Date: 10 December 2007 SH-13-3-0

To: Office of the Minister of Finance

From: Tax Strategy, Treasury

## Practical Implications of introducing a tax change on 1 October 2008

The purpose of this note is to explore the practical implications of a 1 October 2008 implementation date, particularly in comparison to a 1 April 2009 implementation date.

A general caveat on this note is that this is based on Treasury knowledge of the tax administration system. We would advise testing this thinking with IRD officials prior to taking final decisions as there may be further implications we have not covered.

### Summary

- Tax rates and/or threshold changes introduced mid-tax year require[1] the use of backdated composite rates to be legislated over the entire tax year.

- Composite rates will lead to greater discrepancies across all forms of withholding rates (PAYE, RWT on interest, FBT) resulting in increased filing and administration for IRD, and perceived winners and losers depending on the proportionality of income earned before or after the tax change.

- Given IRD lead times (past experience suggests 3 months from when the legislation is passed until implementation), a 1 October 2008 start date would require Budget night legislation under urgency.

- IRD will need to make changes to IT systems, forms and guides, all of which should be accommodated in the 3-month lead time, though this will come with a price tag and it may compete with other IT programmes IRD are implementing (KiwiSaver and the Student Loan rebuild).

- We recommend including IRD into discussions (to confirm points made in this note) at the earliest possible convenience.

[1] An alternative could be to split the income tax year into two six-month periods though this would not be recommended given administrative complexity.

*Composite rates of taxation*

Although tax is withheld throughout the tax year, an individual's actual tax obligation is based on income earned on an annual basis. In a year where the tax schedule does not change and taxpayers' wages and salaries remain constant over the year, the PAYE system is very accurate at withholding the correct amount of tax.

Adjusting the tax schedule part way through the year, say on 1 October, would require either:

- Splitting the income tax year into two six-month periods with different tax schedules and filing obligations for each. Given the administrative complexity this would not be recommended and is not discussed further in this note.
- the use of composite rates for the entire tax year in which the schedule change is implemented. This would be the recommended approach.

Any discrepancy (under or over) can be reconciled with IRD at the end of the year via the issuing of a personal tax summary (PTS). IRD automatically sends PTS's to individuals who are most likely to have a discrepancy e.g. Working for Families recipients, Student Loan payers who are eligible for an interest write-off and those on wrong or special tax codes. In addition those who earn interest or dividends greater than $200 at a withholding rate lower than their marginal rate must request a PTS.

The PAYE system in the composite tax rate year will be less accurate leading to more people needing to reconcile with IRD at the end of the year. This will lead to more request for PTS's – particularly from those who earn proportionately more in the first half of the year and are therefore have an incentive to claim their refund.

To illustrate the use of composite rates, consider a 4 percentage point reduction in the 39% tax threshold for income between $60,000 and $80,000, implemented on 1 October 2008. Employers will switch tax schedules on 1 October 2008 to ensure income earned in the $60,000 - $80,000 band is taxed at 35%. However, the way this would be legislated is for a backdated (to 1 April 2008) composite rate (in this case 37%) to be imposed. This unwinds the following year when all income between $60,000 and $80,000 in the 2008/09 year is taxed at 35%.

| 2006/07 tax year | | 2007/08 tax year | | 2008/09 tax year | |
|---|---|---|---|---|---|
| Rate | Threshold | Rate | Threshold | Rate | Threshold |
| 19.5% | $0 - $38k | 19.5% | $0 - $38k | 19.5% | $0 - $38k |
| 33% | $38 - $60k | 33% | $38 - $60k | 33% | $38 - $60k |
| 39% | $60k+ | **37%** | **$60 - $80k** | 35% | $60 - $80k |
| | | 39% | $80k+ | 39% | $80k+ |

The use of composite rate rates can result in perceived winners and losers. Perceived losers will be those who earn proportionately more of their annual earnings in the second half of the year. PAYE will under-withhold versus the composite rate (as some income will face an end-of-year tax liability of 37% instead of 35%). Taxpayers who earn more in the first half of the year will be in the reverse position, i.e. over-withheld and due a tax refund. This may lead to claims that incorrect withholding in the part-years should not generate tax liabilities. However, the reality is that tax rates are typically set on an annual basis and composite rates are used to "average" the tax change effect over the year.

Composite rates can become quite complex if both rates and thresholds change. For example, increasing the $9.5k and $38k threshold and lowering the 15% and 19.5% rates would produce 4 new composite rates. Irrespective of whether LIR is kept or abolished, composite LIR and LIR abatement rates would be required.

In order to remove the LIR mid year, the 15% effective tax rate would need to be repealed retrospectively from 1 April 2008 and replaced with a composite rate of 7.5% in the range a zero tax rate would apply. Other composite tax rates may need to apply where there are new thresholds or new rates.

Despite the apparent complexity, the composite rate approach was used for the 1 October 1996 and 1 October 1998 personal tax cuts, and appeared to cause little public comment at the time. IRD systems now aim to minimise filing obligations. The full implications of this change cannot be fully worked through until we consult IRD on implementation issues. Treasury would expect IRD to seek additional funding during the Budget to process these additional claims. This would need to be assessed on its merits at the time.

*Provisional taxes*

A standard provisional tax payer will make their first provisional tax payment for the 2008/09 year by 7 July 2008. By then they will be able to estimate their tax using the composite rates. For a non-standard filer (these are a minority) they may have already made a payment prior to the Budget announcement. In these instances they will be able to offset this over payment against future instalments. No one should be in a penalty position given taxes are being reduced (so only overpayments can occur).

Consideration will need to be given to the *uplift* factor that is applied to provisional tax. This is currently set at 105% of the previous year's tax liability. Arguably, with tax rates falling or thresholds increasing, this uplift factor would need to be adjusted down. The calculation for this would need to be computed one the detailed tax changes is known.

*Resident Withholding Tax on Interest*

Banks will need to apply two sets of withholding rates throughout the year (pre and post 1 October) in a similar way that employers will need to operate two sets of tax tables throughout the year.

There will be additional compliance with banks needing to contact customers to determine whether they need to move to alternative withholding rates. However, this would need to be done irrespective of whether the tax changes are implemented on 1 October 2008 or 1 April 2009.

There may also be IT issues for banks. For instance, when the company tax rate was reduced, consideration was given to introducing an additional RWT rate on interest. One factor in not proceeding with the new RWT was that banks' IT systems were not readily available to make such changes. This issue isn't specific to implementing the change mid-tax year.

As previously mentioned, a taxpayer must request a PTS if they have received more than $200 of interest at a withholding rate less than the withholding rate they should have been using. Given the nature of the tax changes (i.e people are likely to either stay at their current marginal rate or have a reduction in their marginal rate), any movement is in the same direction. Hence to the extent that taxpayers do not comply

with requests from their bank to elect new withholding rates, they are likely to be over taxed. One would expect compliance to be very high given it results in less tax to be withheld. Those who do not comply with their bank and are over taxed will be able to reconcile this with IRD at the end of the year by requesting a personal tax summary.

*PIE rules*

Not all PIEs are traditional managed funds. There are different categories of PIEs. The two main categories are Portfolio Listed Companies and Portfolio Tax Rate Entities (PTREs). Portfolio Listed Companies are taxed like companies and pay dividends that are excluded income. These PIEs would not be affected by personal tax rate changes. PTREs are the types of PIEs that attribute income and apply tax at the investors' tax rates. These would be affected by personal tax rate changes.

Most PTREs are either daily attributors or quarterly attributors. They determine tax on a daily or quarterly basis respectively. These PTREs could apply the new tax rates from a particular date, such as 1 October 2008.

The other category of PTRE is a PTRE that pays provisional tax at a composite tax rate and makes adjustments to investors' accounts at the end of the year. This is the smallest in number of PIEs and are generally superannuation funds that don't want to attribute daily or quarterly. For this smallest category of PIE it may be simplest to apply the new full-year rate for the entire transitional year.

Note that the 30% top PIE rate would not change but perhaps the income threshold at which an investor must use the 30% rate may increase. The lower rate is 19.5%. Whether this rate should change or whether there should be more rates (such as nil for investors with total income below a tax-free rate) may be further considered when the shape of personal tax rate changes is more developed.

*Fringe Benefit rates*

In most cases FBT is filed quarterly and given 1 October is the start of a new quarter, the old rates can be used for the quarters up to 1 October and the new rates used thereafter.

For small payers of FBT, who file annually, this could become very complex depending on the number of new composite rates (i.e. there could be several different FBT rates across small income bands). In this situation it would be worthwhile considering granting a concession to allow these taxpayers to use the lower rates for the full tax year rather than persevering with the complexities composite rates would introduce.

*Legislative issues*

Past experience indicates that Inland Revenue requires a lead time of approximately 3 months to implement tax changes after legislation is passed. Assuming a 1 October implementation date, any legislation would need to be passed by 1 July 2008. Assuming any tax changes would not be communicated until Budget day 2008 (assumed to be 22 May 2008) this only leaves 5-6 weeks before the legislation would need to be passed and therefore insufficient time for a select committee process. This timing lends itself to introducing Budget night legislation under urgency.

Assuming that changes would need to be made to both the Income Tax Act and the Social Security Act (to deal with any consequential flow-ons to benefits and or

supplementary assistance rates/thresholds), an omnibus Bill would need to be introduced under standing order 264(a).

There are two precedents for this in recent times. In Budget 2004 the Working for Families legislation was introduced under urgency and was passed before the weekend. This precedent is very similar to the situation the government may face with the current tax change situation in that it is likely to affect the same Acts.

The other precedent is the KiwiSaver legislation in Budget 2007 where one piece of legislation was done under urgency and another piece went through the select committee phase.

The other practicalities to bear in mind are:

- Given the legislation is under urgency then the Bill needs to be introduced in a 3rd reading state. There will be no select committee phase so no opportunity to make any changes to the wording. This lends itself to very clear drafting and perfect quality assurance.
- Legislation writers will need to be coordinated as IRD have their own drafters while any changes to the Social Security Act will be drafted by PCO.

*Inland Revenue systems issues*

We are unable to provide substantial comment on the IRD system changes required, or the lead time necessary, to make the changes without being able to talk with IRD. However, we anticipate there would be some system changes required and, like all changes made to the IRD IT system, this will be accompanied by a substantial bid for additional funding. IRD system changes are typically costly, usually due to the number of systems required to change, the time it takes to make changes (long testing timeframes are required) and scarcity of IT specialists with knowledge of IRD systems.

We also note that IRD are already undertaking substantial system changes at the moment with the KiwiSaver implementation. IRD have also recently submitted their stage 2 business case for the Student Loan IT rebuild, which, if successful in Budget 2008, will be started in July 2008. These projects will compete for IRD IT resource and our current view is that IRD IT capacity is already at full stretch until early 2009. We will also need to discuss with IRD how these changes would affect the e-filing tools that IRD are continually encouraging.

*Inland Revenue forms and documentation*

Again we would need to have substantive discussions with IRD about their requirements in this area. However, changing any rates and/or thresholds will result in new forms and documents needing to be developed and rolled out. IRD should be able to accommodate this within the three month lead time between when the legislation is passed and implementation date. However, past experience with the department would suggest that changing documentation fields is more difficult than would be apparent at first inspection.

Many forms (such as the IR 3 return and the associated guidance material) will not be required until year end (31 March 2009). Again we can expect IRD to seek additional funding for this.