Inland Revenue
Te Tari Taake

POLICY ADVICE DIVISION

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: Tax reform – Budget 2010

Date:	18 March 2010	**Priority:**	**High**
Security Level:		**Report No:**	T2010/362 PAD2010/044

Action sought

	Action Sought	Deadline
Minister of Finance	**Note** the issues raised in this report and **agree** to the recommendations.	23 March 2010
Minister of Revenue	**Note** the issues raised in this report and **agree** to the recommendations.	23 March 2010

Contact for telephone discussion (if required)

Name	Position	Telephone	
Matt Benge	Assistant Deputy Commissioner, Policy Advice Division, Inland Revenue	[deleted – privacy]	[deleted – privacy]
Bill Moran	Manager, Tax Strategy, The Treasury	[deleted – privacy]	[deleted – privacy]

18 March 2010

Minister of Finance
Minister of Revenue

Tax reform – Budget 2010

Executive summary

The purpose of this report is to finalise the structure of the tax reform package to be announced in Budget 2010. This tax reform package is an integral part of the government's economic and fiscal objectives, which, *inter alia*, include lifting New Zealand's economic growth performance by improving incentives to work, save and invest.

In doing so it draws from previous reports on individual measures and asks for Ministers to confirm preliminary decisions already made and decide on a final tax package structure (subject to the possibility of minor changes following final costings using preliminary BEFU forecasts). Final decisions on the tax package are expected to be subsequently made by the Ministers' sub-group at their meeting on 29 March 2010.

All decisions will be made in the context of the objectives of the reform and the combined impact of all elements of the package so that the package is broadly revenue neutral. The key decisions to be made by Ministers are:

- to confirm preliminary decisions regarding base-broadening and the rate of GST;
- to determine the schedule of personal tax rates. Five rate schedule options are examined depending upon other elements of the package:
  - the current base case scenario rates of 10.5%/17.5%/30%/33% (which has been assumed so far);
  - alternative 1 – rates of 10%/18%/30%/33%;
  - alternative 2 – rates of 10.5%/18.5%/30%/33%;
  - alternative 3 – rates of 10.5%/17.5%/33%; and
  - alternative 4 – rates of 10.5%/18.5%/33%.
- to determine whether the package should be rebalanced relative to the base scenario to reduce its impact on business and companies; and

- if the package is to be rebalanced (discussed in tax policy report T2010/373; PAD2010/43), whether:
  - to maintain the company tax rate at 30 percent and relax some base broadening measures affecting companies; or
  - to reduce the company tax rate to 28 percent.

The report also highlights some consequential issues that will require consideration depending on which decisions are made about the content of the package.

Recommended action

We recommend that you:

(a) **Agree** that the tax package to be announced in Budget 2010 includes an increase in the rate of GST to 15%.

Agreed/Not agreed Agreed/Not agreed

(b) **Indicate** whether Ministers would like to change any of the preliminary decisions made on the specific base-broadening and integrity measures (as contained in the table in Appendix 1 to this report).

Base-Broadening measure	**Preliminary decision**	**Confirm decision**		**Rescind decision**	
		Minister of Finance	**Minister of Revenue**	**Minister of Finance**	**Minister of Revenue**
Depreciation on buildings	• Agreed that tax depreciation should be removed from all buildings with an estimated useful life of 50 years or more. (Inland Revenue considers that scaling back of depreciation would be preferable to a company tax rate cut if there was to be a rebalancing of the package towards the corporate sector – see recommendation i(ii)) • Agreed that this change should apply to both existing buildings and newly acquired buildings.				
Depreciation loading	• Agreed that the 20% depreciation loading should be removed. • Agreed that this change should only apply to new assets.				
Capital contributions	• Agreed that taxpayers should not be able to claim depreciation for costs where a capital contribution has been received.				
LAQCs	• Agreed that an announcement be made in Budget 2010 that LAQCs will be taxed like flow-through entities, similar to limited partnerships.				

Thin capitalisation	• Agreed that the 75% safe harbour thin capitalisation rule be reduced to 60%.				
WFF indexation	• Agreed that indexation of the WFF tax credit abatement threshold be removed.				
WFF integrity	• Agreed that investment losses should be excluded when calculating WFF. • Agreed that an announcement be made in Budget 2010 that a review to address integrity concerns relating to WFF tax credits will be undertaken.				
Savings vehicles	• Agreed that the top PIE tax rate should not be changed as part of Budget 2010. • Agreed that PIE rates below 30% should be reduced to reflect any reductions made to corresponding personal income tax rates.				

(c) **Note** that officials are reporting separately to Ministers on a list of further potential revenue raising measures.

Noted Noted

(d) **Note** that, at present, the overall cost of the current base scenario package is as follows:

$ million	***2010/11***	***2011/12***	***2012/13***	***2013/14***
Personal Tax (10.5, 17.5, 30, 33)	-2370	-3565	-3890	-4080
Net NZS	-220	-310	-330	-335
Net main benefits	-75	-105	-105	-105
WFF Compensation	-45	-60	-65	-65
Other compensation	-40	-60	-60	-60
GST (including clawback)	1960	2715	2845	2965
WFF de-indexation	0	25	95	95
WFF Integrity Measures	5	15	15	15
Building Depreciation (all buildings)	0	720	725	730
Depreciation Loading (with grandfathering)	140	260	330	370
LAQCs (incl. closing remission loophole)	0	75	65	55
Thin Cap 60%	0	210	210	210
Depreciation - capital contributions	5	5	5	10
Contingency	-50	-50	-50	-50
Net cost of base scenario	***-690***	***-125***	***-210***	***-245***

Noted Noted

(e) **Note** that the current base scenario results in a transfer from the corporate sector to individuals and that the revenue shortfall can be filled by either including further revenue raising measures in the package, restructuring the existing personal tax rate structure, or some combination of the two.

Noted Noted

(f) **Note** that any rebalancing of the tax package towards the corporate sector will require additional funds in order to achieve revenue neutrality.

Noted Noted

(g) **Indicate** whether or not some rebalancing towards the corporate sector should be part of the final tax package.

Rebalance/Don't rebalance Rebalance/Don't rebalance

(h) **Note** that Treasury's preferred option would be 10.5%/18.5%/30%/33% (i.e., alternative 2); a company tax rate of 28%; combined with a number of additional revenue raising measures (which officials will report on separately). Inland Revenue's preferred option would be 10.5%/17.5%/30/33% (the base case) combined with no company tax rate cut, maintaining depreciation on industrial buildings and a number of revenue raising measures. The estimated costs of these packages are:

Preferred option		**2009/10**	**2010/11**	**2011/12**	**2012/13**	**2013/14**
Treasury	10.5/18.5/30/33	0	(290)	45	25	(15)
Inland Revenue	10.5/17.5/30/33	0	(465)	31	(50)	(95)

Noted Noted

(i) **Indicate** whether, if the final tax package is to be rebalanced towards the corporate sector, this is to be achieved by:

i. Reducing the company tax rate to 28% in conjunction with some additional revenue raising measures (Treasury's preferred option).

Yes/No Yes/No

OR

ii. Scaling back existing base-broadening measures affecting the corporate sector (Inland Revenue's preferred option).

Yes/No Yes/No

(j) **Indicate** which of the following alternative personal tax rate structure options you prefer (subject, if appropriate, to identification of further acceptable revenue raising measures):

i. Base case – 10.5%/17.5%/30%/33%.

Yes/No Yes/No

OR

ii. Alternative 1 – 10%/18%/30%,33%, noting that revenue savings relative to the base scenario are approximately:

Scenario		**2009/10**	**2010/11**	**2011/12**	**2012/13**	**2013/14**
Alt. 1	10/18/30/33	0	30	45	50	55

Yes/No Yes/No

OR

iii. Alternative 2 – 10.5%/18.5%/30%/33%, noting that revenue savings relative to the base scenario are approximately:

Scenario		**2009/10**	**2010/11**	**2011/12**	**2012/13**	**2013/14**
Alt. 2	10.5/18.5/30/33	0	305	420	440	455

Yes/No Yes/No

OR

iv. Alternative 3 – 10.5%/17.5%/33%, noting that revenue savings relative to the base scenario are approximately:

Scenario		**2009/10**	**2010/11**	**2011/12**	**2012/13**	**2013/14**
Alt. 3	10.5/17.5/33	0	235	335	365	390

Yes/No Yes/No

OR

v. Alternative 4 – 10.5%/18.5%/33%, noting that revenue savings relative to the base scenario are approximately:

Scenario		**2009/10**	**2010/11**	**2011/12**	**2012/13**	**2013/14**
Alt. 4	10.5/18.5/33	0	540	755	800	845

Yes/No Yes/No

(k) **Note** that a separate paper setting out advice on the consequential effects of reducing personal tax rates on provisional tax for individuals (i.e. whether or not to reduce the provisional tax uplift) will be provided to Ministers shortly. This would affect the timing of costs over the forecast period although, other than financing costs of deferred revenue, revenue costs eventually net to zero. The revenue profile over the forecast period of reducing the provisional tax uplift (by 5%) in relation to individuals is as follows:

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

Noted Noted

(l) **Note** that, if a reduction in the company tax rate is agreed, the separate paper noted in recommendation (k) will also detail advice on the consequential effects of doing this. This would include advice with respect to the imputation crediting ratio – officials note that the preliminary cost of grandparenting the 30/70 imputation crediting ratio for two years has an estimated total fiscal cost over the forecast period of approximately $120 million.

Noted Noted

(m) **Note** that, once Ministers have decided on the nature and specifics of the final tax package, the final costs and revenues for the package elements can be recalculated based on preliminary BEFU forecasts.

Noted Noted

(n) **Note** that, once Ministers have decided on the structure of the final tax package, there will be a number of consequential legislative changes required.

Noted Noted

Bill Moran
for Secretary to the Treasury

Matt Benge
Assistant Deputy Commissioner
Policy, Inland Revenue

Hon Bill English
Minister of Finance

Hon Peter Dunne
Minister of Revenue

Background

1. The purpose of this report is to finalise the structure of the tax reform package to be announced in Budget 2010. This tax reform package is an integral part of the government's economic and fiscal objectives, which, *inter alia*, include lifting New Zealand's economic growth performance by improving incentives to work, save and invest.

2. The reform being examined has been informed by the work of the Tax Working Group (TWG). The package is being developed within a framework consistent with Cabinet Minute (10) 3/2 and the Prime Minister's Statement at the opening of Parliament on 9 February 2010.

3. This report consolidates issues that have been canvassed in previous reports on individual components of a potential suite of tax reforms, and invites Ministers to consider their preliminary policy guidance in light of the reform as a whole and decide on a final tax package structure.

Objectives of the tax reform

4. The overall goals of the tax reform package are to improve efficiency and growth and deal with current integrity issues in a manner which is fair. The cornerstone of the tax reform is a shift in the balance of government tax revenues from income taxes to GST. This shift is expected to increase the growth potential of the New Zealand economy.

5. However, increasing consumption taxes and lowering income taxes raises concerns about fairness. The reform will therefore contain across the board reductions in personal income tax rates as well as other measures to compensate vulnerable individuals for the increase in GST. Ensuring that most individual New Zealanders are no worse off implies that other base-broadening measures will be required to fund personal tax rate reductions and other compensatory measures.

6. Base-broadening can be efficiency enhancing in its own right to the extent that it brings taxation of particular activities more in line with their underlying economic returns. For example, increasing taxation of income from property, through reductions in depreciation and possibly other measures, is intended to reduce existing tax preferences and shift investment to more efficient uses.

7. By financing reductions in personal tax rates, the base broadening measures will have a second important impact on efficiency. This will increase the incentives for New Zealanders to work, save and invest and encourage productive skilled workers to remain in New Zealand.

8. However, the package is also to be broadly revenue neutral. Achieving the desired degree of fairness in the personal tax system will imply base-broadening that impacts the company sector and will have an impact on that sector's incentive to invest. The extent to which the burden of taxation should be shifted from individuals to companies focuses on the trade-off between supporting the fairness of the tax system with across the board personal tax rate reductions versus raising taxes on investment.

Key decisions required to be made by Ministers

9. All decisions will be made in the context of the objectives of the reform and the combined impact of all elements of the package so that the package is broadly revenue neutral. The key decisions to be made by Ministers are:

- to confirm preliminary decisions regarding base-broadening and the rate of GST;
- to determine the schedule of personal tax rates (subject to the possibility of minor changes following final costings using preliminary BEFU forecasts). Five rate schedule options are examined depending upon other elements of the package:
  - the current base case scenario rates of 10.5%/17.5%/30%/33% (which has been assumed so far);
  - alternative 1 – rates of 10%/18%/30%/33%;
  - alternative 2 – rates of 10.5%/18.5%/30%/33%;
  - alternative 3 – rates of 10.5%/17.5%/33%; and
  - alternative 4 – rates of 10.5%/18.5%/33%.
- to determine whether the package should be rebalanced relative to the base scenario to reduce its impact on business and companies; and
- if the package is to be rebalanced (discussed in tax policy report T2010/373; PAD2010/43), whether:
  - to maintain the company tax rate at 30 percent and relax some base broadening measures affecting companies; or
  - to reduce the company tax rate to 28 percent.

Key tax package parameters

10. Cabinet Minute (10) 3/2 provides parameters for the overall form of the Budget 2010 tax reform. The analysis in this report is made within the context of these parameters and is also informed by preliminary policy guidance from Ministers in response to subsequent reports on individual tax measures.

11. Through Cabinet Minute (10) 3/2, Cabinet sought further work from officials on matters including: reductions in personal tax rates, increasing the rate of GST, changes to the depreciation rules, changes to Working for Families and various property-related tax matters, while ruling out certain structural measures (such as a land tax). Since then, we understand that the following preliminary decisions on tax reform to be announced in Budget 2010 have been made by Ministers:

- The top personal rate and the trust rate are to be aligned at 33%; and the lower personal tax and PIE rates are to be lowered (the current base scenario structure for personal tax rates being 10.5%/17.5%/30%/33%).
- GST is to be increased to 15%, and compensation for certain groups provided.
- Depreciation on all buildings is to be removed.

- Depreciation loading on new assets is to be removed.
- Assets funded by capital contributions will have their cost base reduced for depreciation.
- The thin capitalisation safe harbour threshold is to be reduced from 75% to 60%.
- The abatement threshold for the Family Tax Credit is to be de-indexed, and additional Working for Families integrity measures will be put in place.
- LAQCs will effectively be treated as limited partnerships for tax purposes.

Changing the tax mix

The effect of shifting from personal income taxes to GST

12. The following represents a brief description of the major implications of shifting the balance of tax revenues from personal income taxes to GST. More detailed discussion is provided in the tax policy report T2010/191; PAD2010/10.

Growth and efficiency

13. Reducing personal income tax rates, in conjunction with an increase in GST (and other base broadening measures), would enhance the broad-base low-rate tax framework in New Zealand and is, in officials' view, an important part of any tax reform package that seeks to shift the current tax system away from bases that are considered more damaging to efficiency and growth. This is on the basis that a number of studies have found that GST tends to be less harmful to growth than company and personal income taxes.[1]

14. By encouraging savings (which are not in themselves subject to GST), a switch towards GST can also boost GNP and support a more sustainable longer term tax base. Encouraging domestic savings can be particularly important in providing finance for smaller firms which may have limited access to international capital markets. Moreover, because not all forms of saving are taxed neutrally, reductions in personal tax rates are likely to reduce savings biases through reducing the extent of tax distortions.

Equity and integrity

15. There is strong evidence to suggest that taxpayers who would otherwise be facing the top personal tax rate are using trusts, companies and other savings vehicles to shelter income from higher personal tax rates. This raises efficiency and integrity problems and concerns about the fairness of some taxpayers escaping higher personal tax rates and others, such as salary and wage earners, being unable to do so. Officials consider that a reduction in the top personal income tax rate to 33% is likely to ease much of this integrity pressure.

[1] See, for example, Johansson, A., Heady, C., Arnold, J., Brys, B., Vartia, L. (2008), *Taxes and Economic Growth*, OECD Working Paper 620.

16. In addition, a GST increase can improve fairness by raising taxes on higher income individuals who are currently avoiding the top personal tax rate. The increased GST on such taxpayers helps to finance cuts in lower marginal tax rates, and so, in combination with compensation measures for certain groups, provides a way of supporting the progressivity of the tax system while restoring integrity.

17. More generally, reducing the top marginal tax rate to 33 percent, whilst increasing GST, may amplify concerns that income tax cuts are being targeted at those who are better off. However, the distributional impact can only be determined by examining the total package, not individual components such as GST.

Global competitiveness

18. Personal taxes affect incentives to work and upskill. They also affect the decision to stay and work in New Zealand or work abroad, and the incentives for skilled foreigners to come to New Zealand. Given our highly mobile and skilled labour force and the need to compete internationally for skilled labour, reducing personal tax rates is important to growth. Any further deterioration in emigration levels may cause problems for New Zealand in maintaining its tax base, enhancing its skills and knowledge bases (and therefore its productivity potential), and more generally, maintaining or improving our living standards.

Providing revenue through base-broadening measures

19. The tax and welfare base broadening measures selected for this package have been considered in previous reporting on potential components of a tax package. To the extent that they reduce inefficient tax preferences in the current tax rules and/or improve integrity in the system, they have the potential to improve the efficiency of the tax system and increase its integrity. Doing so is more likely to facilitate investment of greater national benefit.

20. This base broadening also has the potential to raise revenue to fund the reduction of personal income tax rates. This should further enhance efficiency and growth.

21. Appendix 1 provides brief outlines of preliminary policy guidance provided, and key in-principle decisions made, on the base-broadening measures considered to date.

22. Officials note that should further revenue be required to fund the final tax package, there are a number of other measures that could be considered. Officials are reporting separately on these.

Distributional analysis of base broadening measures

Depreciation denial

First round impacts

23. The removal of depreciation on buildings will initially impact the owners of property in respect of which depreciation is being claimed. This impact will be divided between onshore

and offshore owners; and will flow either directly to households (where property is held directly), or through other structures such as companies (where property is held indirectly).

24. The size of the offshore impact is unknown, although it is likely to be higher for non-residential buildings than for residential (given the lack of institutional investment in residential property in NZ). Based on data about dividend distribution, approximately 35% of dividends are distributed offshore, 65% are distributed within New Zealand, and 5% are distributed to government.

Residential buildings

25. Under the base scenario, revenue from denying depreciation on residential investment property is estimated at $280 million in 2011/12.

26. Figure 1 shows the average value of rental property held by a decile (based on household total income) as a proportion of each decile's total income. This shows a general trend that, as incomes increase, the proportion of rental property holdings to income increases: from approximately 24% in decile 2, to 58% in decile 9. Figure 2 shows that the proportion of households that own rental properties increases as incomes increase (from 2% in decile 2, to 15% in decile 9); and that where a household owns rental property, the value of the average rental property holding generally increases with income.[2]

Figure 1: Average value of rental property as a proportion of average household income [SoFIE]

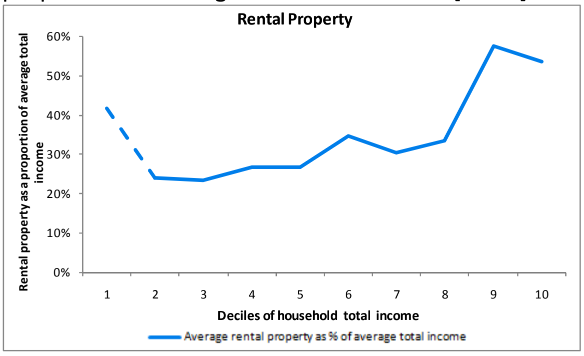
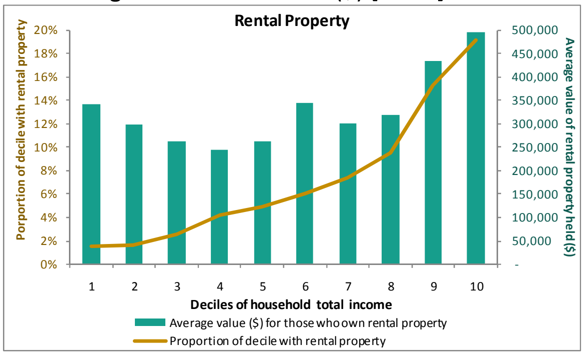


Figure 2: Proportion of decile with rental property (% and average value where held ($) [SoFIE]



27. Given this, if it is assumed that the capital value of a property is distributed in the same way as the book value of depreciating properties, and the pattern of those claiming depreciation is distributed proportionally across the income distribution, the impact of removing depreciation on buildings will be concentrated at the higher end of the income scale.

28. Due to the unavailability of data on the book value of depreciating properties, the amount of properties owned by companies and trusts, and the wide variation within deciles, officials have not attempted to estimate an impact for each decile in dollars.

[2] Figure 1 is the mean value of rental property as a percentage of the median household income. Figures in the bottom decile should be treated with caution, as incomes may be artificially low due to rental or self-employment losses, or under-reporting of Government assistance. Similarly, figures in the upper deciles may underestimate the income of these deciles. SoFIE data does not include properties owned through trusts or companies, which are more likely to be distributed at the upper end of the income distribution, and is recognised to under-represent high wealth households (http://www.treasury.govt.nz/publications/research-policy/wp/2009/09-04/).

Non-residential buildings

29. Excluding government-owned buildings, revenue estimated from denying depreciation on this class of buildings is estimated at $440 million in 2011/12. Officials have found no reliable information on the relative split between non-residential buildings owned directly by households, or through companies or trusts.

30. Where these buildings are owned indirectly – e.g. through a company – the burden of the tax is likely to fall on shareholders.

31. Figure 3 shows the average value of net business assets held as a proportion of average household income. With the exception of decile 1 and decile 5[3], the proportion of net business assets to household income seems generally proportional, but increasing in decile 10. Figure 4 shows a similar pattern for the average value of net business assets where held by a household, and that the proportion of households owning net business assets within a decile increases from around 9% in decile 1 to 42% in decile 10.

Figure 3: Average value of net business assets as a proportion of average household income [SoFIE]

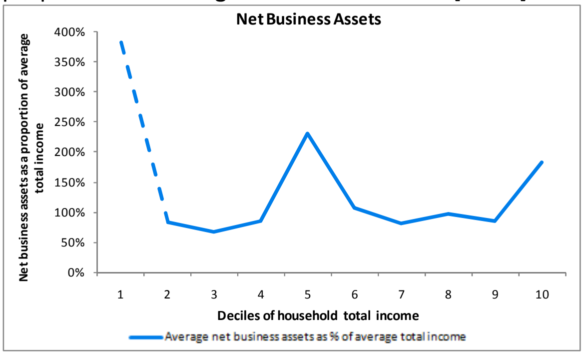
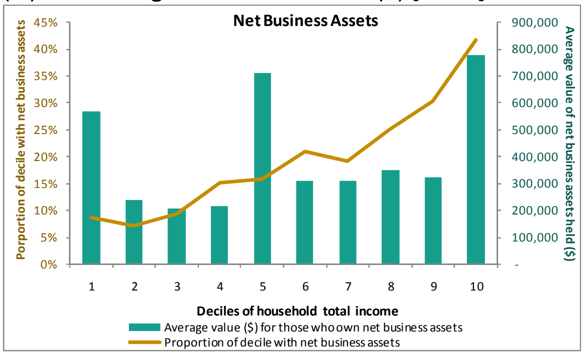


Figure 4: Proportion of decile with net business asset (%) and average value where held ($) [SoFIE]



32. Where assets are owned through companies, households' ownership of these companies will be held through listed or unlisted shares. One way of attempting to measure how the incidence of removing depreciation on different households is to examine how dividend payments vary across deciles. Figure 5 (based on Household Expenditure Survey data) shows the average dividend income received by households as a proportion of total household income.[4] Although there is some variation in this measure given the small sample sizes involved, this generally shows a somewhat progressive profile across the income distribution. Figure 6 shows the value of the dividend income where it is received by households, and the proportion of households in each decile that receive dividend income. This shows that, based on the data, approximately 3% of households in the first decile receive dividend income (of an average value of $1,700), compared to 21% in decile 10 (with an average value of $12,800).

[3] Figure 3 is the mean value of net business assets as a percentage of the median household income. The high value in decile 5 of figures 3 and 4 is driven by an average net business asset holding in decile 5 that is significantly higher than both deciles 4 and 6. Officials are unsure whether this represents an anomaly in the data and have been unable to confirm this within the available timeframes.

[4] Figure 5 is the mean value of dividend income as a percentage of the median household income. This data should be treated with some caution as sample sizes are often small (ranging from 13 to 76 households who receive dividend income).

Figure 5: Average dividend income as a proportion of average household income [HES]

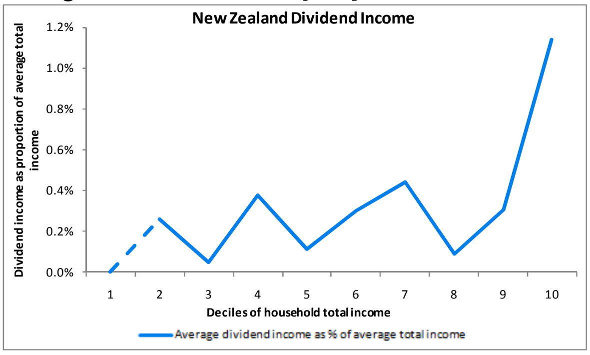
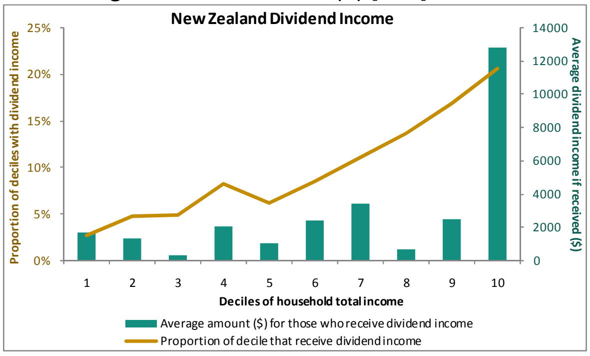


Figure 6: Proportion of decile with dividend income (% and average value where held ($) [HES]



33. If properties are held through trusts, the impact will be felt through changes in trust income received by households. Officials do not have reliable evidence of the trust income received by household income deciles.

Second round impacts

34. Second round impacts of depreciation changes on residential property will impact on rents and on house prices. We will provide further information on the impact of these changes before the final subgroup meeting on 29 March.

Depreciation loading

35. Revenue from the removal of depreciation loading, with grandfathering, is estimated at $140 million in 2011/12, increasing to $370 million in 2013/14. As with building depreciation denial, officials would expect some of the impact of this measure to be distributed offshore.

36. Depreciation loading will affect households and companies that own plant and equipment that was bought new. These assets are more short-lived than buildings; and as this change under the base scenario will be grandfathered, it will not affect existing owners of plant and equipment in respect of which depreciation loading is currently being claimed. Removing loading is more likely to affect companies than building depreciation denial due to the increased likelihood that companies will own assets subject to the loading, and the impacts are expected to flow through to households in a similar manner to the non-residential buildings discussed above.

Thin capitalisation

37. Thin capitalisation changes will impact offshore as the rules apply to foreign-owned New Zealand companies.

Conclusion

38. Due to the unavailability of data, it is not possible to provide a definitive account of the likely distributional impact on households of the proposed base broadening measures under the base scenario. However, given what available data there is in relation to the distribution of property and receipt of dividend income, officials consider that the base broadening measures are likely to have a larger impact on high income households than on low income households. Accordingly, the base broadening measures are likely to be progressive in nature.

The relative impacts on companies and individuals

39. An indicative increase in aggregate tax on the business sector (particularly on companies) of the current base scenario is given by the following:

- Commercial and industrial building depreciation $440 million
- Removal of depreciation loading $160 million
- Change to thin capitalisation safe-harbour $210 million
- Reduced taxation of dividends ($190 million)
- Total $620 million

40. Care must be taken in interpreting the impact on companies and the consequential impact on growth. Some of the burden of any increase in company tax is likely to fall on domestic shareholders of New Zealand firms. To that extent, the split between company tax and personal tax is somewhat artificial. Moreover some of the costs will be offset by reductions in the personal taxes of such income. The impact on companies relying on domestic capital markets is offset somewhat by the reduced taxation of dividends received by individuals from companies. This reduces taxes paid by residents on profits distributed from companies. A particular concern may arise that increases in taxes paid by non-resident owned companies could deter foreign portfolio investment (FPI) and foreign direct investment (FDI) into New Zealand. The depreciation measures will affect both FPI and FDI.

41. The extent to which the burden of taxation should be shifted from individuals to companies focuses on the trade-off between supporting the fairness of the tax system with across the board personal tax rate reductions versus raising taxes on investment.

42. The feasibility of rebalancing the current base scenario package depends on decisions on personal tax rates and other revenue raising measures (refer to the tax policy report on the company tax rate – T2010/373; PAD2010/43).

Analysis of potential tax rate structure scenarios

43. The following analysis discusses various tax rate structure scenarios. It should be noted, however, that there are still some fundamental decisions to be made on the individual components of the tax reform package.

44. Under all scenarios noted, the personal tax structure would be accompanied by an increase in the rate of GST to 15%, compensation payments to New Zealand Superannuation welfare recipients, and the base broadening measures summarised in Appendix 1. All scenarios involve tax reductions greater than required to offset the price increase from the GST rise (the neutral structure is 10.7%/19.4%/31.6%/36.7%)[5].

Current base scenario

45. The following table represents the current base scenario of the personal income tax rate structure being considered for Budget 2010.

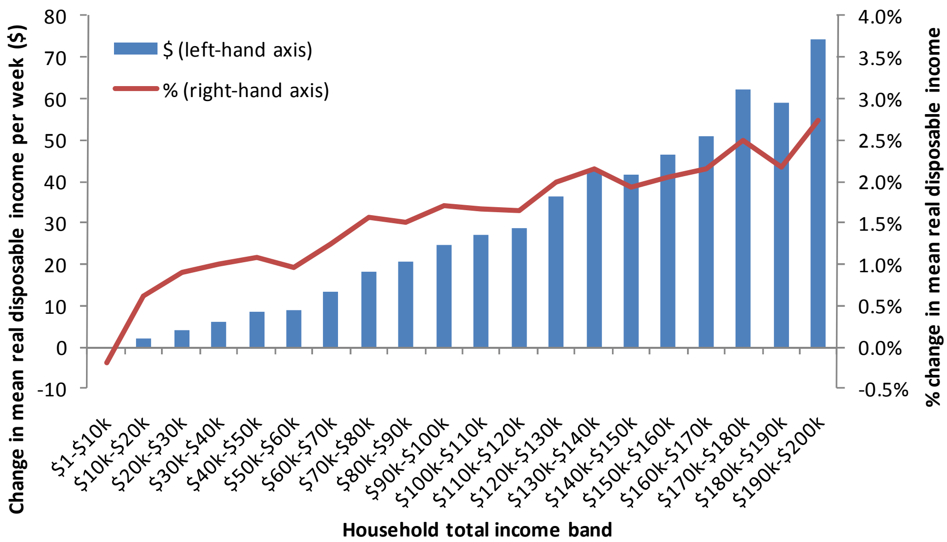
Thresholds	Rates
0 - 14,000	10.5%
14,001 - 48,000	17.5%
48,001 - 70,000	30%
70,000+	33%

Distributional analysis of current base scenario (personal tax and GST)

46. Distributional analysis on the 10.5%/17.5%/30%/33% base scenario has already been provided (T2010/191;PAD2010/16 refers). Treasury's Taxwell modelling (based on HES data), in Figure A, shows that households across total income bands over $10,000 are *on average* better off in terms of real disposable income,[6] i.e. after the price effect of GST is taken into account.

47. This modelling does not take account of the compensatory increases to non-taxable social welfare income, which are discussed in T2010/191; PAD2010/16 – and therefore the slight reduction that is apparent below $10,000 (equivalent to an average of 21c per week) is an overestimate of the decrease in disposable income (if there is a decline at all) assuming these measures are agreed to.

Figure A



[5] This assumes that all disposable income is consumed, with 91% being consumption that attracts GST, consistent with the CPI basket.
[6] Note total income excludes WFF tax credits, whereas these are included in the calculation of disposable income.

Cost of current base scenario

48. The cost of the current base scenario tax package (with a personal income tax rate structure of 10.5%/17.5%/30%/33%) is estimated to be[7]:

$ million	***2010/11***	***2011/12***	***2012/13***	***2013/14***
Personal Tax (10.5, 17.5, 30, 33)	-2370	-3565	-3890	-4080
Net NZS	-220	-310	-330	-335
Net main benefits	-75	-105	-105	-105
WFF Compensation	-45	-60	-65	-65
Other compensation	-40	-60	-60	-60
GST (including clawback)	1960	2715	2845	2965
WFF de-indexation	0	25	95	95
WFF Integrity Measures	5	15	15	15
Building Depreciation (all buildings)	0	720	725	730
Depreciation Loading (with grandfathering)	140	260	330	370
LAQCs (incl. closing remission loophole)	0	75	65	55
Thin Cap 60%	0	210	210	210
Depreciation - capital contributions	5	5	5	10
Contingency	-50	-50	-50	-50
Net cost of base scenario	***-690***	***-125***	***-210***	***-245***

- This table assumes no cut to the company tax rate.
- Numbers for GST compensation have been updated for officials' recommendations based on a 2.02% shock to CPI (refer T2010/339; REP10/03/095; IRD 2010/042).
- The thin capitalisation figures in the tables are maximums based on an assumption that worldwide group debt percentages do not allow for deductions if the safe harbour is breached. To the extent that assumption does not hold, these figures will be overstated.
- PIEs are assumed to be capped at 30%
- Clawback is included in the GST revenue line and assumes direct incidence on individuals from: personal tax, NZS, benefits & compensation, WFF measures, LAQCs (100%), and building depreciation and depreciation loading (38%).

49. These figures of the combined package differ slightly from those previously provided to Ministers *(Budget 2010 tax package – base scenarios (as at 4 March 2010))* due to the following:

- Previously, NZS, benefit and WFF compensation figures were based on Treasury Taxwell modelling with at 2.22% inflation assumption. Since then, the inflation estimate has been revised to 2.02% and the benefits and NZS costs are now modelled on MSD's M-Sim model. The cost of additional compensation for supplementary assistance has also been included (refer T2010/339; REP10/03/095; IRD 2010/042).
- LAQCs (including closing the remission income loophole), WFF Integrity measures, and capital contributions changes have now been incorporated into the base scenario.
- Clawback has been adjusted for these changes, and now 38% of the depreciation measures are assumed to fall on individuals (as opposed to 100% previously).
- A contingency of $50m per annum has been included to reflect remaining uncertainty in numbers and expected IRD implementation costs.

[7] Based on HYEFU2009 forecasts.

50. Note that the static clawback figures are an initial estimate for the interaction between tax types. In final costings, clawback will be replaced by the dynamic interaction effects determined from incorporation of the tax package into the macroeconomic and fiscal forecasts.

51. Officials note that funding shortfalls could be filled by identifying other revenue raising measures, by altering the proposed rate schedule, or a combination of the two. Officials are reporting separately on additional revenue raising measures.

Alternative scenarios

52. The following section considers four alternative personal tax scenarios to the one shown above, which differ only by the marginal tax rates (thresholds remain the same as they are currently). These are shown in the table below.

Reduced cost compared to base scenario (10.5/17.5/30/33): $ million					
Scenario		**$0 – $14,000**	**- $48,000**	**- $70,000**	**$70,000+**
Base case		10.5%	17.5%	30%	33%
Alt. 1		10%	18%	30%	33%
Alt. 2		10.5%	18.5%	30%	33%
Alt. 3		10.5%	17.5%	33%	33%
Alt. 4		10.5%	18.5%	33%	33%

Cost reduction of alternative scenarios

53. The reduction in cost compared to the cost of the base scenario is shown below (indicative figures only[8]):

Reduced cost compared to base scenario (10.5/17.5/30/33): $ million					
Scenario		**2010/11**	**2011/12**	**2012/13**	**2013/14**
Alt. 1	10/18/30/33	30	45	50	55
Alt. 2	10.5/18.5/30/33	305	420	440	455
Alt. 3	10.5/17.5/33	235	335	365	390
Alt. 4	10.5/18.5/33	540	755	800	845

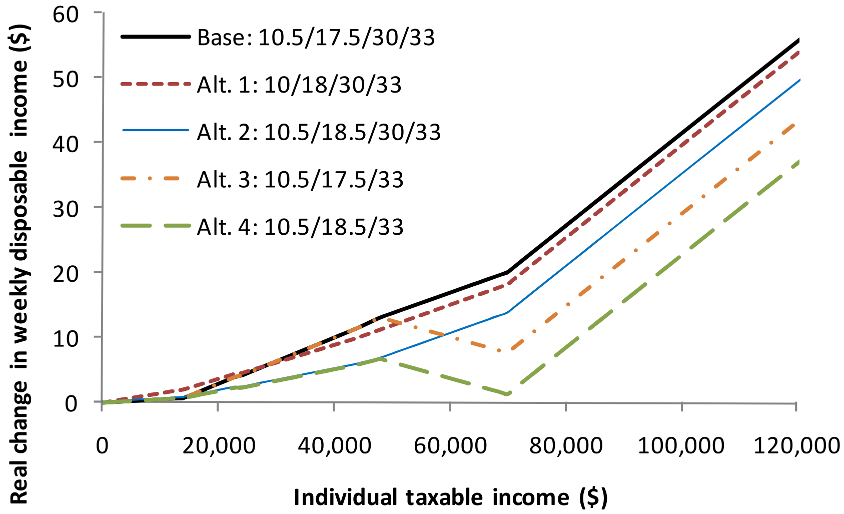
54. Modification of tax rates under these alternative scenarios will affect the revenues delivered by the base broadening measures. This is because they are interdependent. Initial analysis indicates that there would be a minor increase in expected base broadening revenues provided through each of alternative scenarios 1 through 4, with alternative scenario 4 providing the largest expected increase in revenues.

55. Once the desired scenario has been decided upon and its precise parameters known, a full recasting of the estimated costs and revenues from the package will be performed.

[8] These figures are indicative only, and do not properly account for the interaction with the welfare system, or changes to FBT, ESCT, PIEs and timing of provisional and terminal tax. Full costings on an updated economic basis will be provided to inform Cabinet decisions. Figures are based on June years and include clawback of 17.3%.

Distributional effects of alternative scenarios

56. The chart below shows a representation of the distributional effects of the alternative scenarios and the base scenario. In contrast to Figure A, this chart shows the basic mechanical effect on an individual's (rather than household) real weekly disposable income[9] based on their taxable (rather than total) income.



57. The information captured in the following table, for individuals with different levels of income, shows the increased amount (on an annual basis) that a taxpayer who was previously consuming all net income could now save (although clearly only a fraction of this will be saved). The calculations are indicative only and are provided by Inland Revenue for Ministers' attention. In contrast to the previous distributional analysis Ministers have received from officials, the following figures are expressed in post-GST change dollars, rather than pre-GST change dollars. In the time available, Treasury was not able to confirm the accuracy of the calculations.

Increase in net real annual disposable income: $					
Taxable Income	**Base Scenario**	**Alternative 1**	**Alternative 2**	**Alternative 3**	**Alternative 4**
10,000	27.29	77.29	27.29	27.29	27.29
20,000	154.88	194.88	94.88	154.88	94.88
30,000	338.84	328.84	178.84	338.84	178.84
40,000	533.30	473.30	273.30	533.30	273.30
50,000	733.11	633.11	393.11	673.11	333.11
60,000	901.81	801.81	561.81	541.81	201.81
70,000	1,070.51	970.51	730.51	410.51	70.51
80,000	1,449.31	1,349.31	1,109.31	789.31	449.31
90,000	1,828.11	1,728.11	1,488.11	1,168.11	828.11
100,000	2,206.91	2,106.91	1,866.91	1,546.91	1,206.91

[9] New disposable income, including effects of income tax, ACC levy and Independent Earner Tax Credit, based on the tax rate structure in question is deflated by the 2.02% price effect assumed from the GST increase and compared to the initial disposable income. This in effect assumes that all disposable income is consumed, 91% of which is consumed on GST-able expenditure.

58. The base case scenario provides some relief to taxpayers on lower income levels. At incomes over $14,000 this relief increases steadily with income.

59. Alternative scenario 1, compared to the base scenario, shifts the balance slightly between the bottom two tax rates, reducing the bottom rate from 10.5% to 10% while increasing the 17.5% rate to 18%. The Ministers' subgroup on tax asked for this option to be analysed. Gains are very slightly higher (up to $1.35/wk) for those earning less than $28,000 per annum under alternative scenario 1 than they are for the base scenario, while very slightly lower (up to $1.92/wk) for those earning over $28,000. This saves on the order of $50 million per year.

60. Neither the base case scenario nor alternative 1 would be broadly revenue neutral by themselves. Either would need to be accompanied by other base broadening measures to bridge the revenue gap.

61. Alternative scenarios 2, 3 and 4 provide significant amounts of additional revenue and could be used to bridge the revenue gap (and in the case of alternative 4 substantially more than bridge the revenue gap) without any other revenue raising measures. They could be combined with base broadening measures for a rebalancing of the tax package to reduce taxes on companies.

62. A relatively large revenue gain comes from increasing the 17.5% tax rate as shown in alternative 2 ($400-450 million per annum). This is because most taxpayers pay some portion of their tax at this rate and the rate is applied over a relatively wide band ($14,000-$48,000). Relative to the base case scenario, all individuals earning more than $14,000 would be worse off with those on incomes above $48,000 worse off by $340 per annum or $6.54 per week.

63. Not reducing the 33% rate to 30% (alternative 3) saves around $350-$400 million per annum. As shown in the chart, under this scenario there are fewer gains to those earning over $48,000. Also note that, because there is no reduction in marginal tax rate for those in the $48,000-$70,000 band, the growth and efficiency gains are expected to be lower than the base scenario. Relative to the base scenario those earning more than $48,000 will be worse off, with those earning more than $70,000 worse off by $660 per annum or $12.69 a week.

64. Alternative 4 combines these changes to give the greatest cost reduction (compared to the base scenario) of around $800 million per annum over the forecast period. While no taxpayers are worse off compared to the status quo, they would be worse off than under the base case if they earned more than $14,000, with those earning more than $70,000 worse off by $1,000 per annum or $19.23 per week.

Inland Revenue

65. Inland Revenue considers that it is critical for the final package to attain a high level of public support. For this reason we would counsel considerable caution before abandoning the personal tax reductions envisaged in the base case scenario. Any of the alternatives which raise significant amounts of money (namely, alternatives 2, 3 and 4) would provide substantially less assistance to lower income individuals. For example, alternative 2 would more or less cut in half the gains to individuals on $30,000 or $40,000.

66. We believe that the package that Ministers have preliminarily agreed to is coherent. The switch from personal income taxation to GST will reduce biases between different forms of saving and encourage saving. While company tax collections will rise, the thin capitalisation change is likely to result in an important offset. This will promote efficiency and growth. Higher taxes in New Zealand will tend to be offset by lower taxes overseas. Moreover, companies and their shareholders will benefit from lower personal taxes on New Zealand shareholders. Lower personal taxes will also tend to make it easier and less costly for firms to acquire and retain highly-skilled and mobile workers. The one area of concern we have is with the proposed removal of depreciation from industrial buildings.

67. We believe that the empirical evidence for removing depreciation deductions on industrial buildings is weak and that this move will be seen to be unfair. If firms are denied valid deductions for assets which do fall in value, this is likely to decrease the efficiency of investment decisions. A number of members of the Tax Working Group have argued quite forcibly that some buildings do depreciate and that to deny depreciation deductions in these circumstances would be unreasonable. We also note that Treasury has voiced concerns about the effects of the package on aggregate investment. In our view, continuing to allow depreciation deductions on industrial buildings is likely to increase both the efficiency of investment and aggregate investment.

68. While reducing the company tax rate would also boost investment, we are concerned that it would be a relatively cost ineffective way of doing so relative to continuing to allow depreciation on industrial buildings. A particular concern with cutting the company tax rate is that to the extent that companies are earning economic rents, reducing the company tax rate will provide a windfall to investors. This can be particularly costly from the point of view of New Zealand as a whole when such rents are earned by foreigners. Reducing company tax rates in a way which provides a windfall to non-resident shareholders and leaves New Zealanders to pick up the tab can make New Zealand as a whole worse off.

69. Reducing the company tax rate will also reintroduce incoherence into the taxation of savings vehicles. Savings would be subject to a 33 percent rate if held directly, 30 percent if held by a PIE and 28 percent if held in a unit trust. Resolving these issues would be very complex and would need intensive consultation. This incoherence would be opposed to the explicit recommendations of the TWG for greater coherence in the tax treatment of savings.

70. For all of these reasons we do not believe that it is desirable for a reduction in personal tax rate cuts to be used to finance a cut in the company tax rate.

71. We believe that it is possible to make the tax package broadly revenue neutral while at the same time continuing to allow depreciation on industrial buildings (costing, after the first year, about $180 million per annum) without paring back on personal tax rate cuts. This involves using a number of base broadening measures, revenue from the tobacco excise and a reduced contingency allowance, as follows:

	2010/11	2011/12	2012/13	2013/14
Current net cost of base scenario package	**-690**	**-125**	**-210**	**-245**
Tobacco excise	160	170	160	150
Increase in totalisator duty	10	50	50	50
GST phoenix schemes	10	60	60	60
Child tax credit	0	7	17	17
Transitional circumstances tax credit	0	4	8	8
Reduced contingency	45	45	45	45
Less allowing depreciation on industrial buildings	0	-180	-180	-180
Total net cost of Inland Revenue preferred package	**-465**	**31**	**-50**	**-95**

Treasury

72. In Treasury's view, the final tax package should reflect a strategic approach to tax policy that is growth-oriented, fiscally prudent and consistent with a savings, investment, and growth-themed budget. We also recognise the government's preference to meet the constraints of making the vast bulk of taxpayers better off. The base scenario provides a strong message around personal work incentives and a shift from consumption to saving, with significant personal tax rate cuts and the increase in tax on consumption through the rise in GST. However, to produce a broadly revenue neutral package, it involves a switch in the burden of tax from personal taxes to taxes on business, particularly companies.

73. The base scenario is therefore weak around creating corporate incentives to invest and only partially tackles the bias towards property investments. If the government wants a package which promotes investment as well as savings and work (as Treasury recommends), we need measures to promote corporate investment and profitability – with the favoured option being a cut in the rate of company tax. Large base broadening measures for targeting property have been ruled out. However, moving to a bright line test for investment property would give the package more credibility in respect of targeting identified gaps in the taxation of property.

74. The base scenario package includes a number of measures aimed at broadening the base (reducing tax deductions in this case) which fall on business. A cut in company tax would rebalance the package, offsetting some of the increased tax burden on business, and promote incentives for business investment in New Zealand.

75. We consider that a reduction in the company tax rate, alongside base broadening measures is worth pursuing as:

- High corporate rates discourage investment and productivity improvements.
- Economies are increasingly open and average tax rates can influence global investment decisions; statutory rates can influence where profits are declared.
- A tax reform package without incentives for business investment is not consistent with the Budget theme of savings, investment and growth.

76. To enable a broadly revenue neutral package, if a company tax rate cut (to 28%) is included, further principled base broadening measures can be introduced to provide revenue for personal tax rate cuts. These would make affordable across the board personal rate cuts which ensure that most individual New Zealanders are better off.

77. The Treasury-preferred option below achieves this by slightly reducing the generosity of the personal tax cuts (reducing the current 21c lower middle rate to 18.5c instead of 17.5c), reducing the company tax rate to 28c and introducing a number of additional tax initiatives that have merit in themselves and also raise revenue. These measures include initiatives to improve the neutrality of the GST rules, an increase in totalisator duty, and clarification of the capital revenue boundary around certain property. Officials will be reporting to you shortly on these further base broadening measures. The revenue profile of the Treasury-preferred option is as follows:

$ million	***2010/11***	***2011/12***	***2012/13***	***2013/14***
Personal Tax (10.5, 18.5, 30, 33)	-2040	-3085	-3375	-3555
Net NZS	-215	-305	-325	-330
Net main benefits	-75	-105	-105	-105
WFF Compensation	-45	-60	-65	-65
Other compensation	-40	-60	-60	-60
GST (including clawback)	1875	2595	2720	2835
WFF de-indexation	0	25	95	95
WFF Integrity Measures	5	15	15	15
Company tax 28%	-30	-410	-375	-395
Building Depreciation (all buildings)	0	685	690	695
Depreciation Loading (with grandfathering)	135	245	315	355
LAQCs (incl. closing remission loophole)	0	75	65	55
Thin Cap 60%	0	195	195	195
Depreciation - capital contributions	5	5	5	10
Tobacco Excise	160	170	160	150
5 year Brightline Test (grandfathered)	0	0	10	30
GST Phoenix Schemes	15	60	60	60
Increase Totalisator Duty on Racing	10	50	50	50
Contingency	-50	-50	-50	-50
Net revenue of Treasury recommended package	***-290***	***45***	***25***	***-15***

78. The changes compared to the base scenario are shown below:

$ million	***2010/11***	***2011/12***	***2012/13***	***2013/14***
Personal Tax (10.5, 18.5, 30, 33)	330	480	515	525
Net NZS	5	5	5	5
Net main benefits	0	0	0	0
WFF Compensation	0	0	0	0
Other compensation	0	0	0	0
GST (including clawback)	-85	-120	-125	-130
WFF de-indexation	0	0	0	0
WFF Integrity Measures	0	0	0	0
Company tax 28%	-30	-410	-375	-395
Building Depreciation (all buildings)	0	-35	-35	-35
Depreciation Loading (with grandfathering)	-5	-15	-15	-15
LAQCs (incl. closing remission loophole)	0	0	0	0
Thin Cap 60%	0	-15	-15	-15
Depreciation - capital contributions	0	0	0	0
Tobacco Excise	160	170	160	150
5 year Brightline Test (grandfathered)	0	0	10	30
GST Phoenix Schemes	15	60	60	60
Increase Totalisator Duty on Racing	10	50	50	50
Contingency	0	0	0	0
Net revenue compared to base package	***400***	***170***	***235***	***230***

Other issues for consideration

79. Reducing personal tax rates and any company tax rate cut raises transitional issues. Firstly, a question arises as to whether the provisional tax uplift percentage should be reduced. This would affect the timing of costs over the forecast period although, other than financing costs of deferred revenue, revenue costs would eventually net to zero. The revenue profile over the forecast period of reducing the provisional tax uplift (by 5%) in relation to individuals is as follows:

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

80. In addition, if the company tax rate were cut, there is a question as to whether relief in terms of an imputation crediting window should be provided. Officials note that the preliminary cost of grandparenting the 30/70 imputation crediting ratio for two years has an estimated total revenue cost over the forecast period of approximately $120 million.

81. Officials will report further on these issues shortly.

Estimate of range of administration costings

82. The following table summaries the indicative implementation (excluding a communications campaign) and on-going administrative costs for the package of tax measures under consideration, including the flow on impacts to depreciation and capital charge.

	$m				
	2009/10	**2010/11**	**2011/12**	**2012/13**	**2013/14 and out years**
Total Capital impact	**0.441**	**6.083**	**0.963**	**0.265**	**-**
Total Operating impact	**0.593**	**5.315**	**2.831**	**3.746**	**3.434**

83. Further work is still being undertaken to refine the overall administrative and on-going costs such as the communication strategy. Depending on the communication approach taken, the cost of a communication campaign could be between $400,000 and $4 million. A separate paper will be submitted to you outlining options and the corresponding administration cost for your consideration. The final implementation and on-going costs (including the communication strategy) will be available in the final Cabinet paper.

84. Inland Revenue will endeavour to self-fund both the capital and operating impacts in 2009/10 through efficiency savings achieved during the year.

85. In addition, Inland Revenue is able to commit to self fund additional operating costs of $3 million per year from 2010/11 onwards to support the Budget 2010 package. This equates to $13 million of additional operating expenditure over the 5 year period considered in the table above. This will be achieved through Inland Revenue initiatives that will drive ongoing value for money delivery. Operating funding will need to be sought if total Budget 2010 package costs are higher than $3m in any one year.

86. Given existing capital constraints Inland Revenue will need to seek capital funding for impacts relating to Budget 2010 in 2010/11 and out years.

Timing of decisions and announcements

87. The next Ministers' sub-group on tax meets on 22 March 2010 to consider:

- compensation for an increase in GST;
- company tax rates;
- other sundry policy issues (including provisional tax and imputation crediting); and
- composition of the final tax package.

88. The sub-group then meets on 29 March 2010 to confirm a final tax package, and will thereafter develop a Cabinet paper for final Cabinet decisions on 12 April 2010. Budget 2010 is scheduled to be delivered on 20 May 2010.

Appendix 1 – summary of key base-broadening and integrity measures

The table below summarises the key base-broadening and integrity measures preliminarily agreed for inclusion in the Budget 2010 tax package. Further summarised descriptions follow of the main tax and welfare broadening base-measures already considered in previous reporting on potential components of a tax package.

Key base-broadening measures preliminarily agreed for Budget 2010 tax package

Depreciation on buildings	• Agreed that tax depreciation should be removed from all buildings with an estimated useful life of 50 years or more. • Agreed that this change should apply to both existing buildings and newly acquired buildings.
Depreciation loading	• Agreed that the 20% depreciation loading should be removed. • Agreed that this change should only apply to new assets.
Capital contributions	• Agreed that taxpayers should not be able to claim depreciation for costs where a capital contribution has been received.
LAQCs	• Agreed that an announcement be made in Budget 2010 that LAQCs will be taxed like flow-through entities, similar to limited partnerships.
Thin capitalisation	• Agreed that the 75% safe harbour thin capitalisation rule be reduced to 60%.
WFF indexation	• Agreed that indexation of the WFF tax credit abatement threshold be removed.
WFF integrity	• Agreed that investment losses should be excluded when calculating WFF. • Agreed that an announcement be made in Budget 2010 that a review to address integrity concerns relating to WFF tax credits will be undertaken.
Savings vehicles	• Agreed that the top PIE tax rate should not be changed as part of Budget 2010. • Agreed that PIE rates below 30% should be reduced to reflect any reductions made to corresponding personal income tax rates.

Changes in depreciation rules

Changes being considered include removing depreciation from buildings where empirical evidence suggests they do not decline in value, and removing the 20% depreciation loading that currently applies to certain assets.

Depreciation of buildings

Existing law provides a depreciation allowance for the cost of a building used to earn taxable income over its estimated useful life. The estimated useful life of a building is generally 50 years. There are shorter life estimates for a number of other classes of building (for example barns, chemical works, dairy sheds and fowl houses).

Overall, officials consider that there is a strong case for the removal of depreciation on residential buildings, a less strong but reasonable case for removing depreciation on commercial property and a weaker case for doing so on industrial buildings.

Key decisions on depreciation of buildings

- That tax depreciation should be removed from all buildings with an estimated useful life of 50 years or more.
- That the change should apply to both existing buildings and newly acquired buildings.
- That the current treatment of gains and losses on buildings should be retained.

Depreciation loading

Depreciation loading applies to all new plant and equipment, and accelerates depreciation of an asset by 20%. It does not apply to some types of assets, including buildings, second-hand assets and intangible property. Loading was originally introduced as an incentive for capital investment.

Key decisions on depreciation loading

- That the 20% depreciation loading should be removed.
- That the loading should be removed only in respect of new assets.

Capital contributions

Currently, taxpayers can claim depreciation on assets at a value that is gross of capital contributions. A capital contribution is a capital payment to a person compensating them for undertaking some work or service. The current treatment allows taxpayers to claim depreciation for costs that they have not, in fact, incurred.

Key decision on capital contributions

- That the cost of a depreciable asset be reduced by the amount of any capital contribution so that taxpayers cannot claim depreciation for costs they have not in fact incurred.

Other property tax base broadening measures and issues

Other potential measures to address tax base integrity issues include:

- Moving Loss Attributing Qualifying Companies (LAQCs) to a tax treatment that is consistent with limited partnerships.
- Introducing ring-fencing rules to prevent losses on rental property being used to offset tax on other income.
- Introducing a bright-line test to clarify when gains on assets such as property are taxable.

LAQCs

There are significant problems with the current LAQC rules:

- Profits are taxed at the company tax rate (30 percent), but any losses can be allowed as a deduction at the shareholder's marginal tax rate (up to 38 percent). This disparity creates arbitrage opportunities and raises a number of issues around tax base integrity.
- An LAQC shareholder can deduct losses in excess of their equity in the LAQC.
- A loophole in the LAQC rules allows shareholders to claim losses and then avoid personal liability for the company's tax where remission income arises.

Officials have recommended making qualifying companies (QCs) and LAQCs full flow-through entities for income tax purposes, similar to limited partnerships.

Key decision on LAQCs

- That an announcement should be made in Budget 2010 that LAQCs will become flow-through entities for income tax purposes, similar to limited partnerships.

Ring-fencing of rental property losses

Under current law, a loss arising from a rental property investment is able to be offset against other income of the taxpayer. This reduces the tax payable on any other income earned. Ring-fencing rental housing losses would limit the offset of such losses in any given year to the net income earned from rental housing investments.

Key decision on ring-fencing of rental property losses

- That officials should undertake further work on the ring-fencing of losses (Inland Revenue considers that the disadvantages of ring-fencing outweigh the advantages, while Treasury considers that further work may be worthy of consideration after the Budget).

Capital / revenue boundary

The distinction between capital and revenue can be important, particularly given the absence of a general capital gains tax in New Zealand. Distinguishing between capital and revenue in any particular case is a subjective exercise. This creates complexity and uncertainty, which in turn creates compliance costs for taxpayers and cause challenges for audit and enforcement work. The question is whether a time-based test would help to address these problems.

Key decision on the capital / revenue boundary

- Whether a time-based test should be introduced for disposals of property to clarify the boundary between capital and revenue. Officials do not consider that a time-based test using a short period is desirable. Inland Revenue also considers that a lengthy time-based test (say, 10 years) would raise much the same issues as a general capital gains tax.

Note, the Treasury-preferred tax package option discussed earlier in this report includes a bright-line test as one of the base-broadening measures.

Thin capitalisation changes

The inbound thin capitalisation (interest allocation) rules applying to the NZ operations of foreign multinationals limit the scope for foreign multinationals to reduce taxable profits by over-allocating debt to New Zealand. Interest deductions are disallowed to the extent that the debt-percentage (essentially, the debt-to-asset ratio) of the NZ group exceeds a 75% "safe harbour" and also exceeds 110% of the worldwide group's debt percentage.

Overall, New Zealand's current 75% safe harbour is not inconsistent with that of other countries. A 60% safe harbour would be low by international standards but may nevertheless be justified. A 50% safe harbour would be well below international norms.

Key decision on thin capitalisation changes

- That the 75% safe harbour in the inbound thin capitalisation rules applying to the NZ operations of foreign multinationals should be reduced to 60%.

Removing indexation of abatement threshold for Working for Families tax credits

Existing law requires that both the amount of the Family Tax Credit and the income threshold at which Working for Families (WFF) tax credits begin to abate be adjusted for inflation. This ensures that the real value of assistance is maintained over time. However, it results in a double benefit for those above the abatement threshold.

Officials have recommended removing the indexation of the WFF tax credits abatement threshold only, which would not affect families with incomes below the current threshold.

Key decision on removing indexation of abatement threshold for WFF tax credits

- That indexation of the WFF tax credits abatement threshold ($36, 827) should be removed as part of Budget 2010.

Working for Families integrity issues

The TWG noted integrity concerns with respect to Working for Families (WFF) due to the ability of taxpayers to artificially lower their incomes and qualify for WFF payments. Some families have structured their financial affairs with an effect that they receive more WFF tax credits than they would in the absence of these arrangements and beyond what their true economic circumstances justify. A review that addresses integrity concerns relating to WFF tax credits could help to determine the appropriate measure of income, from an integrity perspective, for determining WFF tax credits.

Key decisions on Working for Families integrity issues

- That a review to address integrity concerns relating to WFF tax credits should be announced as part of Budget 2010, with a view to developing comprehensive solutions for legislation potentially as early as 2011.
- That initial WFF changes that exclude investment losses (such as losses from rental properties) should be enacted as part of Budget night legislation (Treasury recommendation).

Tax rates for savings vehicles

Portfolio investment entities (PIEs) are an optional set of tax rules for managed funds and other collective investment vehicles. The PIE rules were introduced in October 2007 to coincide with the launch of KiwiSaver.

The PIE rules are designed to reduce investment distortions by making the tax rules for managed funds more consistent with the tax treatment that would apply if the underlying investments were held directly.

Key decisions on tax rates for savings vehicles

- That the top PIE tax rate should not be increased as part of Budget 2010 (instead, officials would report to Ministers after the Budget with further advice).
- That, if reductions are made to personal tax rates below 30%, the PIE rates below 30% should be reduced accordingly.