including the repeal in the reinstated bill would require a Cabinet decision to repeal the tax credit to be made before the pre-budget moratorium period. A later decision would mean the fiscal savings from the repeal of the credit could not be taken into account in the Budget 09 planning process.

Application date

86. There are two options for when the repeal of the R&D tax credit should take effect: repeal on an income year basis or repeal from a fixed date. We recommend that the repeal take place from the 2009-10 income year as it is the most simple option and comes closest to ensuring that all potential claimants have the benefit of the concession for the same length of time. However, it could potentially mean a retrospective repeal for possible claimants with very early balance dates, who could in theory be up to two months into their 2009-10 income year when the credit is repealed. We consider that the retrospective effect is unlikely to be a major issue, given that very few claimants are likely to be affected and the removal of the credit was clearly signalled in the National Party's election manifesto.

87. The other option would be for the repeal to take place from a fixed date, such as the date the bill is enacted or 1 April 2009. The benefit of this option is that, unlike the first option, it is not retrospective. However, this option is likely to be complex requiring claimants, for whom the fixed date is not their balance date, to make timing and apportionment adjustments. Further, it would be considered unfair by taxpayers with standard or late balance dates, as taxpayers with an early balance date could receive the benefit of the credit for a longer period of time.

Compliance costs

88. Removing the credit from the 2009-10 income year would address most ongoing compliance cost issues. However, significant set up costs are likely to have already been incurred by many firms and advisors to these firms. We expect that costs will have been mainly incurred by firms for large R&D projects, as consultation with research-intensive firms undertaken during the formulation of the guidelines indicated that, for the first year, these firms intended to focus their efforts on those types of projects.

Impact on number of R&D claims

89. The consultation undertaken during the formulation of the guidelines further indicated that, in subsequent years, firms intended to shift their focus to include projects that are likely to provide a lower return on compliance cost efforts than readily identifiable large R&D projects. Removing the credit will tend to reduce claims on these smaller projects. It is

probable that firms will consider it not worthwhile to incur the related compliance costs for smaller claims when the credit is only in place for one year.

90. The consultation also showed that some firms intended to bring forward their R&D programmes because of the tax credit. It is likely that the progress of those programmes will now be delayed if the credit is repealed. Similarly, some firms have indicated their preference for locating R&D activities in New Zealand because of the tax credit. The repeal of the tax credit will therefore mean that some R&D that would have been carried out in New Zealand over the next few years will be undertaken overseas.

Revenue implications

91. Assuming that there is no behavioural change from taxpayers, the table below outlines the fiscal costs if the credit is repealed, against the costs if the credit remains in place:

Table 1

Fiscal years	**Fiscal costs if not repealed ($ m)**	**Cost of removing the credit ($ m)**	**Savings if repealed ($ m)**
2007-08	37	37	0
2008-09	208	154	54
2009-10	250	7	243
2010-11	290	0	290
2011-12	332	0	332
2012-13	373	0	373

92. If there is an increase in claims from businesses accelerating their R&D programmes to bring forward expenditure from later years, we consider that the savings for the 2008-09 and 2009-10 years from repealing the credit may be less than indicated in the table above. However, as we have indicated, it is possible the repeal will reduce smaller claims. Given that we do not have sufficient information to judge how claims will be affected, the figures given in the table are the most accurate as to the costs/savings from repealing the credit.

Administrative implications

93. If the R&D tax credit is in place for only one year, it will still need to be administered for a number of years to come. This is because disputes, filing returns, processing and auditing claims for the 2008-09 income year are likely to take some time to be resolved. The table below indicates the administration costs if the credit remains in place compared with the situation if it is repealed:

Table 2

Fiscal years	Costs if ongoing ($m)	Costs if repealed ($m)	Savings from repeal ($m)
2008-09	6.9	6.9	0
2009-10	7.2	7.2	0
2010-11	6.5	4.2	2.3
2011-12	6.3	3.0	3.3
2012-13	6.3	3.0	3.3
Outyears	6.3	0.6	5.7

94. The savings indicated in 2010-11 and in subsequent years are mainly from resources that would otherwise be necessary to process and audit new tax credit claims. Note that beyond the 2012-13 year, there may be an ongoing capital charge of $0.6 million if the credit is repealed.

95. The total capital cost of administering the project is around $9 million. Much of this cost will need to be written off.2

96. There are likely to be more doubtful claims than originally anticipated, and claimants may bring forward claims from later years. Processing and auditing these claims will create significant work pressures on Inland Revenue, which will face significant staffing challenges because finding personnel with the necessary skills for short-term positions may be difficult.

97. Another operational issue is that the current evaluation programme will need to be refocused and condensed to measure the impact of the credit for the year it is in force. The administrative guidance material on the R&D tax credit will also need to continue to be updated.

Matters for further consideration outlined in appendix 2

98. Currently, claimants have two years from the date on which their tax return is filed to adjust their claims. You will need to decide whether this adjustment period should be shortened. Inland Revenue is concerned that there will be an increase in doubtful claims, as well as the number of claims made overall, if the credit is withdrawn. One way to mitigate this effect would be to reduce the time available to adjust claims from two years to one year.

[2] If Inland Revenue were to cease the project as at 30 November 08 the capital cost to be expensed in the 2008/2009 financial year would be $6.2million. If the project continued for a year the asset would be capitalised at 1 May 2009 and depreciated over 5 years. The anticipated book value of the assets is $5.6 million as at 31 December 2010. If Inland Revenue were to write off the remaining value at this point in time we would have to expense the $5.6 million in the 2010/2011 financial year. This is in addition to the depreciation already incurred.

99. There are some legislative amendments that have already been signalled publicly and which officials consider should still proceed even if the credit is only in place for one year. They are largely intended to ensure that the credit works according to the underlying policy.

[deleted – not relevant to Taxation (Urgent Measures and Annual Rates) Act 2008]

Overpayments of WfF tax credits caused by Budget 2008 change

107. The previous government's 1 October 2008 tax cuts package brought forward an inflation adjustment to Working for Families (WfF). From 1 October, the weekly and fortnightly amounts of WfF tax credits paid out were increased to reflect the entire inflation indexation adjustment.

108. Final entitlements to WfF tax credits are calculated at the end of the year, however, and are based on the annual amount of the tax credit and the income abatement threshold. In the 2008-09 tax year the annual family tax credit and the abatement threshold are increased to reflect a composite amount; the average between the annual amount before 1 October 2008, and the annual amount after the 1 October 2008 inflation adjustment.

109. Families paid weekly or fortnightly and whose WfF tax credit entitlements changed part-way through the year (due to changes in their family circumstances, such as a child entering the family in the middle of the year) could therefore receive overpayments of WfF tax credits. The end of year entitlement based on the composite amount will be lower than the fortnightly or weekly amount received for recipients who, for example, have a new child after 1 October 2008. These overpayments could in turn result in tax bills for affected families at the end of the tax year.

110. The previous government decided that overpayments caused by the mid-year change to WfF tax credit entitlements should not be required to be repaid. It is not possible, however, for Inland Revenue to identify who is overpaid WfF due to the Budget changes, or how much of a person's WfF overpayment is caused by the Budget changes or other reasons.

111. The previous government therefore agreed to agree to include amendments to the Taxation (International Taxation, Life Insurance, and Remedial Matters) Bill to provide that Inland Revenue will write off up to $100 on all WfF overpayments made in the 2008-09 tax

year. They also agreed to a law change providing Inland Revenue the discretion to write off WfF overpayments over $100 threshold in cases where the Commissioner is satisfied the overpayment is caused by the Budget 2008 changes.

112. We seek the government’s confirmation that this policy will continue.

113. Due to concerns that the Taxation (International Taxation, Life Insurance, and Remedial Matters) Bill may not be enacted before Inland Revenue needs to process WfF recipients’ personal tax summaries and tax returns, we also seek the government’s agreement to include these amendments in the urgent taxation bill to be enacted before Christmas.

[deleted – not relevant to Taxation (Urgent Measures and Annual Rates) Act 2008]

Proposed timeline for pre-Christmas tax bill

121. It has been indicated that a bill introducing the tax and KiwiSaver changes should be introduced during the week beginning 8 December 2008. To meet this date officials suggest the following timeline:

- Week beginning 1 December – officials provide Ministers with a Cabinet paper covering tax cuts, KiwiSaver and R&D.
- Week beginning 8 December:
    - Monday 8 December – Cabinet consideration
    - Wednesday 10 December – bill introduced into Parliament

Fiscal consequences

122. The fiscal implications of changes to personal tax rate structure and introduction of the independent earner tax credit are:

($ million) - cost/(saving)	**2008/09**	**2009/10**	**2010/11**	**2011/12**	**2012/13**	**5-year total**
Tax rates and threshold changes ***AND***	211	818	702	616	719	3,066
Independent Earner Rebate	44	239	356	364	353	1,356
Total cost	**255**	**1,057**	**1,058**	**980**	**1,072**	**4,422**

123. The savings generated from discontinuing the R&D tax credit from the beginning of the 2009-10 income year are shown below. Also shown is 2/3 of the savings as officials understand it is the government's intention to direct 1/3 of the savings to initiatives outside of the tax package.

($ million) - cost/(saving)	**2008/09**	**2009/10**	**2010/11**	**2011/12**	**2012/13**	**5-year total**
Full savings ***OR***	(54)	(243)	(290)	(332)	(373)	(1,292)
2/3 savings (if 1/3 allocated elsewhere)	(36)	(162)	(193)	(221)	(249)	(861)

124. The fiscal implications of the three options for changes to Kiwisaver are shown in the table below. Each assumes Employer Superannuation Contribution Tax is exempt up to 2% and that the Employer Tax Credit has been removed. The figures shown are based on the assumption that the new annual member tax credit cap applies from 1 July 2009 (if the new annual member tax credit cap applies from 1 April 2009, a further $31m will be saved in 2008-09).

($ million) - cost/(saving)	**2008/09**	**2009/10**	**2010/11**	**2011/12**	**2012/13**	**5-year total**
Option 1 - Union MTC proposal ***OR***	(86)	(640)	(763)	(839)	(870)	(3198)
Option 2 - MTC capped at $780 per annum ***OR***	(86)	(772)	(911)	(996)	(1032)	(3797)
Option 3 - Union MTC proposal with no kickstart or fee subsidy	(86)	(825)	(900)	(942)	(974)	(3727)

125. The net cost of the tax package discussed in this paper is shown below for the three Kiwisaver options.

2/3 R&D savings						
($ million) - cost/(saving)	**2008/09**	**2009/10**	**2010/11**	**2011/12**	**2012/13**	**5-year total**
Tax, IER, 2/3 R&D, and Kiwisaver Option 1	133	255	102	(80)	(46)	**363**
Tax, IER, 2/3 R&D, and Kiwisaver Option 2	133	123	(46)	(237)	(209)	**(236)**
Tax, IER, 2/3 R&D, and Kiwisaver Option 3	133	70	(35)	(183)	(150)	**(166)**
Full R&D savings						
($ million) - cost/(saving)	**2008/09**	**2009/10**	**2010/11**	**2011/12**	**2012/13**	**5-year total**
Tax, IER, Full R&D, and Kiwisaver Option 1	114	175	5	(191)	(171)	**(68)**
Tax, IER, Full R&D, and Kiwisaver Option 2	114	42	(142)	(348)	(333)	**(666)**
Tax, IER, Full R&D, and Kiwisaver Option 3	114	(10)	(132)	(294)	(275)	**(597)**

126. Officials understand that the government intends to use some of the savings from the removal of the R&D tax credit for initiatives outside the tax package. Under the assumption that 2/3 of the R&D savings will be directed towards funding the tax changes, the net cost of the tax package is shown in the top half of the table above. Under Kiwisaver Option 1 (the Union Member Tax Credit proposal), the package costs $363 million over the five-year forecast period, i.e. the tax package is not self-funding. The other Kiwisaver options yield net savings over five years (Option 2 gives $236 million savings, Option 3 gives $166 million savings).

127. Until Cabinet decide to proceed with the science and research initiatives, the full amount of savings from the R&D tax credit will be used to reduce the operating deficit. During that time, the reduction in operating balance is shown for each option in the second half of the table.

128. If the new annual member tax credit cap applies from 1 April 2009 (rather than 1 July 2009), a further $31m will be saved in 2008/09.

129. Where appropriate, the numbers in these tables include an offsetting tax clawback (15.54%) on the basis that taxpayers will spend a portion of their tax cut on goods that attract GST and excise taxes. The cost of tax rates and threshold changes above also takes account of consequential changes to gross New Zealand Superannuation and benefit appropriations.

130. Officials will report next week on the administrative savings and costs associated with implementing these proposals after Treasury has had the opportunity to review Inland

Revenue's administrative cost estimates. Some initial estimates for some aspects of the changes have been indicated in this report.

Compliance implications

131. The compliance cost implications of the proposals to be included in the December tax bill will be discussed in the Regulatory Impact Statement that will be prepared in conjunction with the Cabinet paper.

Consultation

132. Officials consulted with the Ministry of Economic Development, the State Services Commission, the Ministry of Social Development, the Department of Labour and the Securities Commission as appropriate in the development of this report. Officials also discussed with employer organisations on an informal basis the implementation of the new two percent employee contribution rate.

Appendix 1 – Tax cuts: Consequential amendments

As noted in the main body of the report, as a consequence of changing the personal tax rate structure a number of amendments will need to be made to the tax legislation. These are listed below.

PAYE

1. Adjust the PAYE withholding rates downwards from 1 April 2009 to reflect each phase of the personal tax cuts package.

Resident withholding tax (RWT) on interest

2. Introduce a new optional 38% RWT rate for banks and other financial institutions that would apply for the 2009/10 year.

For banks and other financial institutions that elect to use the optional 38% rate, allow them to apply it to recipients of interest that have previously elected the 39% rate without receiving another election from them.

3. Note that further changes to the RWT rate structure should be made in the tax bill introduced in July 2008 to provide consistency with the new personal tax rates structure.

Portfolio investment entity (PIE) tax rates

4. Note that no changes to the PIE tax rate structure would be made at the current time.

5. Note that any changes to the PIE tax rate structure for consistency would be considered as part of the July 2008 tax bill with application from 1 April 2010.

Fringe benefit tax (FBT) rates

6. Change the rates and thresholds for FBT calculations to reflect each phase of the personal tax cuts package.

Provisional tax for individuals using the standard uplift and GST ratio methods

7. Note that provisional tax calculations for the 2009/10 – 2012/13 income years were reduced to reflect Budget 2008 tax cuts.

8. The reductions will continue to apply for the 2009/10 income year, with rules for reductions in subsequent years' provisional tax calculations repealed.

Secondary tax codes

9. Reduce the top secondary tax code from 39% to 38% from 1 April 2009.

10. Reduce the top secondary tax code from 38% to 37% from 1 April 2010.

11. Reduce the 21% secondary tax code to 20% from 1 April 2011.

12. Note that officials will report back on the issue of a new secondary tax code for the 12.5% bottom tax rate with potential application from 1 April 2010.

Casual agricultural employees and election day workers

13. Reduce the withholding tax rate for casual agricultural employees and election day workers from 21% to 20% from 1 April 2011.

Extra pays

14. Reduce the top extra pays tax rate from 39% to 38% from 1 April 2009.

15. Reduce the top extra pays tax rate from 38% to 37% from 1 April 2010.

16. Reduce the 21% extra pays tax rate to 20% from 1 April 2011.

17. Note that officials will report back on the issue of a new 12.5% extra pays rate with potential application from 1 April 2010.

ACC attendant care

18. The amount of tax withheld by ACC on attendant care payments will continue to reflect the bottom income tax rate and threshold.

Maori authority tax rate

19. Do not adjust the 19.5% tax rate that applies to Maori authorities at this stage. We will report back on this, with any change potentially applying from 1 April 2010.

Retirement scheme contribution tax (RSCT) rates

20. Do not change the RSCT structure from 1 April 2009.

21. Note that any changes to the RSCT for consistency with the personal tax rate structure would be considered as part of the July 2008 tax bill with application from 1 April 2010.

Other consequential changes

22. Make other amendments to tax legislation of a mechanical nature that are necessary to reflect the new personal tax rate structure.

Confirmation of annual tax rates

23. Confirm the 2009/10 income tax rates in the taxation bill that is enacted before Christmas.

Appendix 2 – Research and development tax credits

Background

1. Should you agree to repeal the R&D tax credit effective from the 2009-10 income year, two subordinate decisions need to be made. This appendix outlines these two issues.

Timeframe for claiming the credit

2. Under the current rules, for the 2008-90 and 2009-10 years, claimants have two years from the date on which their tax return is filed to adjust their claims for the R&D tax credit. The reason for having more relaxed rules was in recognition of the need for some flexibility around return filing, as businesses would take some time to come to grips with the requirements of the R&D regime in its early years.

3. If the credit is withdrawn after being in place for only a limited period, it is highly likely that there will be an increase in doubtful claims, although the number of claims overall may fall. Doubtful claims are likely to increase as:

- businesses might not implement systems for tracking eligible expenditure as robustly as they would had the credit been ongoing;
- businesses may have a view that they are entitled to recover the one-off compliance costs associated with setting up systems to justify claims and they will have only one year in which to do that.

4. Another concern is that there is an incentive for practitioners to “grave-dig” through business accounts for expenditure that might be eligible for the credit. This is likely to increase the number of low value claims. These are claims where a high percentage of the claim goes to advisors and where the potential claim is identified after the R&D has started. This is contrary to the policy underlying the credit, which is that it should provide an incentive to undertake R&D.

5. One way to mitigate the increase in doubtful claims and grave digging would be to reduce the time available to adjust claims from two years to one year. However, doing so will be perceived to be retrospective; businesses will be expecting to be able to claim for two years and would have planned accordingly.

6. Therefore, officials recommend that the timeframe for making adjustments should not be changed.

Proposed amendments to the R&D rules

7. Remedial legislation is required to align the legislation with the policy intent and to administer the tax credit. These changes have already been signalled publicly and officials consider that they should still proceed even if the credit is only in place for one year. Officials recommend that work on these issues be progressed with a view to including any required amendments in the first tax bill next year. The main issues are:

- the eligibility of government agencies for R&D tax credits
- capitalised expenditure
- the treatment of revenue account property
- administration issues

The proposed amendments are intended to ensure that the credit works according to the underlying policy for the year that it is in place.

8. In addition, minor remedial matters were contained in the Taxation (International Taxation, Life Insurance, and Remedial Matters) Bill. Some of these amendments are no longer necessary and officials will report accordingly to the Select Committee.

Eligibility of Government Agencies for R&D tax credits

9. The business test used in the eligibility requirements was expected to exclude most but not all crown-related entities from eligibility for the tax credit. Three classes of such entities, crown research institutes, district health boards and tertiary institutions, were specifically excluded from eligibility. Other crown-related entities such as state-owned enterprises were expected to meet the test and thereby qualify for the tax concession. Since the introduction of the concession other crown agencies, such as the Accident Compensation Corporation, have questioned whether they may be eligible for the concession.

10. While the legislation does not appear to prohibit such an outcome, this result appears inconsistent with the stated objective of the tax credit, which is to increase the amount of R&D carried out by private sector firms. We recommend that this uncertainty should be resolved by determining whether the crown entities (on an individual basis) should be treated as providers of core government services (and not be eligible for the credit) or treated more akin to state-owned enterprises (and be eligible).

11. For some crown entities, the current situation appears inconsistent with stated policy, and it creates significant uncertainty for other crown entities that have business activities and who have not received clear direction about their eligibility. We consider that the uncertainty should be resolved for the year that the tax credit is in force.

Capitalised expenditure

12. The R&D tax credit rules allow the credit to be claimed on all of the costs incurred in the intended development of depreciable intangible property (a narrow class of assets, comprising

things like copyright, the right to use a design, trademarks, and plant variety rights) and tangible property intended to be used only in the R&D activity.

13. This is a narrow definition, and some R&D expenditure falls outside it. For example, where costs are incurred in designing a prototype ("design costs"), either no credit will be available, or the amount of credit will be calculated under the depreciation rules, and be very small.

Treatment of revenue account property

14. Some kinds of R&D activities may create a direct output that is valuable and can be sold. The treatment of these outputs and the expenditure incurred in creating the outputs is inconsistent. Significant fiscal risks also arise because the credit can be manipulated to subsidise “business as usual” activities.

15. While not key to the tax credits, these rules are important for claimants involved in manufacturing and we consider that they should be clarified for the year that the credit is in place.

Administrative amendments

16. Several changes are required to administer the R&D tax credit effectively. They will:

- remove the option for partnerships to file a detailed statement supporting an R&D tax credit, on behalf of partners;
- create a requirement that a detailed statement that supports an R&D tax credit claim must be received before the claim, or a proposed amendment leading to a tax credit can be processed;
- align final dates for filing a tax credit claim, providing supporting information, amending a tax credit claim, by making them relative to the due date for the initial claim;
- allow more time for Inland Revenue to revise up claims in some cases where a request for amendment arrives close to the final date; and
- confirm current policy in relation to imputation rules, refunds, effective dates of transfer, and the tax status of the credit.