Inland Revenue
Te Tari Taake

POLICY ADVICE DIVISION

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: Personal tax cuts - consequential amendments

Date:	4 April 2008	**Priority:**	**High**
Security Level:		**Report No:**	T2008/575 PAD2008/083

Action sought

	Action Sought	**Deadline**
Minister of Finance	Agree to recommendations	Wednesday, 9 April 2008
Associate Minister of Finance (Hon Trevor Mallard)	None	
Minister of Revenue	Agree to recommendations	Wednesday, 9 April 2008

Contact for telephone discussion (if required)

Name	**Position**	**Telephone**
[Privacy]	Inland Revenue	**[Privacy]**
[Privacy]	The Treasury	**[Privacy]**

4 April 2008

Minister of Finance
Minister of Revenue
cc: Associate Minister of Finance (Hon Trevor Mallard)

Personal tax cuts - consequential amendments

Executive summary

This report seeks your agreement to a number of consequential amendments to the Income Tax Act and Tax Administration Act resulting from proposed tax cut package.

It has been indicated that these changes are likely to take effect from 1 April 2009, but may be brought forward to 1 October 2008. Each start date would require a different set of consequential changes. This report covers both sets of possible changes.

The main policy issue concerns what the PIE tax rate structure should be under the new personal tax rate structure. *[information deleted in order to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials]*

The remainder of the consequential changes are largely mechanical in nature.

This report also highlights the administrative and cost implications that arise for Inland Revenue under a 1 October 2008 start date and a 1 April 2009 start date. Issues such as the need for composite tax rates for the 2008/09 tax year, greater customer contacts due to increased tax returns and requests for personal tax summaries and provisional tax changes mean that a 1 October 2008 start date has significantly greater administrative and cost implications for Inland Revenue. In addition, delivering the changes by 1 October 2008 will present the need for Inland Revenue to adjust its current work programme.

Recommended action

It is recommended that you:

Composite rates

(a) **Agree** that if a 1 October 2008 start date is chosen, composite income tax rates are adopted for the 2008-09 income year which would reflect a blended average of the 2007-08 income year rates and the 2009-10 income year rates (treating the 2007-08 income year rates as if it had 15% and 21% marginal rates instead of a 19.5% rate and a low-income rebate).

Agreed / Not agreed Agreed / Not agreed

Low income rebate

(b) **Agree** to remove the low income tax rebate as it will be superseded by the new personal tax rate structure (if a 1 October 2008 start date is chosen the low income rebate would be removed from 1 April 2008).

Agreed / Not agreed Agreed / Not agreed

PAYE rates

(c) **Agree** that PAYE withholding rates are adjusted downwards from the date the tax cuts begin (including from 1 October 2008 if that is the intended start date for the tax rate reductions).

Agreed / Not agreed Agreed / Not agreed

Resident withholding tax (RWT) on interest

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

Portfolio investment entity (PIE) tax rates

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

Provisional tax

(h) **Agree** that from the 2009-10 income year, the standard uplift that would otherwise apply to calculate provisional tax instalments should be reduced as if the tax cut had applied to the whole of the previous tax year; a similar approach would be used for taxpayers using the GST ratio method to pay provisional tax. A similar approach would also apply to the 2010-11 and 2011-12 income years.

Agreed / Not agreed Agreed / Not agreed

(i) **Agree** that if a 1 October 2008 start date is chosen, the figure on which provisional tax instalments are based should be reduced by the dollar amount of the maximum tax cut that a person earning $70,000 would receive as if the 2008-09 blended tax rate scale applied to the prior income year on which the uplift amount is determined.

Agreed / Not agreed Agreed / Not agreed

ACC attendant care

(j) **Agree** to change the amount of tax withheld by ACC on attendant care payments to 12.5% to reflect the new bottom income tax rate from the start date of the tax rate cuts.

Agreed / Not agreed Agreed / Not agreed

Minimum family tax credit (MFTC)

(k) **Agree** that the MFTC not be increased as part of the tax cuts package as it will be reviewed later in the year.

Agreed / Not agreed Agreed / Not agreed

Maori authority tax rate

(l) **Agree** that the 19.5% tax rate that applies to Maori authorities remain unchanged until officials complete a review of what the appropriate rate should be.

Agreed / Not agreed Agreed / Not agreed

Fringe benefit tax (FBT)

(m) **Agree** that the rates and thresholds that apply for the FBT square-up calculation be adjusted to reflect the tax cut package.

Agreed / Not agreed Agreed / Not agreed

(n) **Agree** that if a 1 October 2008 start date is chosen composite FBT rates be used for the transitional year.

Agreed / Not agreed Agreed / Not agreed

Other consequential changes

(o) **Agree** to amend Income Tax Act provisions relating to secondary tax codes, extra pay amounts, fund withdrawal tax, retirement scheme contribution tax and the child rebate to reflect the new personal tax rate structure.

Agreed / Not agreed Agreed / Not agreed

(p) **Agree** to other amendments to the Income Tax Act of a mechanical nature that are necessary to reflect the new personal tax rate structure.

Agreed / Not agreed Agreed / Not agreed

Confirmation of annual tax rates

(q) **Agree** that the income tax rates to be confirmed for the 2008/09 tax year reflect the composite personal income tax rates that would apply for this year if a 1 October 2008 start date is chosen.

Agreed / Not agreed Agreed / Not agreed

Administration costs

(r) **Note** that the cost of implementing the tax changes by either 1 October 2008 or 1 April 2009 is:

	$ million				
	2007/08	**2008/09**	**2009/10**	**2010/11**	**2011/12 & Outyears**
1 October 2008 start date	0.502	6.914	1.498	1.860	0.535
1 April 2009 start date	0.342	1.163	1.434	1.636	0.311

Noted Noted

(s) **Note** that Inland Revenue and the Treasury have yet to assess the extent to which the costs under either scenario can be met from within Inland Revenue baselines.

Noted Noted

(t) **Note** that approval for any additional funding to meet Inland Revenue's additional administrative costs will be sought in the Cabinet paper on the personal tax cuts.

Noted Noted

Process

(u) **Agree** that Inland Revenue draft a bill to give effect to all 3 stages of the personal tax cut package for introduction on 22 May – Budget Day.

Agreed / Not agreed Agreed / Not agreed

Application to amended package

(v) Agree that if the final tax cut package differs from that described in this paper and these differences do not affect the basis on which decisions on recommendations (a) - (u) in this paper have been made, the decisions taken on recommendations (a) - (u) in this paper apply to the amended tax cut package.

Agreed / Not agreed Agreed / Not agreed

[Privacy]
for Secretary to the Treasury

[Privacy]
Inland Revenue

Hon Dr Michael Cullen
Minister of Finance

Hon Peter Dunne
Minister of Revenue

Background

1. It is proposed that the Minister of Finance will announce a package of changes to the personal tax rate structure as part of this year's Budget. It is understood that the package will be implemented over 3 years, starting with the tax year beginning 1 April 2009. This application date may be brought forward to 1 October 2008.

2. After application of the low income rebate, the current personal tax rate structure imposes marginal tax of 15% on the first $9,500 of income, 21% tax on income between $9,501 and $38,000 (producing a statutory income tax rate of 19.5% on the first $38,000 of income), 33% tax on income between $38,001 and $60,000 and 39% tax on income above $60,000.

3. This structure will be changed in three stages as follows:

- From 1 April 2009:
    - The low income rebate would be removed
    - 12.5% on income up to $15,000
    - 21% on income between $15,001 and $40,000
    - 33% on income between $40,001 and $70,000
    - 39% on income over $70,000

- From 1 April 2010:
    - 12.5% on income up to $20,000
    - 21% on income between $20,001 and $40,000
    - 33% on income between $40,001 and $75,000
    - 39% on income over $75,000

- From 1 April 2011:
    - 12.5% on income up to $25,000
    - 21% on income between $25,001 and $45,000
    - 33% on income between $45,001 and $80,000
    - 39% on income over $80,000

4. As a result of these changes a number of consequential amendments to the Income Tax Act and Tax Administration Act are required. This report seeks Ministers' agreement to these consequential changes. A 1 October 2008 start date would require a different set of consequential changes to a 1 April 2009 start date. This report covers both these sets of possible changes.

5. The changes also have administrative implications for Inland Revenue, which, differ significantly according to whether the start date is 1 October 2008 or 1 April 2009. This report highlights the administrative implications of each start date and outlines high level costings.

Main consequential changes

Composite tax rates if 1 October 2008 chosen

5. If a 1 October 2008 start date is chosen it is recommended that composite personal tax rates be applied for the 2008/09 tax year. This is because income tax rates are applied to the entire tax year. If tax rate cuts are implemented part way through a tax year the existing annual rates need to be adjusted for the whole of that year – resulting in a composite rate for the year.

6. The first stage of the proposed tax rate changes would result in 7 composite rates. Based on the low income rebate being repealed from 1 April 2008, these rates would be as follows:

- 0 - $9,500 – 13.75%
- $9,501 - $15,000 – 16.75%
- $15,001 - $38,000 – 21%
- $38,001 - $40,000 – 27%
- $40,001 - $60,000 – 33%
- $60,001 - $70,000 – 36%
- $70,000 and above – 39%

Low income rebate

7. The low income rebate is the mechanism that gives low income earners an effective 15% marginal tax rate on income up to $9500 by 'rebating' 4.5% from the 19.5% marginal tax rate. If a 1 April 2009 start date is chosen, the low income rebate would be removed as part of the structural changes to tax rates. Likewise, if a 1 October 2008 start date is chosen, it is recommended that the low income rebate be removed for the 2008/09 tax year as the composite rates mean that the effective marginal rate of 15% up to $9,500 before tax cuts have been taken into account. (It should be noted that the application of these composite rates to interest income for the entire 2008/09 tax year will result in a reduction in the tax liability for people earning interest income that have total income that is $15,000 or less.) It can be expected that a portion of these people will file tax returns to claim a refund on the excess RWT that would have been deducted.

PAYE rates

8. The most significant change resulting from the new personal tax rate structure is that the PAYE withholding rates applied by employers need to be adjusted downwards. This is the mechanism that delivers the tax rate cut to most individuals. We anticipate that the PAYE rate changes can be implemented smoothly from either 1 October 2008 or 1 April 2009. For both start dates the PAYE rates would be changed to the new proposed tax rates, rather than composite tax rates.

Resident withholding tax (RWT) on interest

9. Currently banks and other interest payers withhold RWT on interest that they pay to their customers at 19.5%, 33% or 39%. The rate that the bank applies depends on the rate that their customers elect with the bank. If a person elects a rate that is too low based on their income for the tax year and the person earns more than $200 of interest for the year, the person must return the income and pay the additional tax.

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

Portfolio investment entity (PIE) tax rates

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

Provisional tax

10. Changes to provisional tax rate rules are necessary to deliver the immediate benefit of the tax cut package to self-employed individuals. Provisional tax provides a mechanism for non-salary and wage earners (e.g. sole traders) to pay their tax in instalments throughout the year with a square-up at the end of the year. People can elect to calculate their provisional tax instalments by basing them on previous years' income tax liability plus an uplift factor.

11. If a 1 October 2008 start date is chosen it is recommended that the figure on which provisional tax instalments are based is reduced by the dollar amount of the maximum tax cut that a person earning $70,000 would receive for the remainder of the 2008/09 year ($772).

12. From 1 April 2009 it is recommended that the standard uplift that would otherwise apply to calculate provisional tax instalments be reduced as if the tax cut had applied to the whole of the previous tax year. This would mean that the provisional tax for the 2009/10 year would be based on the previous year's tax liability taking into account the tax cut. It is further recommended that this approach is adopted for future stages of the tax cut package.

13. In addition, it is recommended that a similar approach to reducing provisional tax instalments be implemented for provisional taxpayers that base their provisional tax payments on a ratio of their GST payments.

ACC attendant care

14. Tax on ACC attendant care payments is withheld by ACC at source, and attributed to the caregiver engaged by the claimant of the attendant care payment. The amount of tax withheld by ACC is 15% as this is likely to be the marginal tax rate of the caregiver. If the caregiver's marginal tax rate is more than 15% the caregiver must file a tax return at the end of the year and pay the additional tax.

15. Given that it is proposed to change the bottom tax rate to 12.5% it is recommended that the rules be amended so that ACC withholds 12.5% rather than 15%. If a 1 October 2008 start date is chosen it is recommended that the 12.5% rate should apply to payments that are made by ACC to claimants after 1 October 2008. If 1 April 2009 is chosen it is recommended that the 12.5% rate should apply to payments that are made by ACC to claimants after 1 April 2009.

Minimum family tax credit (MFTC)

16. The minimum family tax credit provides certain low income working families with a top up payment to ensure a minimum family after-tax income of $18,460. This credit is designed to ensure that working families are better off as a result of being in the workforce. This payment is reduced by a dollar for each additional dollar of after-tax family income. It follows that every dollar of additional after-tax family income received due to the tax cuts will reduce any entitlement to the MFTC by a dollar. Therefore, if the level of the MFTC is not increased as part of the tax cut package, many families that currently receive the MFTC will receive no net benefit from the tax cuts.

17. Currently the level of the MFTC is set in December each year by Order in Council with effect from 1 April the following year. Therefore, if it was considered appropriate to increase the MFTC as part of the tax cuts package, this mechanism could be used to achieve the increase with effect from 1 April 2009. However, if a 1 October 2008 start date is chosen any increase to the level of the MFTC would need to be undertaken earlier or have retrospective effect.

18. As the MFTC is reviewed annually and adjusted by Order-in-Council if warranted, we recommend that no change to MFTC be made now but the change in tax rates may be considered in its annual review which will occur later this year.

Child support implications

19. It should be noted that personal tax rate cuts will have child support implications. The living allowance (an amount of income not subject to child support obligations) for a liable parent in child support formulas is based on a gross (pre-tax) benefit. This amount will decrease to reflect the personal tax cuts, thereby increasing the amount of child support payable by the liable parent. This increase would, however, be more than offset by the tax cut.

20. Child support implications will take effect in the 2009/10 tax year if a 1 October 2008 start date is chosen, and in the 2010/11 tax year if a 1 April 2009 start date is chosen.

Maori authority tax rate

21. Currently the tax rate that applies to Maori authorities is 19.5%. This rate was chosen as, at the time, it reflected the marginal tax rate of many of the beneficiaries of Maori authorities. Beneficiaries on higher marginal tax rates that receive Maori authority distributions must pay tax on the difference.

22. From 1 April 2009, the new tax rate structure introduces a new 12.5% tax rate for income below $15,000 and replaces the 19.5% statutory tax rate with a 21% rate for income earned over $15,000. The question therefore arises whether the Maori authority rate should be consequentially changed and, if so, whether the 12.5% or 21% tax rate should apply.

23. It is recommended that officials undertake further work to determine what the appropriate Maori authority tax rate should be. This work will involve distributional analysis of the income levels of Maori authority beneficiaries. In the interim it is recommended that the 19.5% rate should remain unchanged.

Fringe benefit tax

24. Fringe benefit tax (FBT) taxes non-cash benefits provided to employees by an employer. Although the liability for FBT lies with the employer, it is economically a tax on employee remuneration and has been designed as such. Changes to personal tax rates should therefore be reflected in FBT rates. Currently the FBT rates are 49% and 64% - equivalent to the 33% and 39% personal income tax rates. Employers that use the 49% rate during the year (or the quarter if they return the tax on a quarterly basis) must attribute the fringe benefits to particular employees on different marginal tax rates at the end of the period. This provides a square-up mechanism to ensure that FBT paid reflects employees' marginal tax rates.

25. It is recommended that the rates and thresholds that apply for this square-up calculation should be adjusted to reflect the tax cut package. If a 1 October 2008 start date is chosen it will be necessary to use composite FBT rates for the transitional year.

Specified superannuation contribution withholding tax (SSCWT)

26. SSCWT is a final withholding tax on employer contributions to certain employee superannuation schemes (not including KiwiSaver or complying funds). SSCWT rates reflect the personal tax rate structure, capped at 33%. It is therefore recommended that SSCWT rates and thresholds be adjusted to reflect the new personal tax rates and thresholds.

Other consequential changes

27. The following minor mechanical changes to the Income Tax Act as a consequence of the tax cut package are also required:

- Updating the tax thresholds and applicable rates that apply in respect of:
  - secondary tax codes
  - extra pay amounts
  - fund withdrawal tax
  - retirement scheme contribution tax (RSCT)

- Amending the child rebate to reflect the new 12.5% tax rate

It is recommended that you agree to these changes.

28. It is possible that during the drafting of the bill we will become aware of further mechanical changes that are required in order to reflect the tax cut package. It is recommended that officials be given permission to make these drafting changes. If any of these changes are more than mechanical it will be specifically highlighted in the report to Ministers accompanying Cabinet Legislation paper.

Confirmation of annual tax rates

29. We recommend that you agree that the income tax rates to be confirmed for the 2008/09 tax year reflect the composite personal income tax rates that would apply for this year if 1 October 2008 start date is chosen. (In PAD2007/257 you agreed to the confirmation of annual rates based on the current basic tax rates.)

Administrative implications and costs

30. The changes have administrative implications which differ significantly according to whether the start date is 1 October 2008 or 1 April 2009. Some activities will be necessary regardless of which start date is chosen (e.g. communication activities and responding to increased call volumes).

31. The discussion below highlights the administrative implications for each start date and outlines a high level costing for each. The extent to which the costs can be met from Inland Revenue's baselines has not been assessed. Approval for any additional costs will be sought in the Cabinet paper on the personal tax cuts.

Implementation for a 1 October 2008 start date

32. In order for Inland Revenue to implement the tax cuts for a 1 October 2008 start date, the following activities will need to be undertaken:

- IT system changes – including:
    - Changing the calculation of 2008/09 provisional tax
    - Re-calculating existing 2008/09 provisional tax assessments and auto-generation of advice to customers
    - Changing the calculation of 2008/09 special tax codes
    - Re-calculating existing 2008/09 special tax codes and auto-generation of advice to customers
    - Changing the 2008/09 tax assessment rates to apply composite tax rates
    - Altering 2009/10 provisional tax calculations
    - Changing the 2010/11 and 2011/12 tax assessment rates and altering the 2011/12 and 2012/13 provisional tax calculations

- Updating various web calculators
- Auto-generating replacement tax tables for employers
- Changing the method by which the current level of MFTC is calculated

- Additional customer enquiries and personal tax summary (PTS) requests resulting from RWT transitional issue:
  - Analysis indicates approximately 130,000 individuals with income less than $15,000 will have RWT over-withheld from interest payments between 1 October 2008 and 31 March 2009. Two thirds of these individuals are superannuitants. The administrative cost of initial voice contacts, preparing and processing additional PTS requests and issuing resulting refunds is significant. In addition, these activities present some delivery risk in terms of Inland Revenue's ability to service the high customer demand over a short period of time (1 April 2009 – 30 June 2009). Such a risk is not present with a 1 April 2009 start date.
  - In addition, while it is assumed that banks and other financial institutions will be able to make the structural changes required to RWT rates from 1 April 2009, it is assumed that some people eligible to use the lower 12.5% RWT rate will fail to notify their interest payer accordingly. Such people will need to claim a refund for over-withheld RWT for the 2009/10 tax year, by requesting a PTS. The administrative cost of initial voice contacts, preparing and processing additional PTS requests and issuing resulting refunds is significant.

- Redesign of forms and publications - including:
  - Revising tax tables for employers – these must be reprinted and posted to all employers
  - Updating various publications which refer to individual tax rates

- Communicating the changes - including:
  - "Budget Special" newsletter editions
  - RWT rate campaign (communicating that people may need to request a PTS to claim RWT over-withheld between October 2008 and March 2009)
  - Direct mail to provisional taxpayers, special tax code holders
  - Direct mail to employers

- Project personnel and associated overhead costs:
  - A project team of approximately 25 FTEs is required over an 8 month period (May to December 2008) to both manage the implementation activities, and make system development changes as outlined above.

33. Delivering the tax cuts package for a 1 October 2008 start date will require Inland Revenue to reprioritise its existing work programme. This is currently being considered.

34. A high level costing for delivering the changes for a 1 October 2008 start date is outlined in the table below:

	$ million				
	2007/08	**2008/09**	**2009/10**	**2010/11**	**2011/12 & Outyears**
Operating					
One-off operating	0.340	5.644	1.048	1.048	-
Ongoing operating	0.012	0.106	0.131	0.535	0.535
Total operating	0.352	5.750	1.179	1.583	0.535
Capital					
One-off capital	0.150	1.164	0.319	0.277	-
Total	0.502	6.914	1.498	1.860	0.535

Implementation for a 1 April 2009 start date

35. In order for Inland Revenue to implement the changes for a 1 April 2009 start date, the following activities will need to be undertaken:

- <u>IT system changes – including:</u>
    - o Changing the calculation of 2009/10 (and following years) provisional tax
    - o Changing the calculation of 2009/10 (and following years) special tax codes
    - o Changing the 2010 (and 2011, 2012) tax assessment rates and altering the 2011 (and 2012, 2013) provisional tax calculations
    - o Updating various web calculators
    - o Changing the method by which the current level of MFTC is calculated

- <u>Additional customer enquiries and PTS requests resulting from taxpayers' failure to alter their RWT rate:</u>
    - o While it is assumed that banks and other financial institutions will be able to make the structural changes required to RWT rates from 1 April 2009, it is assumed that some people eligible to use the lower 12.5% RWT rate will fail to notify their interest payer accordingly. Such people could claim over-withheld RWT for the 2009/10 tax year by requesting a PTS. The administrative cost of initial voice contacts, preparing and processing additional PTS requests and issuing resulting refunds is significant.

- Redesign of forms and publications - including:
    - Updating various publications which refer to individual tax rates

- Communicating the changes - including:
    - Direct mail to employers
    - "Budget Special" newsletter editions

- Project personnel and associated overhead costs:
    - A small project team of approximately 3 FTEs is required to take specific responsibility for implementation activities, including system development, over the term of the tax cut package.

36. A high level costing for delivering the changes by 1 April 2009 has been undertaken and is outlined in the table below:

	$ million				
	2007/08	**2008/09**	**2009/10**	**2010/11**	**2011/12 & Outyears**
Operating					
One-off operating	0.286	0.657	1.048	1.048	-
Ongoing operating	0.004	0.042	0.067	0.311	0.311
Total operating	0.290	0.699	1.115	1.359	0.311
Capital					
One-off capital	0.052	0.464	0.319	0.277	-
Total	0.342	1.163	1.434	1.636	0.311

Process

37. Subject to Ministers' agreement to the recommendations in this report, officials will incorporate these recommendations in a Cabinet paper from the Minister of Finance that is due to be considered on Monday 14 April. It is recommended that the Inland Revenue draft a bill to give effect to all 3 stages of the personal tax cut package for introduction on 22 May – Budget Day.