The Treasury

Budget 2023 Tax Initiatives Information Release

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POLICY AND REGULATORY STEWARDSHIP

Tax policy report: Minimum tax – Remaining design decisions

Date:	13 February 2023	**Priority:**	High
Security level:		**Report number:**	T2023/164 IR2023/030

Action sought

	Action sought	**Deadline**
Minister of Finance	**Agree** to recommendations **Discuss** the contents of this report	18 February 2023
Minister of Revenue	**Agree** to recommendations **Discuss** the contents of this report	18 February 2023

Contact for telephone discussion (if required)

Name	**Position**	**Telephone**
Stephen Bond	Manager, The Treasury	[39]
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13 February 2023

Minister of Finance
Minister of Revenue

Tax Policy Report: Minimum tax – Remaining design decisions

Executive summary

Purpose

1. The purpose of this report is to provide you with advice on the further design decisions required to implement a minimum tax.

Context and background

2. Following initial advice in December, you have directed officials to proceed with policy work on a minimum tax and agreed to a series of preliminary design decisions. Under this regime, a person with high wealth pays tax on the greater of either their "deemed income" (calculated as a percentage of their net wealth) or the taxable income they have under existing income tax rules.

3. In this report, we seek your agreement to further design decisions in order to meet the intended Budget timeline.

Indicative revenue ranges

4. This report also contains indicative ranges for the revenue that could be raised by a minimum tax. We present figures for several different deemed income rates and net worth thresholds. These figures are preliminary, subject to high uncertainty, and are likely to differ significantly from the final fiscal costing for this policy.

5. We will report a more refined fiscal costing on 10 March, although the novelty and complexity of the minimum tax means that we will continue to refine the fiscal costing until Treasury forecasts are finalised in late March. We will provide a final fiscal cost for the minimum tax in the Cabinet paper to be lodged on 5 April 2023.

Deemed rate

6. We are not aware of any country that has introduced a minimum tax which would allow for cross-jurisdictional analysis. Accordingly, we have drawn from the analysis undertaken by the 2001 McLeod review of the New Zealand tax system which considered a "risk-free return" method (RFRM) of taxation.

7. An RFRM tax would be broadly equivalent to a comprehensive tax on capital income. A minimum tax set at the risk-free rate differs from an RFRM tax in that it imposes a higher tax on risky assets.

8. A minimum tax set above the risk-free rate of return would be broadly equivalent to a comprehensive income tax plus an additional tax on wealth (but still with a higher tax on risky assets). However, as the deemed rate increases, the higher tax on risk decreases.

9. Whether the minimum tax is set at, or higher than, the risk-free rate depends on whether you want the additional tax to apply only when economic income is being

undertaxed or whether you want to levy the minimum tax even when economic income is fully taxed. This would require trade-offs between competing objectives.

10. We will provide further advice on this on 10 March 2023 and recommend delaying decisions until then. In this report, we set out three options for setting the deemed income rate:

    10.1 *Setting the deemed income rate at the risk-free rate of return:* This is appropriate if you want the minimum tax to tax capital income similarly to a comprehensive income tax applying at personal rates. If this was chosen, at current interest rates the risk-free rate would be approximately 5%.

    10.2 *Setting a deemed income rate above a risk-free rate of return:* This would set effective tax rates on capital above personal tax rates. This option may be appropriate if you want to set rates above personal rates to increase revenue and support progressivity objectives. However, it is unlikely to be an effective way of targeting any above-average returns that wealthy individuals may be able to make.

    10.3 *Different deemed rates for different classes of investment:* For example, this option may involve a risk-free rate for government bonds and a higher deemed rate for other assets. However, a minimum tax could discourage investment in risky assets even at the risk-free rate. A higher deemed rate for risky investments would compound this investment bias further. We would therefore not recommend this option.

Mechanics of setting the risk-free rate and administration

11. If the deemed rate of return is to be a risk-free rate (or a risk-free rate plus basis points) we suggest this be set at the beginning of each tax year (that is, 31 March). We recommend the deemed rate be adjusted each year to take account of any movements in the risk-free rate.

12. We would not recommend taxing the deemed return at a rate other than the normal personal tax rates, as this could produce unusual outcomes.

Concessions for start-ups

13. You have advised that you are concerned about the application of the minimum tax to "start-up" businesses. We have assumed you are focused on businesses providing innovative products or services rather than firms "starting-up" per se.

Valuation

14. Valuing start-ups is likely to be challenging, because the value of a start-up in its early stages will mostly be comprised of investor capital and some amount of intellectual property which may be more difficult to value.

Concessions for start-ups

15. There are several reasons you may wish to exempt or defer liability on taxpayers' investments in start-ups, including that start-ups are unlikely to produce a return in their early stages (and some may never succeed). Levying the minimum tax on start-up investments could disincentivise investment and innovation in New Zealand, ultimately reducing activity and growth in the economy. Although an exemption or temporary concession could partially mitigate this risk, investment could still be affected if investors expect the minimum tax to apply in future.

16. Conversely, there are reasons for not exempting taxpayers on their investments in start-ups, including that, despite their high failure rate, start-ups have the potential to earn large non-taxable returns if successful. An exemption for start-ups could therefore undermine your revenue objectives. Extending concessionary treatment to start-ups could also distort investment decisions between start-ups and other businesses (including those also conducting similar innovative activities).

17. We do not recommend a specific exemption or deferral for start-ups as we do not believe it would be practical to administer. Problems of definition include identifying a start-up and determining when it reaches maturity (i.e., ceases to be a start-up). However, we have offered our view on designing concessions for start-ups if you wish to pursue them.

Deferral and cashflow

18. A deferral mechanism would recognise the difficulty that some taxpayers will have in meeting a deemed minimum tax liability that accrued in advance of cash receipts from the asset. This mechanism could provide relief for taxpayers and/or certain asset classes.

19. However, there are significant issues associated with a deferral mechanism, which is why officials recommend against introducing one. A deferral mechanism would need to operate (at least partially) at an individual asset level and would involve significant complexity. An alternative would be to defer calculating and paying tax for all assets of a particular class, so that tax only became payable if the asset was sold for a gain in the future. However, this alternative would undermine the design of the minimum tax by essentially taxing realised gains rather than deemed accrued gains. Other challenges in designing deferral rules include designing access criteria to match unique taxpayers' circumstances and a need for anti-avoidance rules.

20. A further alternative would be valuing unlisted companies at a discount below market value which could be removed as the company became successful. However, choosing a discount factor would be arbitrary and would not fully mitigate concerns where investors have no cashflow to meet the tax liability. This approach would also potentially undermine your revenue objectives more than a deferral mechanism.

Concessions for farms

21. You have requested advice on whether the net asset entry threshold should be higher for farms. We do not recommend a separate farm-specific entry criteria as it would distort investment decisions toward farming and reduce horizontal and vertical equity by creating different rules for different asset classes of the same value. A concession for farms would also create complexity in the administration of the tax.

22. However, if you wish to include a concession for farms, we have included two options for its design:

    22.1 *Capped exemption*. This would involve exempting farm assets from the minimum tax calculation unless their value exceeds a given threshold (for example, $5 million).

    22.2 *Valuation discount*. This would involve discounting the value of farm assets (net of any debt used to fund the farm) by a given percentage for the purpose of the minimum tax entry threshold (but *not* for the purpose of the deemed income calculation).

23. We have included examples of how these approaches would work. Although a capped exemption would be simpler for taxpayers to understand, it is likely to be

fiscally more expensive than the valuation discount approach and more generous for taxpayers who have relatively substantial non-farm assets. In contrast, the valuation discount is more generous to those with larger farms but relatively minor non-farm assets. Therefore, if you wish to include a concession for farms, we would recommend the valuation discount approach.

Discretion

24. You have expressed interest in a discretion to offer specific relief where the application of the minimum tax is seen as unfair through a regulation-making power. We do not recommend including a wide discretionary power within the design of the minimum tax.

25. Taxpayers expect to be able to determine their tax obligations with reference to legislation rather than through a discretionary process. Although current law offers the Minister of Revenue and the Commissioner of Inland Revenue the discretion to modify certain provisions, the circumstances under which this discretion can be exercised are limited to where there is a clear error in the legislation.

26. Including the discretion to grant relief from the imposition of tax through regulation would risk undermining the rule of law. The use of specific exemptions would avoid raising this issue and offer greater certainty to taxpayers.

27. However, if you wish to include a discretion within the legislation, we recommend this be through an Order in Council recommended by the Minister of Revenue. We would not recommend an application process for the application of this discretion as this would risk undermining the integrity of the tax. We also recommend that any discretion be time-limited.

Transitional resident exemption

28. In our 2 February report (IR2023/009; T2023/74 refers) we recommended that foreign assets owned by New Zealand residents be included in the minimum tax regime.

29. New migrants, temporary residents and some returning New Zealanders may qualify for a transitional resident exemption. The effect of the exemption is that most of a transitional resident's foreign income is not subject to income tax in New Zealand (with the exception of income derived from employment or the supply of services). This means that income derived by a transitional resident from foreign business or passive investment is exempt from New Zealand tax during the 48-month period in which the regime applies.

30. We recommend the transitional resident exemption be extended to the minimum tax. This would mean the minimum tax would not apply to foreign assets of those transitional residents during the first four years of residence. This would reduce the disincentive for high wealth individuals to come to New Zealand caused by the compliance and tax burden of this regime.

Legislative implications

31. Proposed amendments could be included in an omnibus tax bill scheduled for introduction in May 2023. Among other policy initiatives and remedial amendments, the 2023 omnibus tax bill would set the annual income tax rates for 2023–24. This means it should be passed by 31 March 2024.

32. The bill could be introduced on Budget night or shortly thereafter, with a First Reading on 30 or 31 May and subsequently referred to the Finance and Expenditure Committee for its consideration. However, as the House will rise at the end of

August 2023 ahead of the General Election on 14 October 2023, the select committee process would not be completed before the election.

Next steps

33. We expect to send our next reports on the minimum tax on 2 March (for any outstanding issues) and 10 March. Along with an overall policy assessment of the tax, advice on administrative impacts, including design, implementation and operational costs and implications of this work for IR's work programme and capacity will be detailed in the 10 March report. This initiative will need to be considered as part of the wider policy work programme to mitigate potential deliverability risks.

Recommended action

We recommend that you:

a) **discuss** this report with officials at the Joint Ministers meeting on 16 February.

Noted Noted

Start-ups

b) **agree** not to proceed with a specific deferral or exemption for start-up businesses *(officials' recommended option)*.

Agreed/not agreed Agreed/not agreed

OR

c) **agree** to proceed with a specific exemption for start-up businesses

Agreed/not agreed Agreed/not agreed

OR

d) **agree** to proceed with a specific deferral regime for start-up businesses

Agreed/not agreed Agreed/not agreed

Deferral and cashflow

e) **agree** not to proceed with a general deferral mechanism *(officials' preferred option)*

Agreed/not agreed Agreed/not agreed

OR

f) **agree** to a discounted valuation method for certain businesses *(officials' second preferred option)*

Agreed/not agreed Agreed/not agreed

OR

g) **agree** to an optional deferral mechanism based on taxpayers' specific circumstances (*not recommended)*

Agreed/not agreed Agreed/not agreed

OR

h) **agree** to a compulsory deferral mechanism for certain business assets *(not recommended)*

Agreed/not agreed Agreed/not agreed

Farms

i) **agree** not to proceed with a concession for farms (*officials' preferred option*)

Agreed/not agreed Agreed/not agreed

OR

j) **agree** to a valuation discount concession for farms (*officials' second preferred option*)

Agreed/not agreed Agreed/not agreed

OR

k) **agree** to a capped exemption concession for farms (*not recommended*)

Agreed/not agreed Agreed/not agreed

Discretion to vary the application of the minimum tax

l) **agree** not to include a general discretion to vary the application of the minimum tax (*officials' preferred option*)

Agreed/not agreed Agreed/not agreed

OR

m) **agree** to include a general discretion to vary the application of the minimum tax;

Agreed/not agreed Agreed/not agreed

If you agree to recommendation (m) to have a general discretion

n) **discuss** with officials the criteria for the discretion to apply

Noted Noted

o) **agree** to officials discussing a proposed discretion with LDAC;

Agreed/not agreed Agreed/not agreed

p) **agree** to the discretion power:

i. Being at the discretion of the Minister of Revenue;

ii. Being time-limited to three years after the year when the minimum tax is enacted;

iii. Not being subject to an application process;

iv. Being for groups of taxpayers who share specific circumstances.

Agreed/not agreed Agreed/not agreed

q) **agree** to variations made under any discretion power being time-limited to two years to enable the variation to be supported with legislation

Agreed/not agreed Agreed/not agreed

Transitional resident exemption

r) **agree** that the transitional residents' exemption be extended to the minimum tax

Agreed/not agreed Agreed/not agreed

Indicative revenue ranges for a minimum tax

s) **note** the indicative revenue ranges for a minimum tax that are provided in this report.

Noted Noted

t) **note** that these figures are preliminary, subject to high uncertainty, and are likely to differ significantly from the final fiscal costing for this policy

Noted Noted

Stephen Bond
Manager
The Treasury

Phil Whittington
Chief Economist
Inland Revenue

Hon Grant Robertson
Minister of Finance
/ /2023

Hon David Parker
Minister of Revenue
/ /2023

Minimum tax – Remaining design decisions

Purpose

34. The purpose of this report is to provide you with advice on the remaining design decisions required to implement a minimum tax.

Context and background

35. On 13 December 2022, we provided you with an initial assessment of a minimum tax for inclusion in Budget 2023 (T2022/2703; IR2022/516 refers). Under this regime, a person with high wealth would pay tax on the greater of either their 'deemed income' (calculated as a percentage of their net wealth) or the taxable income they have under existing income tax rules.

36. At the 15 December Joint Ministers meeting, you directed us to proceed with policy work on a minimum tax and agreed to a series of preliminary design decisions.

37. On 2 February 2023, we provided you with a report seeking your agreement to further design decisions (IR2023/009; T2023/74 refers).

38. We are seeking your agreement to the remaining design decisions required to meet the intended Budget timeline.

39. Table 1 outlines our proposed timeframe. Under this timeframe, decisions on a minimum tax will be made before the Budget moratorium which will mean the revenue from a minimum tax is included in Budget 2023 forecasts.

Table 1: Proposed decision-making timeframe for a minimum tax

Date	Action
2 March	Officials will report to you seeking final decisions on any outstanding issues for a minimum tax.
10 March	Officials will report to you with: • Our final views on the policy and revenue impacts of a minimum tax • Any legal risks with a minimum tax, including potential risks under Te Tiriti o te Waitangi
17 March	A draft of the Cabinet Paper and officials Regulatory Impact Assessment
5 April	Cabinet paper lodged
11 April	Cabinet decision

Deemed rate and tax rate for the minimum tax

Purpose

40. In this section we outline the key considerations and analysis for setting a deemed income rate. We also seek your agreement on the mechanics of setting a deemed rate and the tax rate that applies to any deemed income under the minimum tax.

41. The deemed income rate will be a key determinant of the overall size and impact of the minimum tax. As outlined in this section, the choice of rate is linked to your objectives for a minimum tax and desired size of impacts.

42. As a result, at this stage we are only seeking a high-level indication of your objectives and we suggest making final decisions once you have received the 10 March report. Your early discussion of your objectives will help us prepare further advice on this issue.

Analysis of a deemed rate

43. As far as we are aware, this form of minimum tax is unique, and no other countries have introduced similar rules. As a result, we have drawn from analysis of similar taxes, in particular on analysis provided by the 2001 McLeod review of the New Zealand tax system which considered a ”risk-free return” method of taxation.

44. The section below provides a summary of this analysis when applied to the proposed minimum tax. Further analysis is included Box 1 and **Appendix I**. In summary this analysis indicates that if assets are making a normal rate of return[1] then:

    44.1 **A minimum tax set at the risk-free rate of return** creates a broadly equivalent tax to a comprehensive tax on capital income but with a higher tax rate on risky assets.[2]

    44.2 **A minimum tax set above the risk-free rate of return** will mean that the tax on capital income is greater than personal tax rates. This means it is broadly equivalent to a comprehensive income tax alongside an additional tax on wealth, but still with a higher tax on risky assets. However, as the rate increases the additional tax on risk decreases (explained in Box 1 below).

45. As a result of this, a key question is whether you want the additional tax to apply only when economic income is being undertaxed or whether you want to levy the minimum tax even when economic income is being fully taxed.

46. The section below considers three options for a deemed income rate based on this analysis.

[1] This means they are earning broadly the expected market rate for the given risk level. As outlined further, some assets may earn greater returns as they earn economic rent or because the owner increased returns through their own labour effort. These concerns are outlined further in paragraphs 51 to 55.

2 One additional complexity is the treatment of inflation. The McLeod Review suggested using an inflation-adjusted risk-free rate of return. If the risk-free rate of return was 5% and inflation was 2%, the real risk-free rate of return that applied would have been approximately 3%. However, as other parts of the tax system are not adjusted for inflation and you have not suggested inflation indexation, we do not consider this further in this note. We consider using a deemed nominal rate of return without any adjustments for inflation.

Box 1: McLeod review analysis

The McLeod Review analysis is outlined in **Appendix I**. It applies to assets that are not expected to generate economic rents (i.e., returns which are higher than normal returns) and which generate only capital income (i.e., where there is no element of labour income in the returns being generated). A portfolio of listed shares and interest-bearing securities might make up such a set of assets.

In this case, the McLeod Review explains why taxing the value of this portfolio multiplied by a risk-free imputed rate at a taxpayers' normal marginal tax rates would be expected to create an equivalent tax burden to taxing the individual on their full economic income from the portfolio (including capital gains on an accrual basis). It suggested an RFRM tax as a *complete replacement* for income taxes in certain circumstances.

Taxing economic income would tend to provide a higher revenue stream on average than taxing imputed returns at a risk-free rate. This is because risky investments will, on average, earn more than a risk-free rate to compensate for risk. It might be thought that this would mean that returns would need to be imputed at more than a risk-free rate to generate an equivalent tax burden to a comprehensive tax on economic income. However, the McLeod Review points out that is unlikely to be true.

If the Government taxes full economic income and allows deductions for any economic losses, it would be sharing in any gains and any losses the portfolio generates and sharing the risk of the portfolio with the shareholder. By contrast, if it levies a tax based on an imputed return on the value of the portfolio, it is not sharing in upside or downside risk. Because of this the portfolio will become riskier for the investor (and the stream of tax revenue for the Government will be correspondingly less risky). This means that the imputed return needs to be less than the expected return on the portfolio to create the same tax on taxpayers as taxing full economic income. Setting the imputed return at a risk-free rate would ensure that a tax on imputed returns and a tax on full economic income create an equivalent tax on taxpayers.

If your key concern is that less than full economic income is often being taxed, an appropriate response might be to levy a tax on imputed returns at a risk-free rate and this tax should be levied as a complete replacement for economic income taxes rather than as a minimum tax. However, this would not always be equivalent to a tax on full economic income.

Option 1. Setting deemed income rate at risk-free rate of return

47. Setting the deemed income rate at the risk-free rate of return is appropriate if you want the minimum tax to tax capital income similarly to a comprehensive income tax applying at personal tax rates.

48. At the risk-free rate, a minimum tax will most closely resemble this comprehensive income tax, however it will have an additional tax impost on risky assets.

49. If this option was chosen, then at current interest rates this is likely to be around 5%. The current yield on one-year government stock is 4.90%. By comparison, one-year term deposits rates in Kiwibank, ANZ, ASB, BNZ, Kiwibank and Westpac vary between 5.30% and 5.45%.

Option 2. Setting deemed income rate above risk-free rate of return

50. Setting the deemed income rate above the risk-free rate would set effective tax rates on capital above personal tax rates. We consider two main rationales for this:

    50.1 If you are trying to capture the greater returns that high-wealth individuals may make above "normal returns"; or

50.2 If you want to set rates above personal rates to increase revenue and support your progressivity objectives.

Capturing higher returns

51. There is some international evidence that high-wealth individuals can earn greater returns from their capital. For example, a widely-cited recent academic paper has found evidence from Norway that the wealthy may generate much higher returns on their capital than the less wealthy especially in the case of private businesses.[3] It finds variance in rates of return which it describes as very large for returns to private businesses, intermediate for housing and more contained for debt and financial wealth (including returns on domestic and foreign listed shares).[4]

52. Setting the deemed income rate above the risk-free rate would result in some increased taxation of these greater returns.

53. However, we do not consider it an effective way of targeting these returns. This is because the minimum tax is likely to apply more frequently the smaller are economic rents and the smaller are expected taxable returns. This is because the minimum tax only applies when taxable income is less than the deemed return and economic rents are likely to make taxable income larger. Thus, higher deemed rates are likely to be most burdensome when there are little or no taxable economic rents.

54. In addition, the higher returns earned by high-wealth individuals are likely to vary significantly. In contrast, a deemed income rate needs to be set at a single rate across the affected population.

55. For example, at times private businesses may earn economic rents by generating a 10% rate of return on their capital when the hurdle rate of return is lower than this. At other times they may earn economic rents by generating a 100% rate of return on their capital. A broad tax on capital income including taxation of capital gains is a natural way of attempting to tax economic rents. Tax would be higher when capital income (including any capital gains) is higher. But it is hard to take account of economic rents through a higher tax rate on deemed returns. Pushing up the deemed return above the risk-free rate is unlikely to get close to taxing the very high returns that some high-wealth entrepreneurs derive. It will also be increasing tax even when assets end up generating losses.

Increasing revenue and progressivity

56. An alternative rationale for taxing capital at higher than personal tax rates may be to achieve your revenue and distributional objectives.

57. This would be similar in rationale and effect to introducing a net wealth tax in addition to a comprehensive income tax. As a result, similar considerations as those which apply to net wealth taxes would also apply.

58. There have been calls for net wealth taxes in New Zealand and internationally. Some have argued that wealth may confer benefits which are over and above income and it may be sensible to tax wealth even if economic income is being fully taxed.[5] If two people have the same economic income but one has greater wealth, the wealthier person will have greater resources to draw on. Wealth can provide benefits of its own including social status, power, greater opportunities and insurance

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[3] See, Fagereng, Guiso, Malacrino and Pistaferri, 2020, 'Heterogeneity and persistence in returns to wealth', *Econometrica*, Vol. 88, No.1, January, 115-170.
[4] See, Fagereng et al., p. 118.
[5] See, for example, OECD, 2018, 'The role and design of net wealth taxes in the OECD', OECD tax policy series, no. 26, p. 53.

against unexpected future needs. It provides the ability to earn income without sacrificing leisure.

59. In addition to having a higher tax on wealth, setting a deemed income rate above the risk-free rate of return reduces the bias a minimum tax creates against risk. This is explained further in Box 2 below. However, these impacts vary across investment types, returns, and riskiness of assets – and so while it is true in a general sense that a higher deemed rate would reduce some of these biases towards risk, it would not be possible to set a rate that did not create any unintended consequences for some investment choices.

Box 2: How a higher deemed rate reduces biases against risks
Suppose, for example, that the minimum tax deemed rate is 8%, which is greater than the risk-free rate of 5%. For someone investing $100 in riskless assets, the individual would earn $5 of income but be taxed on $8.

The higher deemed rate would also be increasing the tax paid on risky investments. But it would only be doing this when tax is levied on deemed returns, not when tax is being levied under ordinary rules. This means that the higher deemed rate will do *less* to push up tax on risky investments than on riskless investments. This will be reducing the relative penalty in investing in risky relative to riskless investments.

In our report of 13 December 2022, we mistakenly said that a higher deemed rate would increase biases against risk. As this box outlines, the opposite is true. The bias against risk is caused by the deemed rate being a *minimum* tax, not by the rate itself being high.

Overall judgement on higher than risk-free rates

60. If you wish to consider a minimum tax at a rate higher than a risk-free rate, the appropriate rate requires trade-offs between the government's revenue and distributional objectives against the efficiency and integrity costs of a minimum tax.

61. We provided our initial advice on these trade-offs in December and we will provide updated advice on March 10.

62. Because the trade-offs for the deemed rate primarily depend on the overall size of these costs and benefits we recommend that you make decisions alongside our updated advice on the size of these in the 10 March report.

Option 3. Different deemed rates for different classes of investment

63. We have also considered the option of having different deemed rates for different assets. For example, it might be possible to set the deemed rate at the risk-free rate for low-risk investments such as government bonds and bank deposits and set a higher deemed rate for other assets. This would reduce potential criticisms about the deemed rate being greater than the interest rate that is being earned on low-risk securities.

64. However, this leaves open the question of how to choose the deemed rate for other assets. One option may be to set a higher deemed rate to tie in with expected returns on risky assets. But, as the McLeod Review has analysed, this can involve a higher tax burden on risky assets than under a comprehensive income tax because the government is levying a tax based on an expected risky return without absorbing any of the risk of the investment.

65. As we discussed earlier, levying a minimum tax at a risk-free rate can already involve a tax bias discouraging investment in risky assets. This bias would be compounded if a higher deemed rate of return were applied to risky investments.

For this reason, we recommend against this option. Different rates for different types of investment would also add to the complexity of the tax rules.

66. Related to this issue is the question of how the deemed rate would interact with the *fair dividend rate* regime that deems income of 5% of the opening value of foreign shares. If the deemed rate is set higher than this 5%, it raises the question of why 5% is an appropriate rate on foreign shares for taxpayers not subject to the minimum tax regime but wealthy taxpayers are deemed to have a higher rate of income.

Conclusion

67. Of the three options, we recommend against Option 3 as it appears to create the greatest risk distortions.

68. Choosing between Options 1 or 2 will ultimately depend on your objectives:

- If you wish to have a minimum tax but also want to minimise any cases where this results in a higher tax burden than would be imposed by a comprehensive income tax, Option 1 would be the recommended choice.

- If, however, you wish to set rates above the risk-free rate, we recommend deferring final decisions on the deemed rate until you make decisions on the tax package as a whole considering revenue, economic, and distributional objectives together.

Mechanics of setting the deemed rate

69. If the deemed rate of return is to be a risk-free interest rate or a risk-free rate plus a number of basis points, we suggest that Inland Revenue sets this rate at the beginning of each tax year (i.e. 31 March) basing this on government debt with a one-year term to maturity.

70. We recommend that the deemed rate be adjusted each year to take account of any movements in the risk-free rate. This will mean that the tax will have a similar burden on wealth through time as interest rates change.

Tax rate

71. You have asked for advice about the most appropriate tax rates to levy. We recommend using existing individual income tax rates.

72. If the goal is to levy tax as much as possible on the basis of ability to pay, it is helpful to measure income as well as we can and then tax different forms of income at the same rates. This will generally promote both fairness and economic efficiency.

73. Taxing the deemed return at other than the normal rate of income tax could do some odd things. Suppose, for example, that the minimum deemed income is $500,000 and this is taxed at a rate of 33% which would lead to a tax liability of $165,000. Suppose that actual taxable income under normal income tax rules is $450,000 and this is taxed at a rate of 39% leading to a potential tax liability of $175,500. The minimum deemed income is $500,000 which is bigger than $450,000 so the minimum deemed tax would apply. However, this would result in less tax being paid.

Practical issues in considering exemptions from the new rules

74. This report discusses possible exemptions or concessions from the minimum tax for a number of policy, compliance, or hardship reasons.

75. For all of these issues we are recommending against the concessions and instead maintaining a broad base for the minimum tax. This is primarily because these concessions will cut across the objectives of the minimum tax. They will reduce revenue, vertical equity and result in uneven taxation among those affected. In addition, these concessions will be complex and are likely to increase compliance costs, create integrity risks, and potentially create arbitrary boundaries.

76. Like our broader tax settings, there can be policy reasons for targeted concessions where there are strong non-revenue reasons. However, in each of the situations considered in this report, we think there are strong reasons to avoid this in order to meet the goals of the minimum tax and minimise the costs of it.

Start-ups

77. You have told us you are concerned about the application of the minimum tax to start-up businesses. We discuss issues with the definition of a "start-up" below. However, for the purposes of this report we have assumed that you are focused on businesses undertaking innovation where products or markets are uncertain (rather than any business which is "starting up", *per se*). Examples of successful businesses which commenced as start-ups are Rocketlab or Xero.

Valuation

78. Valuing a start-up in its early stage is likely to prove challenging. This is because the value of the business in its early stages is likely to consist almost solely of investor capital which will be drawn down as it is used to develop intellectual property and bring the company's offerings to market. The value of the start-up may grow as the "idea" or potential market gains traction.

79. While a start-up's income-earning potential may be high, there is also a significant risk of loss, and estimating or forecasting potential gains if successful is very speculative. Accordingly, jurisdictions that attempt to value start-ups for estate taxes or wealth taxes generally allow conservative methods which do not take into account future earnings, such as using book value. Using a similar valuation method could help reduce start-up owners' minimum tax liabilities (although with more than $100 million sometimes invested, even conservative methods could still result in high minimum tax liabilities). This would assist owners of start-ups, who are unlikely to receive distributions for a long period of time before the start-up becomes viable (if it succeeds). It would also mitigate the need for investors to sell part of their investment to fund a minimum tax liability.

Why you may want to defer or exempt start-ups from the minimum tax

80. There are several reasons why you may wish to consider exempting or deferring application of the minimum tax to start-up businesses.

Lack of cashflow to pay the minimum tax

81. Generally, start-up businesses begin with a small group of entrepreneurs who raise capital from investors to monetise a new product or service. Investor capital is drawn down until the business becomes self-sufficient, or else requires further capital to continue development.

82. In its initial stages, the business will be focused not on immediate financial gains but on the development of a product, process and market. During this time, the actual return from the start-up will be zero if not negative (although the value of the business may be high based on the future prospects of the business).

83. During this phase it is unlikely the business or the owners will realise financial gains from the investment. However, the minimum tax would apply to deem a certain return on that investment. Ultimately that return may result once the start-up becomes a viable business, but until that time it may seem unfair to apply tax on a deemed return where none has been produced.

High risk of failure

84. In addition, many start-ups will fail and the investors will incur an economic loss. However, under the minimum tax they will be taxed as if they had made gains. This outcome could also be seen as unfair to investors in failed start-ups. This outcome (of paying tax under the minimum tax even though an investment fails) will also occur for a wider range of assets than just start-ups.

85. A deferral or exemption may minimise the risk of the minimum tax reducing investment in innovative start-ups. If investment in these innovative start-ups was to reduce, it would likely have a negative impact on encouraging innovation and limit New Zealand's productivity.

86. Such a concession would be unlikely to fully mitigate this risk. Investors would know that a new business would still be liable for the minimum tax when it ceased to meet the definition of a start-up. This means that the risk of the minimum tax applying in future years would still factor into decisions on whether to make an initial investment in a start-up, even if the minimum tax will not apply in the early years of the investment.

Why you may not want to allow deferral or exemption for start-ups

87. Equally, there are several reasons you may not want to defer or exempt the application of the minimum tax on start-ups. These are primarily equity issues.

Support objectives of minimum tax

88. The primary reason for having no concession is that applying the minimum tax to start-ups meets the main policy objective. A concession for start-ups would reduce revenue and progressivity. In addition, it would cut across the objective of reducing under-taxation as start-ups, although they do entail a high risk of loss, have the potential to earn large non-taxable returns if they are successful.

Horizontal equity between start-ups and other investments

89. The application of the minimum tax between a small business and a start-up should be similar otherwise the tax treatment may result in more investment made into start-ups versus other small businesses to an extent which may not be good for the economy as a whole.

Allocative efficiency for investment decisions

90. A further efficiency issue arises between start-up businesses and established larger businesses which are also innovating and investing in similar ideas as part of their ongoing operations. Providing a concession to the smaller start-up that is not

available to larger established businesses produces a further distortion that may result in less investment by larger firms in these innovative projects.[6]

Implementation issues

91. Aside from our concerns around the equity of a specific concession for start-ups there are several implementation issues that we consider would make any concession unworkable at worst or uncertain at best.

What is a start-up?

92. There is currently no single definition of a start-up used in New Zealand or overseas[7] although most people understand that there is a distinct difference between a start-up and a business "starting up".

93. One important distinction is that unlike most new small businesses who can simply follow an existing, well established, business model such as a retail shop or trade business, start-ups often operate in areas where there is no established business model and these tend to be in the technology sector.

94. One definition of a start-up is "a new small business, searching for a repeatable and scalable business model, aiming for exponential growth, often with angel or venture capital investment"[8]. As can be seen this is a particular subjective definition which is likely to create significant boundary issues and uncertainty.

95. A more specific definition could point to some other New Zealand government support for the start-up industry such as the receipt of funding from the Callaghan Innovation or a business that receives funding under the research and development tax incentive. Although these would be imperfect measures, they could be indicators of the innovative businesses to whom the Government wishes to offer a concession.

96. Tax concessions are already received by a number of established businesses who are simply undertaking innovative projects. Accordingly, a definition of "start-up" based on those funding programmes could make a minimum tax concession too wide.

When does a start-up cease to be a start-up?

97. Even more problematic than defining a start-up is determining when a start-up matures and ceases to be a start-up (that is, when the concession ends). There is no real boundary to when this occurs, and the test is very subjective. In most cases, this does not matter, but when assessing a deferral or exemption where tax liabilities will be incurred, any subjectiveness in the boundary will create uncertainty and disputes.

98. It would be extremely difficult to clearly define when a start-up matures and even more so to articulate that in legislation. A more general deferral scheme (discussed in the next section) is unlikely to require a determination of this point in the lifecycle

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[6] Larger business may be more likely to succeed as they are more likely to have a clearer investment strategy for new ideas and products and greater ability to absorb losses.

[33]

[8] #nzentrepreneur – New Zealand's online magazine for entrepreneurs, startups and SME business builders.

Start-up or startup? And what exactly is one anyway?! – NZ Entrepreneur Magazine

of a start-up as that will have other trigger points where the deferral will cease and is more likely to be time-based.

99. A test for when a start-up ceases to be a start-up could be based on financial metrics such as positive cashflow, net profits, positive customer growth for a certain number of years. However, again these would be arbitrary and different businesses may have different trigger points. For example, a business that is attempting to gain market share over profits and cashflow may pass a customer growth test but none of the financial metrics. This means any definition would require some flexibility and therefore create uncertainty.

Recommendation

100. Because of the equity and implementation issues noted above, we do not recommend an exemption or deferral for a specific group of taxpayers which cannot be clearly defined, such as start-ups. If you still want to consider deferral mechanism this could be a more general regime which we discuss below.

101. Having a deferral or exemption for start-ups will also reduce the amount of revenue the minimum tax will generate. This revenue loss will be timing in nature for a deferral or permanent for an exemption. We are unable to estimate the potential cost of any deferral or exemption at this point. This is particularly due to the definitional issues discussed below.

102. You may also wish to factor in the landscape of existing government support programmes that are available for certain businesses (and namely start-ups). If you are concerned about impacts on certain business types, you could consider whether those impacts are (or could be) offset through government support. For example, schemes that seek to target start-ups already exist, including Callaghan Innovation's Technology Incubator Repayable Grant and NZ Growth Capital Partner's Aspire NZ Seed Fund.

103. However, if you wish to pursue a deferral or exemption for start-ups we would see these working as follows.

Mechanism – Deferral or Exemption

Deferral

104. In the next section, we cover how a more general deferral scheme could apply to deal with cashflow issues for investors in investments that do not generate sufficient cash to cover the minimum tax liability. However, under a deferral mechanism specifically for start-ups, the minimum tax liability on investments would be deferred until such a point where the business moves from the start-up phase to being an "ordinary" business.

105. The difficulties with defining what a start-up is and the point at which it ceases to be a start-up are outlined above. However, assuming those can be sufficiently defined, at the moment the start-up ceases to be a start-up, the accrued minimum tax liability for the start-up phase would become due and payable by the investor who is subject to the minimum tax.

106. The crystallisation of this liability potentially creates two issues for the investor. These are:

    106.1 *Quantum of liability:* First, once a start-up has reached maturity, the investor would be faced with a significant tax liability relating to a potentially large number of prior income years. As the minimum tax is a deemed rate of return on the value of the business, and as the value of a successful start-up could

increase significantly over a long period of time, this amount could be material, particularly if use of money interest (UOMI) is charged over the deferral period; and

106.2 *Delayed development:* The second issue relates to the start-up itself. The potential impact of a deferred minimum tax may create a perverse incentive to stay in the start-up phase rather than grow and develop into a mature business. This is like tax concessions for smaller businesses, which can incentivise those businesses to remain small rather than grow to their full potential.

Exemption

107. An alternative to a deferral approach would be to grant an exemption to start-ups, with a minimum tax liability only commencing once the start-up reaches maturity (again assuming this point can be adequately defined). An exemption would deal with the issue of failed start-ups.

108. Compared to deferral, an exemption reduce the disincentive for the start-up to exit the start-up phase and reach maturity, by avoiding the imposition of a large tax liability all at once. However, this alternative would still incentivise start-up companies to remain in their infancy to prevent a liability to minimum tax beginning to accrue. An exemption would also magnify the equity issues with other small businesses and with larger businesses undertaking similar innovative work.

109. However, an exemption will have a larger fiscal impact than a deferral as an exemption is permanent rather than a question of timing. In summary the impacts of each option are:

Table 2: Exemption deferral impacts			
	No Exemption or Deferral	**Deferral**	**Exemption**
Equal treatment with other business	Treats all businesses alike and applies the tax on the investment made	Favours investments in start-ups due to the timing advantage in paying the tax liability	Greatly favours investments in start-ups because of no tax liability accruing until "maturity"
Incentive to remain within the definition of a start-up	No incentive to remain a start-up as tax applies universally	Strong incentive to remain a start-up to continue deferral and avoid crystallisation of large tax liability	Incentive to remain a start-up to avoid application of tax liability
Cashflow impact of tax payments	Negative impact on investors over a period where the investment does not make the minimum return (but this is the same as any other investment that does not make the minimum return)	Has a positive impact on the cashflow of an investor during the deferral period but large negative impact in the year that the business "matures"	No cashflow impact until the business "matures" as no tax is payable
Failed start-ups	Requires a minimum return on failed start-ups (similar to any other investment that does not make the minimum return over the life of the investment)	No tax payable on failed start-ups	No tax payable on failed start-ups
Definitional Issues	None	Yes (unless a more general deferral is used)	Yes
Fiscal Impact	Increases tax revenue over the life of the start-up	Defers tax revenue until the business matures	No tax revenue until the business matures

110. If you want to pursue a solution specific to start-ups, we recommend the deferral option over an exemption, although there are competing considerations. While there are still fairness issues under the deferral option, if tax is deferred for a few years, this will not affect the present value of tax collections much and should not affect the present value at all if interest is charged (assuming the tax is eventually collected). By contrast, with exemption, tax is completely forgiven. The fiscal impact of a deferral is also not as large as it would be under an exemption.

111. A deferral mechanism deals with the issue of failed start-ups by only charging the minimum tax when the start-up matures into an established business. This will only occur if it succeeds and adds to the investor's ultimate wealth.

112. We cover a potential mechanism for a more general deferral regime below. Under that mechanism, deferral would apply to start-up businesses but they may not have to be separately defined as the characteristics required for deferral are likely to include the ordinary profile of a start-up (i.e. no initial profits). While this general

deferral would be a better option than a specific regime for start-ups, in the next section we note significant issues with a deferral regime overall.

Deferral and cashflow

Objectives of deferral

113. A deferral mechanism would recognise the difficulty some taxpayers will have in meeting a deemed minimum tax liability that accrued in advance of any cash receipts from their investments. This could be structured to achieve one or both of the following objectives:

   113.1 *Providing relief to individual taxpayers:* Recognising taxpayers' individual circumstances (e.g. those that hold a significant portion of illiquid assets).

   113.2 *Providing relief for certain asset classes:* Recognising assets' specific features (e.g. investments which do not generate significant cash flows for their investors).

114. Both objectives run into significant design issues. Although providing relief to individual taxpayers is likely to be the more difficult of the two, providing relief to certain asset classes is likely to generate boundary issues, require arbitrary decisions and have a relatively higher fiscal cost.

Problems with deferral

Applying the minimum tax at an asset level will be complex

115. While the overall proposals are designed to operate at a portfolio/taxpayer level, a deferral mechanism would need to (at least partially) operate at an individual asset level. This will require significantly more calculations and could come to different results depending on how (if at all) the taxable income from one high performing asset cross-subsidises a lower performing asset.

116. The two main reasons individual asset calculations are required are:

   116.1 Deferral needs to end when an individual asset is sold, making it necessary to know how much deferred tax is due to that particular asset.[9]

   116.2 Deferral would only be offered on qualifying assets. Therefore, at a minimum, calculations would need to be done on that pool of qualifying assets.

Incentives for taxpayers to not sell assets that have made a loss

117. There is no intention to refund tax paid on the deemed return from prior years if the asset is eventually sold for an amount that generates a lower return than the deemed amount. If an asset with deferred tax is sold for a low amount the person will know their deemed return will never be generated, yet will still be required to pay tax on it — as to do otherwise would put them in a better position than someone who paid without a deferral. When an asset has significantly declined in value the owner will have been offered deferral because they did not have cashflow yet will be required to pay the tax when it is known they will never have the cashflow (from that asset at least) to do so. Requiring payment when a now worthless asset is

[9] This could be removed if the deferred tax was instead payable a set time period after it was initially deferred so that there was no linkage to cashflow or ownership of the asset. However, this would also further delink the tax liability from the taxpayer's ability to pay so is not something that we would recommend.

disposed of would also incentivise people to hold these assets indefinitely to permanently defer the liability.

118. An alternative to the paragraph above would be to allow deferral of all assets of a particular class so that the tax only became payable if the asset was sold for a gain in the future. This would be a significant change to the overall principle of the rules as tax would become payable on realised gains rather than on deemed accrued gains. In this circumstance, a deemed return would likely be inappropriate as the actual return would be known and returns less than the deemed rate would not be taxable. This would also have a significant impact on the amount of revenue raised by the tax.

Use of Money Interest Rate applied to deferred tax could be perceived as unfair

119. The Use of Money Interest (UOMI) underpayment rate is proposed to increase to 10.39% from 9 May 2023. This is 2.5% higher than the Reserve Bank's floating first mortgage new customer housing rate index for December 2022. The UOMI underpayment rate is likely to be regarded as high if the Government is promoting deferral as a valid option. However, we would not recommend applying a lower rate as:

    119.1 The minimum tax is proposed to be part of income tax rather than a separate tax. The system changes to operate different interest rates would be significant.

    119.2 While officials and the government have agreed that the UOMI underpayment rate is appropriate as it is currently calculated,[10] some external stakeholders consider it to be too high. Offering a lower rate for deferred tax is likely to increase pressure to review the UOMI rate from stakeholders and risks the sustainability of the longstanding UOMI calculation method.

[10] This is because it reflects the unknown and variable credit quality of individual taxpayers and that not paying tax should not be considered a funding source. The second of these does not apply to an official deferral scheme.

Other significant complexities in designing a deferral regime

120. Deferral based on taxpayer circumstances should be difficult to qualify for and discretionary so that few taxpayers are able to take it up. To do otherwise would significantly limit the revenue in any particular year. However, designing a deferral regime creates significant complexities which we outlined in Box 3 below.

Box 3: Complexities in designing a deferral regime

- Shareholders of companies in loss may be the least able to pay tax on the deemed return; however, it would be inappropriate for all companies in loss to defer it, so complex rules would be required.
- Individual taxpayers' circumstances will be significantly different so it would be very difficult to design qualification criteria that allowed deferral only where the person genuinely cannot afford to pay without deferral.
- When a person no longer qualifies for deferral, rules will be required to calculate payment of deferred tax from previous years. It would be inappropriate to allow deferral in all circumstances until the asset is disposed of, which could be deferred indefinitely.
- Anti-avoidance rules would be necessary to stop people restructuring to make them eligible for deferral without impacting their total wealth.
- Specific rules would be required where the taxpayer or asset ceases to be within the rules (for example their wealth drops below the entrance threshold) but is still owned by the taxpayer.
- As the rules will only apply to New Zealand residents, rules will be required for taxpayers who migrate. Once a person has left New Zealand these rules will be difficult to enforce and could encourage people to migrate to effectively default on a significant tax liability. While this may already happen, it could potentially be a larger issue with a deemed minimum tax as a multi-year deferral over assets that are not otherwise in the tax base can result in a large deferred tax liability relative to a taxpayer's typical single year tax liability.
- If a person transfers an asset that has a deferred tax liability to someone else they still may not have the cash to pay the deferred tax liability. Rules could be designed so the tax liability could also be transferred to the new owner but these would be complex and a departure from normal treatment.
- A mechanism for partial repayment of deferred tax upon partial sale of an asset will be required. Separate rules will be required for sale of all of an asset. It may be difficult to determine when all of an asset has been sold (for example, restructuring within a group, different classes of shares or retaining a nominal interest to defeat the intent of the rules).
- Tax liability can arise for a settlor of a trust for assets owned by that trust. Rules will be required for changes in the amount that can be deferred based on ownership of assets by that trust. These ownership changes may have no impact on the ability of the settlor to pay the deferred tax.

Existing mechanisms

121. There are a variety of mechanisms already available for taxpayers who cannot immediately pay a tax liability. As the deemed return is to be integrated into Income Tax, these would apply without further changes. The following methods are available, noting that some may not be available or considered acceptable by individual taxpayers:

    121.1 Using available cash reserves (for example, within a bank account or as a distribution from investments is received).

    121.2 Sale of assets, which may be divisible (for example, portfolio holdings of listed shares) or non-divisible (for example, land).

    121.3 Commercial borrowing (for example, extending an existing revolving credit facility).

    121.4 Use of tax pooling. Tax pooling involves buying tax with a historic effective date to meet a past liability. Tax pools offer financing to borrow money at the time the tax is needed – essentially a variation of the commercial borrowing above.

    121.5 Entering into an instalment agreement with Inland Revenue (which will incur UOMI).

122. A taxpayer not using one of these methods will have outstanding debt which will trigger enforcement action including late payment penalties and UOMI.

Recommendation

123. Given the significant design issues associated with designing a deferral regime and the fact that there are existing mechanisms available to assist taxpayers who cannot immediately pay a tax liability, we recommend against a deferral regime.

Valuation rules as alternative support

124. If you consider the existing mechanisms above would place undue hardship on owners of companies while they were developing, we recommend providing a discount factor on the valuation of companies. This could place a valuation below the market range that would otherwise apply. Such rules could apply to all unlisted companies, although this could have a material impact on revenue from the proposals. If it were to apply to a subset of companies, we would not recommend limiting this based on the age of the company as that would encourage existing businesses to be reformed into new companies. Instead, potential criteria could include:

    124.1 The company is unlisted and has a limited number of shareholders (potentially using the existing close company definition).

    124.2 The company has an insufficient history of profits such that a valuation cannot be undertaken as a function of recent or historical profits.[11]

125. Anti-avoidance rules may be needed to prevent one business being split into multiple companies where one or more qualify when they would not if considered collectively.

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[11] Rules would need to exclude companies that were or could be profitable but the company valuation was higher based on realisable assets. For example, a company that mostly held real property and the value of the company was determined by the value of that property rather than the potential net rental income.

126. The advantage of a discount factor for uncertain valuations is if a company became successful the discount factor would automatically disappear. There would also be no catchup of previous periods which would significantly reduce the complexity of the rules.

127. The disadvantage of a discount factor are that it would undermine your objectives for the minimum tax. In particular, valuation discounts are likely to have disproportionate revenue impacts compared with many other options.[12] A discount would also necessarily be arbitrary and would leave an, albeit smaller, tax liability that the owner may still be unable to meet. It would also distort investment decisions.

Farms

128. This section provides advice on whether the net assets entry threshold should be higher for farms.

129. We recommend not proceeding with a separate farm-specific entry threshold for the following reasons, based on the standard tax policy criteria:

    129.1 **Revenue:** A concession for farms would undermine the Government's stated objectives of raising revenue in a progressive manner.

    129.2 **Efficiency:** It would distort investment towards farming in a way that would reduce allocative efficiency.

    129.3 **Fairness:** It would create horizontal equity issues, as different rules would apply to different assets. It would also undermine the vertical equity of the tax. For example, it could mean that a person with $6 million in shares and commercial rental property is subject to the minimum tax rules while a farmer with a farm worth $6 million is not subject to the rules.

    129.4 **Integrity and simplicity:** It would distort investment incentives and decisions and increase the complexity of the rules. This may lead to unintended and perverse outcomes, and potentially undermine the integrity of the tax.

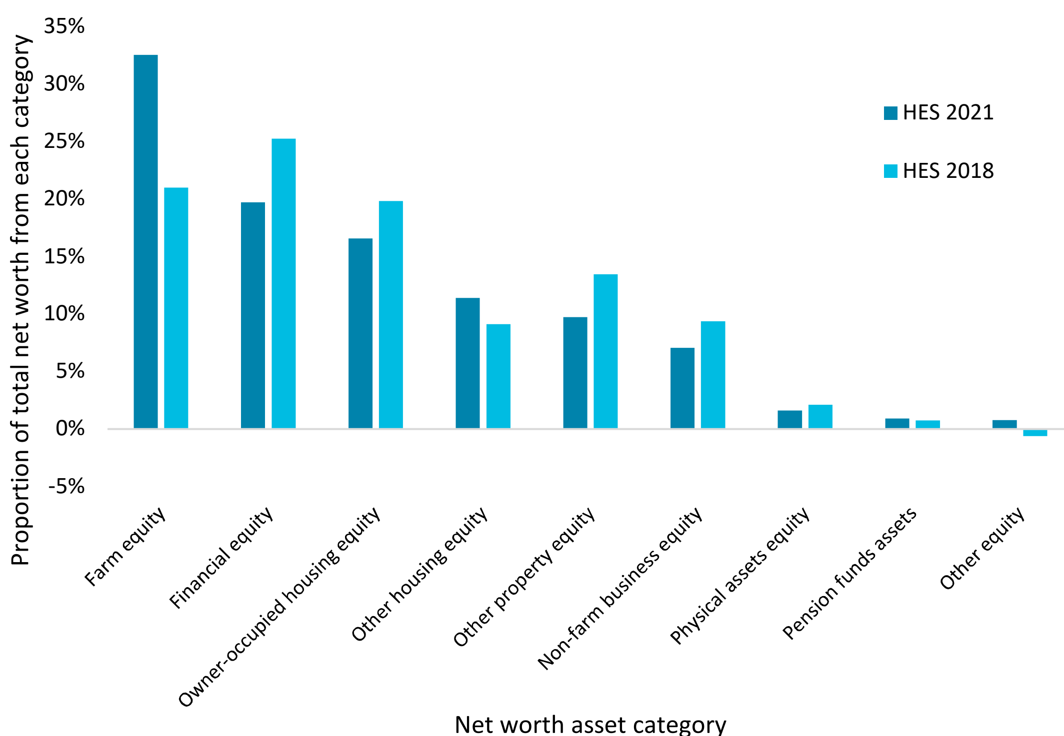
130. Additional detail on these reasons is provided below.

Revenue

131. Figure 1 below, which is based on Household Economic Survey (HES) data for 2018 and 2021, shows that wealthier households tend to hold a significant proportion of their assets in farms (over 30 percent in 2021). Although there is high uncertainty in these numbers it indicates that a significant portion of the minimum tax asset base is farms.

[12] This arises because valuation discounts would reduce the wealth and deemed income for a minimum tax but leave the taxable income that can be offset against deemed income unchanged. As a result it reduces revenue by more than the amount of discount.

Figure 1: Composition of family net worth for those with over $5 million according to HES 2018 and 2021



Note. This is based on the HES which will not be representative of the very top incomes or wealth of the population.

132. Financial statements data held by Inland Revenue for the 2021 year suggests there are approximately 3,760 farming entities[13] that have net assets above $5 million, out of a total of around 50,000 entities for whom a completed IR10 was found. The table below provides a breakdown of the number of farming entities identified with net assets over $5 million across different entity types.

Table 3: Breakdown of farming entities with net assets over $5 million in 2021			
	$5m to $10m	**$10m+**	**Total**
Companies	950	500	1,450
Individuals	240	60	300
Trusts	540	210	750
Partnerships	900	250	1,160
Other	40	60	100
Total	2,670	1,090	3,760

[13] "Farming entities" are those with an Australian and New Zealand Standard Industrial Classification (ANZSIC) code of A01 (Agriculture). The A01 classification covers primary industries such as nursery and floriculture production, mushroom and vegetable growing, fruit and tree nut growing, beef cattle and grain farming, growing of other crops, dairy farming, and other forms of livestock farming such as sheep, poultry, deer, horse and pig farming and beekeeping.

133. Note that caution should be taken with the above numbers as the value of farmers' assets and liabilities (of which land is a large component) for the most part do not affect their tax positions, and so the accuracy of asset and debt values reported by taxpayers in IR10 forms has not been verified. It is also possible that some farms are not represented in the data which may bias the results, as not all entities file an IR10 (or file an IR10 with their assets and liabilities disclosed).

Efficiency

134. A separate entry threshold specific to farms may incentivise people to own farms over other assets, which could reduce the effectiveness of the minimum tax and reduce allocative efficiency. Obviously, the higher a farm-specific threshold is, the greater the incentive and opportunity for these decisions.

135. However, limiting such a concession to only those farms that are owner-operated would reduce the opportunities for wealthy taxpayers to reallocate their investment portfolios into farmland, as it would ensure that any additional investment in farmland is part of an owner-operated farming activity (as opposed to the farm being separately operated by a tenant farmer).

Integrity and simplicity

136. Tax concessions by their nature create incentives and opportunities for taxpayers to arrange their affairs in a such a way to avoid tax. In this instance, a concession for farms could encourage high net worth families to bundle their assets into farms. It would also increase the complexity of the minimum tax.

137. The UK's experience with farming concessions shows how such concessions can lead to tax planning and provide a windfall for wealthy landowners. In the UK, concessions specific to agriculture provide relief from inheritance tax, which is aimed at encouraging the transfer and continuity of agricultural businesses between family members. Rollover relief rules under the UK's capital gains tax allow the sale of farmland to be rolled over into a new business, thus deferring capital gains tax until the sale of the new asset. Agricultural land and associated buildings used for production are also exempt from local body rates. These concessions generally apply regardless of whether the farm is owner-operated or operated by a tenant farmer, although the relief from inheritance tax is less generous if the land is tenanted under a long-term lease as opposed to being owner-occupied. Such concessions have reportedly contributed to speculation on farmland and land banking amidst a backdrop of rising land prices.[14]

Design of a farm concession

138. If you wish to proceed with a concession for farms, our recommendation would be to limit it to owner-operated farms and have the minimum tax apply to larger farms, for instance, those worth over $10 million.

139. Two possible options for how such a concession could be designed are:

    139.1 _Capped exemption:_ Farm assets are exempt unless their net value exceeds a given threshold, for example, $5 million. If the farmer has other assets with a value in excess of $5 million, they would pay minimum tax if their deemed income from those assets exceeds their taxable income. Farm assets, however, would not be included in their assets when calculating their deemed income, provided their total value is below the cap. If total farm assets are above the cap, the entry threshold would be met and the full value

[14] See, for example: https://www.theguardian.com/society/2015/sep/02/britain-farmland-tax-haven-reform.

of farm assets would be added to other assets for the purposes calculating deemed income.

139.2 *Valuation discount:* The value of farm assets (less any debt used to acquire the farm) is discounted by a given percentage up to a certain value but only for the purpose of the entry threshold, not the deemed income calculation. For example, the value of farm assets might be discounted by 50 percent if it is less than $10 million, then added to the full value of other assets for the purposes of comparison against the entry threshold. If the entry threshold is exceeded, the full value of total assets is used to calculate deemed income.

140. Examples 1 to 3 below illustrate how each of these options would work.

Example 1: $4m farm, $1.5m other assets

Assume that farms with a net value below $5 million are exempt from the minimum tax . Above $5 million, the entry threshold is always met and the full value of the farm is added to other assets for the purposes of calculating deemed income.

Andrew owns and operates a sheep farm with a net value of $4 million and has $1.5 million in shares (total $5.5 million in net assets). As the farm is worth less than $5 million, it is not added to the shares to determine whether Andrew’s assets exceed the entry threshold (note that if Andrew’s shares exceed the entry threshold, the farm is also excluded from the deemed income calculation). As the shares are worth less than the $5 million entry threshold, Andrew is not subject to the minimum tax.

If a farm valuation discount of 50 percent applied up to a value of $10 million, instead of a farm exemption capped at $5 million, adding the discounted value of the farm ($2 million) to the $1.5 million in shares would give $3.5 million which is below the $5 million entry threshold. Andrew would not be subject to the minimum tax under either the capped exemption or valuation approach.

Example 2: $6m farm, $1.5m other assets

Assume that the net value of a farm is discounted by 50 percent, but only for the purpose of the $5 million entry threshold. If the entry threshold is exceeded, the full value of the taxpayer’s total assets is used to calculate their deemed income.

Ben owns and operates a dairy farm with a net value of $6 million and has $1.5 million in shares and bonds. Adding the discounted value of the farm ($3 million) to the $1.5 million in other assets gives $4.5 million which is below the entry threshold. Ben is therefore not subject to the minimum tax.

If instead there was a farm exemption capped at $5 million, Ben would be subject to the minimum tax. The farm exemption would not apply as the net value of the farm exceeds the cap, and the combined net value of his net assets ($7.5 million) would be above the entry threshold. Ben would then calculate his deemed income on his entire $7.5 million of net assets.

Example 3: $4m farm, $4m other assets

Assume that a farm exemption capped at $5 million applies, and that the entry threshold is $5 million.

Caroline is the owner and operator of a beef cattle farm with a net value of $4 million and investment property with a net value of $4 million (total $8 million in net assets). As the farm is worth less than $5 million, it is not added to the investment property to determine whether Caroline's assets exceed the entry threshold. As Caroline's net assets excluding the farm are worth less than the $5 million entry threshold, Caroline is not subject to the minimum tax.

If a farm valuation discount of 50 percent applied instead, adding the discounted value of the farm ($2 million) to the $4 million in investment property would give $6 million which exceeds the entry threshold. Caroline would therefore be subject to the minimum tax. She would then calculate her deemed income based on her entire $8 million of net assets.

141. As can be seen from Examples 2 and 3 above, a capped exemption is more generous for taxpayers who have relatively substantial non-farm assets (as in Example 3), while a 50 percent valuation discount is more generous to those with larger farms but relatively minor non-farm assets (as in Example 2).

142. A capped exemption would likely be simpler for taxpayers to understand and comply with. If the exemption applies, the value of farm assets is excluded both for the purposes of the entry threshold and for the deemed income calculation. However, this is more concessionary and therefore may be more expensive fiscally than the valuation discount approach. Under the valuation discount approach, if the entry threshold is exceeded then farm assets are always included in the deemed income calculation at their full value.

143. The valuation discount approach may make more sense if the purpose of a concession is to reduce compliance costs for smaller farmers associated with having to calculate their deemed income and compare it against their taxable income from their assets. If the farmer is above the entry threshold and has to pay minimum tax anyway, there does not seem to be much point in reducing their tax liability by excluding their farm assets from the deemed income calculation as would occur under the exemption approach.

144. On balance, we recommend the valuation discount approach if you wish to proceed with a concession for farms. If you prefer the capped exemption approach, we would recommend a lower threshold such as $5 million to keep the concession as tightly defined and small as possible. Our primary recommendation however is no concession at all.

Interaction with family home exemption

145. For farmers that are subject to the minimum tax regime, we recommend that apportionment between a farmhouse and the rest of the farm be required in instances where the farmhouse is used as the taxpayer's family home. There are existing apportionment rules that could be applied in this context which would provide a reasonable basis for excluding the value of a family home situated on a farm both for the purposes of the entry threshold and calculating deemed income.

Discretion to vary the application of the minimum tax

146. In our earlier report (T2022/2703, IR2022/516 refers) we advised against a general discretion to exempt or modify the application of the minimum tax. Instead, we advised that specific exemptions be incorporated into the legislation if you want to provide some form of specific relief.

147. We understand that you are still interested in a broader discretion and have asked us for further advice on a discretion to vary the application of the minimum tax to allow for situations where its application is seen as unfair, particularly where the situation was not considered due to time constraints in designing and implementing the minimum tax. This discretion could be time-limited and sit with the Minister of Revenue or the Commissioner of Inland Revenue.

148. As advised in our previous report we do not advise using a discretionary power because of the uncertainty it creates and the potentially very wide discretion it delegates to whomever is exercising the discretion. Taxpayers generally expect that they can determine their tax obligations by referring to legislation passed by Parliament, rather than through a discretionary process. We advised that any discretionary power would need to be carefully worked through with the Legislative Design Advisory Committee ("LDAC").

149. Using exemptions rather than a discretionary power provides more certainty and may lead to fewer disputes if the criteria for the exemptions are clearly defined. However, we understand you prefer using regulations to deal with the situations where you may want to modify the application of the minimum tax. Specifically, these will be situations where the application of the minimum tax was not contemplated and may be seen as unfair.

Discretionary power in existing tax law

150. There are current powers that provide some discretionary powers. Box 4 below provides further information on these.

Box 4: Discretionary powers in existing tax law

The Tax Administration Act 1994 ("TAA") allows the Minister of Revenue or the Commissioner to modify the application, or exempt a person from a provision, of the Inland Revenue Acts where there is a clear error in the legislation. The Commissioner can also vary procedural or administrative provisions of the Inland Revenue Acts when COVID-19 issues make those impractical. Two of these relate to what are termed "remedial powers" which are used to correct obvious errors in the legislation. These have yet to be used.

There have also been variation powers to deal with issues that arose from the Business Transformation (BT) programme and the existence of two computer systems. These latter two powers have been used in the limited circumstances they were designed to be used in.

Such override powers are sometimes referred to as "Henry VIII" clauses and are seen as objectionable on "rule of law" grounds. As a fundamental point, laws including tax laws should not be able to be changed by regulation, even if temporarily. When the general remedial powers were introduced, they were pulled from the original bill due to concerns raised by LDAC.

They were finally enacted in a later bill with several restrictions on the use of the provisions added. Those restrictions include it being optional for the taxpayer to apply the modification and a six-week consultation process prior to the modification being made. Modifications made under the provisions only last for two years and must be confirmed by legislation if Parliament wishes to make the modification permanent. We would expect significant opposition to a regulation-making power being included as part of the minimum tax.

The criteria for one of these current powers are strictly defined and only permit the Minister of Revenue to recommend a variation where they are satisfied that the modification:

- is necessary to remedy or mitigate an obvious error, give effect to the provision's intended purpose, resolve ambiguity, or reconcile an inconsistency; and
- does not materially affect the intended scope of the provisions to which it applies; and
- is not inconsistent with the intended purpose of the provisions; and
- is the most appropriate way of addressing the issue at the time; and
- is not broader than is reasonably necessary to address the issue; and
- does not need to be applied by a person to which it may apply (i.e. is optional); and
- has been subject a six-week consultative process (unless the Minister dispenses with that requirement); and
- does not have the effect of extending an existing modification.

151. The next sections set out reasons for and against a discretionary power.

Why you would consider having a discretion

152. Due to the speed at which the minimum tax will be designed and implemented, there are likely to be situations where it will apply in ways that Parliament did not intend.

153. A regulation-making power is a fast and efficient way of making changes to primary legislation to ensure that the minimum tax will apply in accordance with its policy intent. It provides permanent or temporary certainty for taxpayers as to how the minimum tax will apply to that situation. Regulations can be reasonably quickly implemented and, potentially, followed up by legislation.

Why you would not have a discretion

154. There are three reasons why we consider a discretion to deal with unwanted outcomes of the minimum tax is undesirable.

Uncertainty

155. The first relates to the uncertainty that the power creates. One of the fundamentals of good legislation, and particularly tax legislation, is that it provides certainty to taxpayers to ensure that they are clear on the liability they incur. An ability to vary that application can create uncertainty for taxpayers as to how the minimum tax may apply to them and to others.

Inability to have strict criteria

156. Secondly, the criteria for how the discretion may apply are paramount to the workability of the discretion. The question is then: if you can determine the criteria with enough precision to enable a discretion then why could those criteria not form part of an exemption which provides more certainty?

157. As outlined above in Box 4, current discretions are strictly defined. In the instance of the minimum tax it is less likely that the criteria could be defined as it is not known — even in general terms — in what circumstances the impact of the tax will lead to unintended consequences.

Rule of law concerns

158. The nature of the discretion is such that it will need to be more flexible than existing discretions in tax law and hence is more likely to run contrary to the rule of law (see Box 4).

159. A discretion for a minimum tax would modify the application of the minimum tax in circumstances where the outcome was not envisaged at the time the rules were enacted and the result does not accord with the policy intent of the tax (rather than the limited scope of correcting something that is an obvious error or inconsistency). In the case of the minimum tax, this would be a significant extension of what is currently in legislation.

160. The more general the power the more likely it is to be considered a Henry VIII clause and contrary to the rule of law. We are unsure if you have any circumstances where you consider a modification might apply but, as previously advised, specific concerns are better dealt with through exemptions. This is because these avoid the rule of law issues and provide greater certainty to taxpayers.

161. More general cases would be better dealt with by legislative amendment. These amendments could be retrospective in nature. Given the frequency of tax bills to enable the correction of deficient legislation, unlike other areas of government and other countries, tax legislation can be put through the legislative process reasonably quickly (including under urgency). We therefore recommend that legislative amendment be the process relied on, rather than secondary legislation. There are no rule of law issues with primary legislation.

162. Although we recommend against a discretion, the next section outlines how a discretion might be designed if you continue to prefer a regulation-making power.

How a discretion might be designed

Who would have the discretion?

163. Of the remedial powers in the TAA, one sits with the Commissioner and the other with the Minister of Revenue[15]. The former is a variation made without an Order in Council while the second uses the Order in Council process (which requires approval of the Executive Council). However, both variations can ultimately be rejected by Parliament.

164. A discretionary power under the minimum tax would be different than the current remedial powers as it will in effect be altering the liability to tax that is not as a result of an error or inconsistency but rather because the resulting liability is not seen as consistent with the original intent of the tax due to that impact not being identified prior to introduction.

165. This would suggest that that power is a matter for government rather than the tax administrator. We would therefore recommend that, if you wish to have a discretion, it should follow an Order in Council process recommended by the Minister of Revenue.

Potential criteria for a discretion

166. As noted, the criteria for any discretion will need to be worked through with LDAC. However, to meet your objectives for the discretion we consider some criteria could be that the discretion could apply where the Minister is satisfied that:

    166.1 the application of the minimum tax results in an unintended outcome that is contrary to the purpose and policy intent of the rules; and

    166.2 the application of the minimum tax was not foreseen or contemplated in the design of the minimum tax; and

    166.3 the variation:

        166.3.1 does not materially affect the intended scope of the minimum tax; and

        166.3.2 is not inconsistent with the intended purpose of the minimum tax[16]; and

        166.3.3 is not broader than is reasonably necessary to address the issue; and

        166.3.4 does not need to be applied by a person to which it may apply; and

        166.3.5 does not increase the liability of a person to the minimum tax; and

        166.3.6 is subject to a 6-week consultative process (unless the Minister dispenses with that requirement); and

        166.3.7 does not have the effect of extending an existing variation.

167. We suggest any variations be subject to time limits, whereby:

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[15] COVID-19 variations sit with the Commissioner.

[16] This would require a purpose section within the legislation and clear outline of the intent behind the minimum tax to identify those cases outside that intent.

167.1 Any variation would need to be made within three years of the enactment of the tax (i.e. the power to make variations would only last for three years from the commencement of the minimum tax); and

167.2 Any resulting variations made under the power would need to be confirmed in primary legislation within two years of being made (which would serve as an expiry date).

168. A further issue for the criteria of a discretion is the speed at which this tax will be implemented is likely to result in less supporting documentation being created that would support the criteria. Such material would assist in ascertaining the policy intent behind the changes and where that is not as developed as it usually would, it may leave gaps in that understanding that is needed to support the use of a discretion.

169. Again, the specific criteria for any variation power should be worked through with LDAC before the rules are enacted.

Administrative issues with the discretion

Should taxpayers be able to apply for the discretion?

170. Currently, issues which are identified with legislation are raised within Inland Revenue or through external parties such as Chartered Accountants Australia and New Zealand (CA ANZ). They also apply to groups of taxpayers rather than individual taxpayers.

171. However, with a more general discretion to vary the application of the minimum tax, you may want to consider an application process for relief from the application of the minimum tax for individual taxpayers, especially where the criteria for the exercise of that discretion are more general.[17]

172. We strongly recommend against having a formal application process for the use of the discretion similar to the binding rulings regime. We expect that most people subject to the minimum tax will attempt to identify a differing point about their situation and apply for relief, which will result in an increased and potentially unmanageable workload for Inland Revenue.

173. We expect any major issues with the application of the minimum tax can be raised through the usual channels without a specific application process and that relief should apply to groups of taxpayers with similar circumstances rather than to individual taxpayers.

Should the power of discretion be time-limited?

174. You have suggested that any discretion could be time-limited to deal with immediate issues arising with the minimum tax rather than an ongoing power of modification. We agree that any such power should be time-limited as once any initial issues with the minimum tax are dealt with through any discretion and subsequent legislation there is less need for such a power. We would suggest three years following enactment of the minimum tax should be sufficient to identify any unintended overreach of the tax and to have those corrected in primary legislation.

[17] This is more like the process for taxpayers to obtain a binding ruling.

Transitional resident exemption

175. In our 2 February report (IR2023/009; T2023/74), we recommended that foreign assets owned by New Zealand residents be included in the minimum tax regime, otherwise residents could avoid the tax by investing in foreign assets. You agreed to this recommendation.

176. Currently, there is a transitional resident exemption for which new migrants, temporary residents and certain returning New Zealanders may qualify. The exemption applies for a period of 48 months from the date the taxpayer acquires tax residence in New Zealand.

177. The effect of the exemption is that only a transitional resident's foreign income derived from employment or the supply of services is subject to income tax in New Zealand. Income derived from foreign business or passive investments is exempt during this period.

178. The intent of this exemption is to prevent New Zealand's taxation of foreign assets from discouraging temporary residents from coming to New Zealand and allow new migrants more time to get their foreign tax affairs in order. Transitional residents may include temporary visitors such as business expatriates and movie and television performers.

179. We recommend the transitional resident exemption be extended to the minimum tax. During the first four years of tax residence, the minimum tax would not apply to foreign assets of transitional residents. Such individuals may have high amounts of foreign wealth but low amounts of New Zealand assets and may avoid coming to New Zealand to avoid the compliance and tax burden of this regime. For individuals who stay longer than 48 months, the full regime would apply to them after this time.

180. If you agree with this:

    180.1 Foreign assets of a transitional resident will not be taken into account in determining if they are over the minimum tax entry threshold.

    180.2 If the transitional resident is over the threshold in respect of their New Zealand assets, the deemed income under the minimum tax is calculated on the New Zealand assets.

Indicative revenue ranges for a minimum tax

181. This section provides indicative revenue figures for several different deemed income rates and net worth thresholds. We also provide estimates for the number of individuals who might be affected by the minimum tax.

182. These figures are not costings. They are preliminary, subject to high uncertainty, and are likely to differ significantly from the final fiscal costing for this policy (whether positively or negatively). In particular, a final costing will include any further policy decision choices, a finalised behavioural assumption, updated wealth estimates, and refinement of modelling techniques.

183. The indicative revenue figures in this section are based on a variety of data sources from 2020 and 2021. While we usually base our wealth analysis on the Household Economic Survey (HES), it is thought to undercount wealth at the top of the distribution. This means we have supplemented our indicative ranges with figures from alternative data sources (see the **Appendix II** for further detail). There are several factors and uncertainties that would need to be considered in a fiscal costing

that we have not incorporated into the indicative revenue ranges or affected population estimates presented below. These unquantified factors include:

- **Policy design decisions are still not finalised** and many of these will have significant revenue impacts. Decisions to include further asset class exemptions (e.g. farms) are likely to have the greatest impact on expected revenue.
- **We are yet to finalise our behavioural assumptions and for now we have reduced all revenue estimates by 50%**. This reduction is a placeholder while we complete further research into likely behavioural responses. International research on taxes that use a wealth base are prone to certain behavioural responses, including undervaluation, evasion, asset splitting and migration. However, 50% is not out of step with assumptions made in costings in other jurisdictions: for example, the Canadian Parliamentary Budget Office assumed a 35% reduction for a 1% wealth tax.
- The wealth subject to the minimum tax can be expected to change significantly from the 2020 and 2021 figures used in this report. We are still developing a method for forecasting these wealth figures.
- Future variability in taxable capital income will also impact minimum tax revenue because this determines the amount of income available for offset. In years with lower taxable income, for a given wealth base, the minimum tax revenue can be expected to be higher.
- Any change in existing personal tax rates and trust tax rates will impact the expected minimum tax revenue.

184. Table 4, below, shows how our indicative revenue estimates for a deemed minimum tax would vary for different net worth thresholds and deemed interest rates. These figures are based on data from 2020 and 2021, which will likely be different to the wealth above each threshold in the future application year for the minimum tax.

Table 4: Indicative revenue ranges for a deemed minimum tax					
		Net wealth threshold			
		$3m	$5m	$7.5m	$10m
Deemed rates of return …	4%	$1.7b - $3.9b	$1.2b - $2.9b	$1.0b - $2.1b	$0.7b - $1.7b
	5%	$2.4b - $5.0b	$1.7b - $3.7b	$1.2b - $2.7b	$0.8b - $2.1b
	6%	$3.0b - $6.1b	$2.0b - $4.5b	$1.5b - $3.2b	$1.0b - $2.6b

185. The wide ranges between estimates in Table 4 reflects the significant uncertainty we face in costing a minimum tax. At this stage we have developed several different models for costing the policy, resulting in the wide range of estimates. We will continue to refine our costing methods, but a lack of data on high wealth individuals means that our final fiscal costing will still be subject to high uncertainty.

186. Table 5 shows how many individuals would be required to pay additional tax under the minimum tax proposal, for different thresholds.[18] Higher net wealth thresholds also mean that a smaller population would be subject to the minimum tax. We have not reduced the figures in Table 5 to account for behavioural changes, which are likely to reduce the number of individuals paying more tax

187. While not shown in Table 5, a higher deemed rate will also mean that slightly more individuals are required to pay an additional minimum tax, since it is more likely that deemed income will exceed taxable capital income before carry-forward losses.

Table 5: Individuals above each threshold for different deemed minimum tax				
	Applicable wealth threshold			
	$3m	$5m	$7.5m	$10m
Individuals above threshold	92,000 – 179,000	41,000 – 87,000	24,000 – 44,000	12,000 – 29,000

188. We will provide refined revenue figures in the report planned for 10 March 2023. However, the complexity and novelty of the minimum tax means that we intend to continue refining our fiscal cost estimates throughout March until Budget 2023 forecasts are finalised. We will provide a final fiscal cost for the minimum tax in the Cabinet Paper to be lodged on 5 April 2023.

[18] The number of individuals required to pay additional tax is smaller than the number above each threshold, since taxpayers will only need to pay more tax if their deemed income exceeds their taxable capital income before carry-forward losses.

Legislative implications

189. We suggest making a final decision on the legislative process in response to the 10 March report. We will recommend that the corresponding legislation be subject to a full select committee process. Tax technical experts would be able to provide their input on the technical detail during the select committee stage, improving the quality of the final legislation.

190. We also recommend that given the interconnected nature of the proposal, all aspects should be legislated at the same time.

191. Proposed amendments could be included in an omnibus tax bill scheduled for introduction in May 2023. Among other policy initiatives and remedial amendments, the 2023 omnibus tax bill would set the annual income tax rates for 2023–24. This means it should be passed by 31 March 2024.

192. The bill could be introduced on Budget night or shortly thereafter, with a First Reading on 30 or 31 May and subsequently referred to the Finance and Expenditure Committee for its consideration. However, as the House will rise at the end of August 2023 ahead of the General Election on 14 October 2023, the select committee process would not be completed before the election.

193. The Finance and Expenditure Committee would call for submissions when the bill is referred to it and the select committee process would continue following the election if the bill is reinstated by the new Parliament in November. We would continue to work on any technical legislative issues during this period. We note that tax bills introduced in 2017 and 2020 followed a similar timeline during the 2017 and 2020 General Elections.

194. If written submissions close prior to the election, it may be preferable to defer the initial briefing and oral hearings of evidence until after the election. This is because the composition of the Finance and Expenditure Committee is likely to change and new members will be interested in fully understanding the concerns and issues raised by submitters.

Potential bill timeline

Milestone	**Approximate date**
Introduction	Mid May 2023
First Reading and referral to FEC	30 or 31 May 2023
Submissions open (and close)	June–July 2023
Election period: August – October 2023	
Initial briefing and oral hearings of evidence	November 2023
FEC report to the House	By February 2024
Remaining stages	March 2024
Royal assent	By end of March 2024

Next steps

195. We recommend that you discuss these design decisions with us at the next Joint Ministers meeting on 16 February.

196. We will report to you again on 2 March on any final design decisions that will need to be made ahead of Budget 2023.

Appendix I: Taxing economic income or an RFRM tax as alternatives: McLeod Review Analysis

1. The McLeod Review analysed the effects of taxing a risk-free imputed return on comprehensive income for a portfolio of assets where investors were not expected to make economic rents (better than normal returns) and where the assets generate only capital income (there is no element of labour income in returns being generated). A portfolio of shares in domestic and foreign listed companies and of interest-bearing securities might make up such a portfolio.

2. It explained why if a tax on imputed income is being thought of as a complete replacement for a tax on comprehensive income, ***it would be appropriate to levy a tax on imputed income at a risk-free rate*** (i.e., levy an RFRM tax) ***even though risky assets are likely to be earning more than a risk-free return on average.*** Conversely, levying a tax on imputed returns at more than a risk-free rate would impose a higher tax burden on taxpayers than a comprehensive income tax including full taxation of accruing capital gains would.

3. Suppose that an individual on a tax rate of 40% has a portfolio of $200. (Using 40% rather than 39% makes the numbers slightly easier to follow.) Half of the portfolio is invested in a riskless asset which earns 5% interest of $5 per annum. The other half is invested in a risky investment in shares which generate expected income of $8. This higher expected return compensates for the riskiness of the investment. The risky investment generates $28 of economic income half the time in good states of the world and a loss of $12 half the time in bad states of the world.

4. Initially, suppose that we have a tax on comprehensive economic income which fully taxes the returns in the good state and allows a full deduction for any losses in the bad state. Cashflows are as in Table 6 below.

Table 6

Initial Position					
	Return on Govt stock	Return on shares	Total before tax	Tax	Net return
Shares do well	$5.00	$28.00	$33.00	$13.20	$19.80
Shares do badly	$5.00	-$12.00	-$7.00	-$2.80	-$4.20
Expected return	$5.00	$8.00	$13.00	$5.20	$7.80

5. When shares do well there is $33.00 of income in total on which $13.20 of tax is paid. When shares do badly there is a loss of $7.00 which reduces tax by $2.80. The expected after-tax income is $7.80 which provides an expected after-tax rate of return of 3.9% on capital invested.

6. Note that the 3.9% expected return is greater than the 3.0% after-tax return that would be obtained if the individual invested all of the $200 in riskless bonds (which would have provided pre-tax income of $10.00 and after-tax income of $6.00). The higher expected after-tax return is required to compensate for the risk incurred when $100 of the investment is invested in shares. The risky portfolio in Table 6 generates after-tax income of either $19.80 or -$4.20 and there is a difference of $24.00 between after-tax income if shares do well than if they do badly. The extra $1.80 (expected after-tax return of $7.80 from the risky portfolio compared with $6.00 if the $200 is all invested in riskless bonds) compensates for this risk.

7. Now suppose that this economic income tax is replaced by an RFRM tax which imputes a risk-free return of 5% on all capital invested. Thus, $10 of income is taxable and $4 is paid in tax whether shares do well or poorly. The new position would be as in Table 7 below so long as the investor keeps their portfolio unchanged.

Table 7

Returns after RFRM before any portfolio adjustment					
	Return on Govt stock	Return on shares	Total before tax	Tax	Net return
Shares do well	$5.00	$28.00	$33.00	$4.00	$29.00
Shares do badly	$5.00	-$12.00	-$7.00	$4.00	-$11.00
Expected return	$5.00	$8.00	$13.00	$4.00	$9.00

8. This reduces expected tax payments from $5.20 to $4.00 and increases the expected return to the taxpayer from $7.80 to $9.00, which provides the taxpayer with an expected after-tax rate of return of 4.5% on their capital. At first sight, replacing a tax on comprehensive economic income with an RFRM tax may appear to provide a gain for the taxpayer and a loss to the government as, on average, less tax is being collected.

9. However, while the taxpayer is paying less tax on average, the taxpayer's investment portfolio is now riskier. There is now a gap of $40 between after-tax income when shares do well and when shares do badly (compared to $24 above). The tax stream received by the government is smaller on average ($4.00 with certainty rather than a 50% chance of $13.20 and a 50% chance of -$2.80 resulting in expected revenue of $5.20). However, the lower expected revenue stream is necessary to compensate the investor for the fact that the government is no longer bearing a share of the risk of the investment.

10. As the McLeod Review points out, if the investor were concerned about the additional risk being taken on they could alter their portfolio by investing $40 more in riskless bonds and $40 less in shares, such that they have $140 in bonds and $60 in shares. In this case the outcome would be as in Table 8 below.

Table 8

Returns after RFRM after portfolio adjustment					
	Return on Govt stock	Return on shares	Total before tax	Tax	Net return
Shares do well	$7.00	$16.80	$23.80	$4.00	$19.80
Shares do badly	$7.00	-$7.20	-$0.20	$4.00	-$4.20
Expected return	$7.00	$4.80	$11.80	$4.00	$7.80

11. This would reproduce the cash flow generated by the portfolio in Table 6 when economic income was taxable. In theory, the circle could be completed (although there is no need for this to happen) by the government taking advantage of the fact that its revenue stream is now less risky and borrowing an additional $40 to invest in shares. In this case the government's net income stream would also be the same as in Table 6.

12. This means that if the government wanted to levy a tax on imputed returns *instead of taxing economic income*, the neutral deemed rate of return for it to charge in order to create an equivalent burden to a comprehensive income tax would be a risk-free rate rather than a risky rate of return. While the risky portfolio in Table 7 is generating an expected pre-tax rate of return of 6.5%, imposing a deemed rate of return of 6.5% would be increasing the tax burden on the investor over and above that which would be imposed by a fully comprehensive tax on economic income.

Appendix II: Data limitations for indicative revenue ranges

1. The Household Economic Survey (HES) is usually considered the best data source for the distribution of wealth. However, HES is thought to undercount wealth at the top of the distribution. To account for this likely undercount of wealth we have also used two experimental data sources for calculating indicative revenue figures in this report:

    - **Scaled HES 2021 data estimates:** asset totals are scaled up to match the aggregates recorded in Stats NZ's Household balance sheet. This assumes that wealth under-reporting is uniform across the wealth distribution, but still results in significant uplifts for top wealth groups.
    - **Capitalised wealth estimates for 2020:** personal taxable income data is multiplied to match aggregate wealth data contained in the Stats NZ Household Balance sheet, inferring the underlying wealth distribution (T2020/2965 refers). The Treasury is currently drafting on a working paper that will present the capitalisation method and explore its various assumptions and results.

2. These data sources face several limitations and are subject to high uncertainty:

    - HES was not designed to estimate the top of the wealth distribution, so these data are based on small samples and subject to very large sample errors.
    - The capitalised wealth data relies on personal tax returns that were not intended to provide distributional wealth information. By design, those with high capitalised wealth will also have high taxable capital income. The capitalisation method is also limited to estimating wealth on an individual basis, which means we must rely upon HES data for estimating how these figures might be uplifted for family units.

3. Inland Revenue may also be able to draw on anonymised data from the HWI Research Project. However, we have not accessed this data at this time.

4. Note that these results are not official statistics. They have been created for research purposes from the Integrated Data Infrastructure (IDI) which is carefully managed by Stats NZ. The results are based in part on tax data supplied by Inland Revenue to Stats NZ under the Tax Administration Act 1994 for statistical purposes. Any discussion of data limitations or weaknesses is in the context of using the IDI for statistical purposes and is not related to the data's ability to support Inland Revenue's core operational requirements.