Ministers' Sub-Group on Tax

Agenda for meeting 4 – 29 March 2010

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1. Final package

- Overview of final decisions (10 minutes)
- Overview of fiscal estimates
- Confirm change in tax mix away from income tax towards GST
- Confirm base broadening measures that have been agreed in-principle
- Decide if budget should provide relief to companies
- Decide options to provide company relief
- Decide personal tax rate structure
- Confirm other base maintenance issues
- Agree compensation for GST
- Confirm administration issues

Budget 2010 tax package

Introduction

The Ministerial sub-group met on 22 February, 8 March and 22 March 2010 and made in principle decisions on certain areas of the Budget 2010 tax package.

The purpose of this fourth and final sub-group meeting is to make final decisions on the entire package. *These decisions are required as soon as possible in order to deliver the tax package within the timeframes required for the Budget.*

These decisions will form the basis of the draft Cabinet paper and Regulatory Impact Statement (to be sent to the Minister of Revenue and Minister of Finance on 6 April 2010). The Cabinet paper will be discussed at the Cabinet meeting on 12 April 2010.

Tables containing the key decisions are outlined in Appendix A. Further information concerning the appropriate tax rate for savings vehicles if the company tax rate is reduced is included in Appendix B.

Appendix A - key decisions

1. Change in tax mix away from income tax and towards GST

- **Confirm** that the rate of GST be increased to 15% from 1 October 2010 as part of the 2010 Budget tax package.
- **Confirm** that the top rate of income tax is reduced from 38% to 33% from 1 October 2010 as part of the 2010 Budget tax package.
- **Confirm** that the lower rates of income tax are reduced from 1 October 2010 as part of the 2010 Budget tax package (choices on how this is done are outlined in table 7 below).
- **Confirm** that the main benefits (Student Allowances, Family Tax Credit, Minimum Family Tax Credit, NZ Superannuation and Veterans Pensions) be increased by a payment equivalent to 2.02% of these amounts from 1 October 2010 as part of the 2010 Budget tax package (further details on the compensation package are provided below).
- **Note** that the cost of reducing income tax rates will be largely offset by the increase to GST and additional tax base broadening measures.

2. Base broadening measures that have been agreed in-principle

- **Confirm** that tax depreciation should be removed from all buildings with an estimated useful life of 50 years or more as part of the 2010 Budget tax package from the 2011/12 income year.
- **Confirm** that the 20% depreciation loading should be removed on new assets as part of the 2010 Budget tax package from the current income year for purchases made after Budget day.
- **Confirm** that the 75% safe harbour in the inbound thin capitalisation (interest allocation) rules applying to the NZ operations of foreign multinationals should be reduced to 60% from the 2011/12 income year as part of the 2010 Budget tax package.
- **Confirm** that an announcement be made in the Budget that LAQCs will become flow-through entities for income tax purposes, similar to limited partnerships, for income years commencing on or after 1 April 2011.
- **Confirm** that, as part of the Budget 2010 tax package, the cost of a depreciable asset should be reduced by the amount that is funded by a capital contribution, with respect to capital contributions made on or after budget day.
- **Confirm** that projected revenue from the GST base maintenance options, including addressing phoenix scheme fraud, should be included as part of 2010 Budget tax package with effect from 1 April 2011.

- **Confirm** that the indexation of the WFF tax credits abatement threshold should be removed as part of the 2010 Budget tax package.

- **Confirm** that amendments to prevent people offsetting investment losses (such as losses from rental properties) from their taxable income for the purposes of increasing their WfF entitlement should be part of the Budget 2010 tax package with effect from 1 April 2011.

- **Confirm** that a post-Budget review addressing integrity concerns relating to social assistance programmes (covering WfF tax credits, student allowances and health entitlement cards, including review of trust distributions, income from non-locked in funds such as PIEs, income from non-resident spouses, and fringe benefits) is announced as part of the 2010 Budget tax package with the intention of providing legislation addressing the integrity concerns, effective from 1 April 2011.

- **Confirm** that the redundancy tax credit be removed from 1 October 2010 as part of the Budget 2010 tax package.

- **Note** that additional funding that IRD will receive for compliance and enforcement purposes as part of the 2010 Budget has been estimated to result in significant additional tax revenue (for example, around $170m in 2011/12 net of administration costs).

3. Should the Budget tax package provide tax relief to companies?

- **Decide** whether the Budget 2010 tax package should be rebalanced to provide specific tax relief to companies.

- If Ministers decide to rebalance the Budget 2010 tax package to provide specific tax relief to companies, **agree** one of the options to achieve this in table 4 below.

4. Options to provide company tax relief

- If Ministers decide to provide company tax relief as part of the Budget, **agree** to do this by either:

  1. reducing the company tax rate to 28% as part of the Budget 2010 tax package (with application from the 2011/12 income year) (Treasury preferred option); or

  2. Set aside a tagged contingency of $400m for future business-friendly tax measures which would be decided as part of a specific post-Budget consultation with application from the 2012/13 income year (Inland Revenue preferred option).

- **Note** that if option 1 is preferred (reducing the company tax rate) separate consequential decisions are required to be made as outlined in table 5.

- Note that if option 2 is preferred (maintaining the company tax rate at 30%) separate consequential decisions are required to be made as outlined in table 6 below.

5. Other decisions required if company tax rate is reduced to 28%

- **Agree** that either:

  1. the top PIE tax rate and the tax rate for superannuation funds vehicles remain temporarily at 30% as part of the Budget 2010 tax package, and that officials will undertake an urgent review after the Budget on the permanent rate that should apply to these vehicles, with the aim to introduce this rate in time for the 2011/12 income year (Inland Revenue preferred option); or

  2. that the top PIE tax rate and the tax rate for superannuation funds is reduced to 28% from the 2011/12 income year as part of the Budget 2010 tax package.

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

- **Agree** to reduce provisional tax for companies that pay provisional tax on the earlier year basis from the commencement of the 2011/12 year.

- **Note** that officials will report after the Budget on the need or otherwise of integrity measures designed to buttress the difference between the company tax rate and the top personal tax rate.

6. Other decision required if company tax rate remains at 30%

- **Agree** that, if the company tax rate is not reduced to 28% as part of the Budget 2010 tax package, the top PIE tax rate and the tax rate for superannuation funds remains at 30% as part of the Budget and is reviewed as a matter of urgency post-Budget (Officials' preferred option).

7. Alternative personal tax rate structures

- **Agree** which of the following personal tax rate structures is preferred:

1. Base case – 10%/17.5%/30%/33% (Inland Revenue preferred option)
2. Alternative 1 – 10%/18%/30%/33%
3. Alternative 2 – 10.5%/18.5%/30%/33% (Treasury preferred option)
4. Alternative 3 – 10.5%/17.5%/33%
5. Alternative 4 – 10.5%/18.5%/33%.
6. Alternative 5 - 10.5%/17%/30%/33%
7. Alternative 6 - 10.5%/18%/30%/33%.

8. A different personal tax rate structure – Ministers to insert.

- **Decide** whether taxpayers who use the prior year uplift method of paying provisional tax should be allowed to decrease their provisional tax payments from 1 October 2010 to reflect the tax cuts (Inland Revenue preferred option) or whether no change should be allowed (Treasury preferred option).

8. Other base maintenance issues

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

- **Confirm** that the transitional circumstances tax credit should not be removed as part of Budget 2010.

- **Confirm** that the child tax credit should not be replaced as part of Budget 2010.

- **Confirm** that the totalisator duty should not be increased as part of Budget 2010.

- **Confirm** that no further work will be conducted in respect of the ring-fencing of rental property losses.

Bright line test for property disposals

- **Decide** whether a bright line test for property disposals should be introduced (Treasury preferred option) or not (Inland Revenue preferred option), and if so, for what period.

- If you decide to introduce a bright line test, **decide** if this will be done in the budget for residential investment property and post-budget consultation for further refinement, or if it will be announced in the budget with the design and consultation to take place after the budget.

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

9. Compensating for GST - more detailed decisions

- **Agree** that main benefits, Student Allowances, Family Tax Credit, Minimum Family Tax Credit, NZ Super and Veterans Pensions be increased by a payment equivalent to 2.02% of the base amounts from 1 October 2010 to 31 March 2011 and thereafter increase rates of payments through the Annual General Adjustment process, which will reflect the actual impact on the CPI of the GST changes.

- **Agree** that the Disability Allowance, Childcare Assistance and Childcare Disability Allowance be increased by 2.02% from 1 October 2010 to 31

March 2011.

- **Agree** to increase the full range of supplementary assistance that is normally subject to CPI adjustment on 1 April by an estimated 2.02% from 1 April 2011

- **Agree** that the Student Loan Living Cost component ***not*** be brought forward from 1 April 2011 to 1 October 2010; that Budget 2010 tax cuts should ***not*** further increase net Student Allowance amounts (i.e. prevent 'double dipping'), and that the in-work tax credit and parental tax credit ***not*** be increased at this time.

- **Agree**, with respect to Accommodation Supplement (AS), to:

  EITHER

  direct officials to provide advice on whether there is a need for changes to AS as a result of the impact of the property tax changes on rents, in the context of Budget 2011. (Treasury's base case estimate is a 0.7% increase in rents over the medium-term, with a lower estimate impact of 0.2% and an upper estimate of 2.2%, although other base broadening measures that affect rental property - including potential changes to LAQC rules, WfF integrity measures, and the introduction of a bright line test - may change these estimates;

  OR

  increase, as part of Budget 2010, the maximum rates of AS by 2.2%, from 1 October 2010 or 1 April 2011 (note that officials will provide further advice on this option should this recommendation be preferred);

  OR

  direct officials (led by the Ministry of Social Development) to report back to the Ministers of Finance, Social Development and Employment and Housing on the impacts of changes in the tax package on housing affordability, and wider considerations relating to the Accommodation Supplement and Income Related Rents, before Budget 2011;

  OR

  not change the AS settings in response to the Budget 2010 tax package, and ***not*** to set in place a process for doing so in the near future.

- **Agree**, with respect to the Government Superannuation Fund (GSF) and National Provident Fund (NPF), to:

  EITHER

  given the potential benefits that GSF and NPF recipients may receive from other parts of the tax package, and potential fairness issues with non-Government (private) pensions, ***not*** bring forward GSF and NPF indexation to 1 October 2010 (payments would still increase by CPI in April 2011).

  OR

  bring forward the GSF and NPF indexation to 1 October 2010 (in line with the treatment of other benefit types).

  OR

next time GSF and NPF payments are automatically adjusted increase the payment by 2% (GSFA preferred alternative).

- **Agree** that the Budget 2010 tax package include a contingency fund of $10 million per annum to deal with any other compensation matters that may arise after the Budget.
- **Agree** to amend legislation to provide that Inland Revenue will automatically write-off a capped amount of up to $30 per family for all Working for Families overpayments for the 2010/11 tax year.

10. Administration issues

- **Confirm** that Inland Revenue will be funded for the administration costs of implementing the changes confirmed in the attached table.
- **Note** that Inland Revenue administration costs for additional audit activity of roughly $20m per annum have been included in the table attached as an offset against audit revenue.
- **Agree** to delegate authority to decide minor consequential amendments relating to the Budget 2010 tax package to the Minister of Revenue and the Minister of Finance (and other Ministers as appropriate).

Issues requiring post-Budget follow up work

Depending on the final composition of the Budget 2010 tax package the following areas may require post-Budget follow-up work:

- Consultation with business on potential company tax relief options (if option 2 in table 4 above is agreed to).
- Officials report back to Ministers on potential integrity measures if the company tax rate is cut as part of the Budget 2010 tax package.
- Detailed design and consultation on making LAQCs full flow-through vehicles, similar to limited partnerships.
- A review of WfF to address integrity concerns relating to social assistance programmes (covering WfF tax credits, student allowances and health entitlement cards) is announced as part of the 2010 Budget tax package with the intention of providing legislation addressing the integrity concerns effective 1 April 2011.
- An urgent review of the appropriate tax rate for PIEs and other savings vehicles.
- If a bright line test is agreed, further work may be required post Budget (e.g. on whether to extend to other types of property) depending on which decisions are made above.

Appendix B

Tax rate for savings vehicles if company tax reduces

Currently, the tax rate for PIEs and other savings vehicles (unit trusts, superannuation funds, investment companies, and life insurance policyholder income) is the same as the company tax rate (30%). When the company tax rate was reduced from 33% to 30% in 2008, the tax rate of savings vehicles was also reduced from 33% to 30%. The tax rate on savings vehicles is a final tax rate for the investors because distributions to investors from superannuation funds, PIEs, and life insurance (claims on savings policies) are not taxed. Distributions from unit trusts may be taxed, but unit trusts had been offering "manager buyback" where investors could sell their units for a tax-free gain to the manager instead of receiving a taxable distribution.

While having the tax rate on savings vehicles be the same as on companies has some advantages in removing any difference between saving by investing in a savings entity and a company that is used as a savings vehicle, it does mean saving made through a savings entity is taxed at a lower rate than savings invested directly (in debt or a company that distributes dividends).

The capital markets development task force (CMDTF) and the tax working group (TWG) both recommended that the tax rate in PIEs and savings entities be aligned with the personal rate, including the top personal rate.

If the company tax rate is reduced to 28%, this raises the question of whether the tax rate on savings entities should fall with it, or if there should be an attempt to align the tax rate of savings entities with the top personal tax rate as recommended by the CMDTF and the TWG.

It would take some time to think about the ramifications of attempting to align the tax rate of savings vehicles with the top personal rate, and so this could not be done for budget night legislation. Officials would need to take time to consult and to consider if this could be done sustainably. It would also mean increasing the tax rate on savings from that which currently applies.

For the budget, we consider there are two broad options:

- Allow the tax rate on savings vehicles to fall to 28% on budget night. This would maintain the status quo alignment of tax on savings vehicles with the company tax rate, and it would reduce the tax on savings. However, it would mean tax on savings made through vehicles is lower than the tax on savings made directly by an individual, and would be inconsistent with recommendations made by the TWG and the CMDTF. It would still be possible to review post-budget and consider if the rates could be raised to the personal tax rates, however, the expectations raised in the savings industry by lowering the rate on budget day may increase political resistance to such a change.

- (Inland Revenue's preferred solution) Maintain the tax rates on savings vehicles at 30% on budget night, and announce a review of what the tax rate on these vehicles should be. The 30% rate would not be intended to apply in the longer term, it would be a "holding position" with the expectation that the rate be changed either up to the personal rate or down to the company rate before the commencement of the next income year. The disadvantage is this may appear more incoherent than having the savings rate fall on budget day, because the savings tax rate would not align with any other tax rate. It does leave the possibility of ultimately aligning the tax rate on savings vehicles at 33% more credible than it would be if the rate fell to 28% on budget day.

Any future review will create uncertainty in the tax and savings industry while future tax rules are being resolved.

Inland Revenue prefers the second approach while Treasury is relaxed at either approach.

Fiscal Consequences

As we have previously reported to the subgroup, reducing the top PIE rate from 30% to 28% would cost about $14 million per year. At that time, the base company tax costing had included reducing the tax rate on superannuation funds from 30% to 28%. This had a $40 million per year fiscal cost and was included in the company tax costing.

In order to show the company tax costing with consistent treatment for savings vehicles, we have since adjusted the company tax costing to reflect a tax rate on superannuation funds at 30%. This has resulted in a reduction in the cost of a company tax reduction by about $40 million per year. Accordingly, a decision to reduce the tax rate on all savings vehicles from 30% to 28% would cost approximately $54 million per year.

Increasing the tax rate on savings vehicles from 30% to 33% would have a positive fiscal impact of up to $21 million for PIEs and $60 million for superannuation funds, for a total increase of approximately $81 million per year (assuming no behavioural change). This is not being recommended at this time but could be a possible outcome of the review.

TAX PACKAGE COSTINGS (26 March 2010)

The net revenue of the base scenario provided to the Tax Sub-Group on 22 March was:

$ million	2010/11	2011/12	2012/13	2013/14	Total
Net revenue of base scenario (HYEFU)	-690	-125	-210	-245	-1270

The following measures have been added to the package, and recosted on a preliminary Budget Economic and Fiscal Update basis as requested at the meeting.

- Company tax cut to 28%
- GST maintenance (phoenix schemes)
- 5-year brightline test
- Tobacco excise increase phased in over three years
- Inland Revenue audit activity
- Inland Revenue administrative costs (replaces previous contingency)

The preliminary BEFU cost of the tax package including macroeconomic impacts is $535m over the forecast period ($175m net revenue in 2013/14) as shown in the table below:

$ million	***2010/11***	***2011/12***	***2012/13***	***2013/14***	***total***
Personal Tax (10.5, 17.5, 30, 33)	-2,365	-3,720	-4,000	-4,250	-14,335
Net NZS	-255	-360	-385	-390	-1,390
Net main benefits	-75	-100	-100	-105	-380
WFF Compensation	-45	-65	-65	-65	-240
Other compensation	-40	-70	-70	-70	-250
Company tax cut to 28%	-20	-340	-450	-305	-1,115
Inland revenue admin costs	-10	0	0	0	-10
GST (including clawback)	2,040	2,860	3,000	3,165	11,065
WFF de-indexation	0	15	50	40	105
WFF Integrity Measures	5	15	15	15	50
Building Depreciation (all buildings)	0	685	685	690	2,060
Depreciation Loading (grandfathering)	135	245	310	345	1,035
LAQCs (incl. remission loophole)	0	70	65	55	190
Thin Cap 60%	0	200	200	200	600
Depreciation - capital contributions	5	5	5	10	25
GST maintenance	15	60	60	60	195
5-year brightline	10	35	70	70	185
Tobacco excise**	60	105	140	145	450
Audit activity (incl. admin)	85	170	170	130	555
Static estimate of net impact (prelim BEFU)	*-455*	*-190*	*-300*	*-260*	*-1,205*
adjustment for macroeconomic effects	*5*	*25*	*205*	*435*	*670*
Operating balance before gains and losses	**-450**	**-165**	**-95**	**175**	**-535**

*figures rounded to nearest $5m

**cost reduces by $155m over forecast period if CPI effect not flowed through to benefit & NZS indexation