The Treasury

Budget 2023 Tax Initiatives Information Release

July 2023

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Inland Revenue
Te Tari Taake

POLICY AND REGULATORY STEWARDSHIP

TE TAI ŌHANGA
THE TREASURY

Tax Policy Report: Initial advice on a minimum tax

Date:	13 December 2022	Report No:	T2022/2703 IR2022/516
		File Number:	SH-13-5-3-7

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Grant Robertson)	Agree to the recommendations	15 December 2022
Minister of Revenue (Hon David Parker)	Agree to the recommendations	15 December 2022

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
Shane Domican	Senior Analyst, The Treasury	[35]	✓
Stephen Bond	Manager, The Treasury		
Phil Whittington	Chief Economist, Inland Revenue		

Actions for the Minister's Office Staff (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report	

Enclosure: No

Tax Policy Report: Initial advice on a minimum tax

Executive Summary

You have requested advice on a minimum tax for inclusion in Budget 2023 (as outlined in T2022/2478). Under this regime, a person with high wealth pays tax on the greater amount of either their 'deemed income' (calculated as a percentage of their net worth) or the taxable income they have under existing income tax rules.

This report provides our preliminary assessment of a minimum tax and seeks your direction on the next steps and the key design choices needed to begin forecasting the fiscal impact.

The advice in this report has been prepared quickly. This proposal is novel and complex and so this advice should be seen as indicative only. There is a high risk that there are unforeseen issues or impacts that officials have not identified.

Objectives

We understand that your main objective is to: raise revenue in a progressive manner by taxing high-wealth individuals who can have light taxation relative to their economic income (due primarily to the non-taxation of most capital gains).

A minimum tax would support this objective, but it would also generate a range of economic costs.

Policy considerations

Revenue and distributional considerations

In light of your objective, the two key benefits of a minimum tax are that it will raise revenue and increase the progressivity of the tax system. The increase in tax will be paid by high-wealth individuals who may have light taxation relative to their economic income.

Depending on design, a minimum tax could have an uneven impact across high-wealth individuals, potentially creating concerns about the overall fairness of the minimum tax. However, this can be reduced through design choices.

Officials have begun investigating how to estimate the revenue and distributional impacts of a minimum tax and will provide further advice in early 2023.

Economic and integrity considerations

We expect a minimum tax will have economic costs primarily due to the impact on risk and entrepreneurship, and high compliance costs. The size of the impact is uncertain and depends on design.

A minimum tax will create strong incentives for taxpayers to structure their affairs to avoid the tax. This could undermine the objectives of the tax and create economic costs. International experience with taxes on capital indicates that the integrity risks are significant, and that careful design of a minimum tax is vital to minimise these risks.

Administrative impact for Inland Revenue

Implementing a minimum tax will be a significant initiative for Inland Revenue with potentially large administration costs.

Inland Revenue is already at its capacity to deliver policy changes over the next three years. Implementing a minimum tax may therefore require reprioritisation of existing work, meaning Inland Revenue may be unable to deliver on other policy options you wish to consider or have already agreed to.

However, the total administrative impact will depend heavily on the design of the minimum tax. Officials will advise on this next year. As part of this advice, Inland Revenue will need to discuss funding mechanisms for these costs and any reprioritisation of existing work.

Assessment

Decisions on a minimum tax will require balancing your revenue, distributional and economic objectives. The overall impact across these objectives will be highly dependent on design. Design choices will be able to reduce, but not fully resolve, some of these negative impacts and will come with trade-offs.

These impacts will affect the wellbeing of New Zealanders. For example, the overall impact on social cohesion will likely depend on the competing considerations across progressivity, horizontal equity, and any perceived unfairness in how the tax is likely to be applied to some individuals. Any economic costs could also impact our stocks of financial and physical capital and will have implications for the Government’s economic strategy.

Inland Revenue view

Inland Revenue sees the proposal’s main improvement from the status quo as the greater taxation of currently untaxed economic income.

However, the main downside is that it creates compliance costs that are high relative to the revenue raised, and it taxes income in an indirect way that treats risk asymmetrically. If the rate is set at a “risky rate”, it absorbs some upside risk but does not absorb any of the downside risk. Compared to including gains and losses in the tax base comprehensively, the proposal asymmetrically pushes risk onto investors. This means it creates a bias against risk that is likely to discourage entrepreneurship and innovation.

On balance, Inland Revenue recommends against the proposal for these two reasons (the treatment of risk and high compliance costs), but it notes that these issues can be mitigated to some degree through the design (discussed throughout this report).

Treasury view

The Treasury considers whether to progress a minimum tax requires weighing the benefits from supporting the Government's revenue and distributional objectives against the economic costs, particularly the compliance costs and treatment of risk.

The Treasury will provide its overall view on the proposal once the design details are further developed early next year, and the size of these competing impacts is clearer.

Timeframes to design a minimum tax

You need to make design decisions quickly to include a minimum tax in Budget 2023. Tables 1-4 on the following pages outlines the key decisions we seek from you, preferably before Christmas. These decisions form the key "building blocks" of a minimum tax that are needed to progress on a Budget 2023 timeframe.

Both Treasury and Inland Revenue recommend against progressing a minimum tax as part of Budget 2023. This is a highly compressed timeframe and creates significant risks for the quality of policy design and delivery. If the minimum tax proceeds on this timeframe, it will be at a rate faster than any other international example for proposals of this complexity that we are aware of.

Legislative timeframes

However, if you wish to progress a minimum tax for Budget 2023, we recommend providing as much time for consultation and detailed design as possible. As a result, we recommend undertaking public consultation on a minimum tax before a Bill is introduced and having a full Select Committee process. This would help to mitigate some of the risks identified above.

Officials are considering potential application dates for a minimum tax and will advise further on this in early 2023.

Next steps

Officials wish to meet with you on 15 December to discuss this report and our proposed decision-making process if you decide to progress this for Budget 2023.

Recommended Action

We recommend that you:

Inland Revenue and Treasury recommendations

a **agree** to not develop a minimum tax, noting its likely high compliance costs and treatment of risk (recommended by Inland Revenue).

Agreed/Not agreed Agreed/Not agreed

b **note** that Treasury considers whether to progress a minimum tax is a balanced choice and our evaluation of a minimum tax will depend on its overall design.

c **note** that Inland Revenue will provide further advice on funding and potential trade-offs across the tax policy changes it can deliver in 2023.

Timeframe for progressing

d **note** that progressing a minimum tax in time for Budget 2023 is highly challenging. Officials are not confident that we can advise you on the full impacts on the proposal and there is a high risk of unforeseen issues and unintended consequences (including any potential legal risks).

e **agree** to defer decisions on a minimum tax to allow time for a detailed assessment of the option (recommended by Treasury and Inland Revenue).

Agreed/Not agreed Agreed/Not agreed

Or

f **agree** to progress a minimum tax for announcement at Budget 2023.

Agreed/Not agreed Agreed/Not agreed

If you wish to progress for Budget 2023

g **note** that officials do not expect to be ready to provide a robust fiscal estimate in time for Budget Ministers on 20 February.

h **agree** to undertake public consultation on a minimum tax before a Bill is introduced.

Agreed/Not agreed Agreed/Not agreed

Application date

i **note** that officials will advise further on potential application dates in early 2023.

Designing a minimum tax

j note that you need to make design decisions quickly to incorporate revenue from a minimum tax as part of Budget 2023.

k **agree** to proposed key design features of minimum tax in Tables 1-4 on the following pages .

Please provide your decisions in Tables 1-4

l **note** that we will seek your decisions on other design features early next year.

Stephen Bond
Manager, Tax Strategy
The Treasury

Phil Whittington
Chief Economist
Inland Revenue

Hon Grant Robertson
Minister of Finance

_____/_____/_______

Hon David Parker
Minister of Revenue

_____/_____/_______

Table 1. Who tax applies to

Issue	Recommendation	Reason for recommendation	Please tick if you agree and indicate if any additional advice required
1a. Is exemption threshold calculated on an individual or family basis? (page 23)	• The exemption threshold is calculated by combining the wealth of family members and related trusts • However, the deemed income tax is then calculated by each family member and trust individually (with some exceptions)	• Pooling wealth prevents gaming and, in most circumstances, we expect families to share resources • Individual calculations align with how we calculate income tax	
1b. Does the minimum tax apply solely to NZ tax residents? (page 25)	• The minimum tax only applies to NZ tax residents	• We assume NZ tax residents are the intended targets of the minimum tax • Applying to non-residents would be complex and difficult to enforce	
1c. What assets or liabilities are included? (page 26)	• All assets which are likely to increase in value or earn income other than: o Family home (subject to a cap on value) o Consumer durables (e.g. cars), small amounts of cash, and defined benefit funds o Māori interests in communally owned assets managed by Māori entity structures o Personal assets such as art and collectables	• Maximise revenue and distributional gains • Supports horizontal equity and efficiency, and minimises opportunities for tax planning and avoidance • Limited exclusions where compliance costs are disproportionate to revenue or distributional gains	

Table 2. Calculating your deemed income

Issue	Recommendation	Reason for recommendation	Please tick if you agree and indicate if any additional advice required
2a. Does minimum tax compare taxable income or tax paid? (page 28)	• The minimum tax compares an individual's deemed income against their 'ordinary taxable income' • If deemed income is greater than 'ordinary taxable income' then the deemed income is subject to personal tax rates	• This approach aligns with your objective of targeting undertaxed income • The alternative is to compare the amount of tax paid which we think raises very complex issues that may change some of our design recommendations	
2b. Do we include wealth below the exemption threshold included when calculating deemed income? (page 29)	• Include wealth below the exemption threshold	• Recommendation is finely balanced. This approach is less complex than the alternatives and maximises revenue and distributional gain from proposal • However, it leads to a "cliff-edge" incentive effect for people who move across exemption threshold • We consider alternative approaches are likely to significantly reduce gains from the proposal and lead to many people having disproportionate compliance costs relative to revenue	

Table 3. Calculating your 'ordinary taxable income'

<table>
<tr><th>Issue</th><th>Recommendation</th><th>Reason for recommendation</th><th>Please tick if you agree and indicate if any additional advice required</th></tr>
<tr><td>3a. Is labour income included in the calculation?

(page 32)</td><td>• Only capital income generated by assets is included
• Specific rules will be needed to disentangle labour from capital and minimise integrity risks from bundling</td><td>• Aligns with objective to address under-taxed capital investments
• Including labour income would be inconsistent with this and mean working individuals are potentially sheltered from the tax</td><td></td></tr>
<tr><td>3b. How do we attribute income from companies and PIEs? (page 34)</td><td colspan="2">• Special rules to attribute company income in some cases
• Attribute PIE income to relevant taxpayer</td><td></td></tr>
<tr><td>3c. Assets held through trusts

(page 37)</td><td colspan="2">• Excluded
o Charitable trusts, community trusts, or other similar trusts not for the benefit of specific persons or classes of persons are not subject to the minimum tax

• Fixed income beneficiaries
o If there are beneficiaries with fixed income interests, their share of the trust assets are combined with their own assets for determining if the application threshold is met

• Attributing to principal settlor
o If the principal settlor of the trust is alive, the assets of the trust are attributed to the principal settlor (A principal settlor is the person who has made the largest, or largest equal, contribution to the trust)
o If the principal settlor of the trust is dead, the minimum tax applies directly to the trusts they have settled (provided aggregate wealth of such trusts exceeds the exemption threshold)</td><td></td></tr>
<tr><td>3d. Carrying forward minimum taxes (page 39)</td><td>• A minimum tax includes carry forward rules to smooth out timing differences</td><td>• Mitigates some of negative impact of a minimum tax on people with lumpy or volatile income</td><td></td></tr>
</table>

Table 4. Administering a minimum tax

Issue	Recommendation	Reason for recommendation	Please tick if you agree and indicate if any additional advice required
4a. Should there be broad power to provide discretionary relief? (page 40)	• Address concerns with fairness through specific legislative rules, or through targeted discretionary powers for defined situations • However, if you wish to progress with broad discretionary power we would like to discuss the situations you are concerned about further so we can advise further	• Broad discretionary powers would be unusual for tax, increase uncertainty, be difficult to apply and administer, and impose significant administrative costs.	

Tax Policy Report: Initial advice on a minimum tax

Purpose of Report

1. This report responds to your request for advice on a minimum tax for Budget 2023 (as outlined in T2022/2478).
2. In this report we:
   - Provide our **high-level advice** on potential impacts of a minimum tax (pages 11-19)
   - Outline our **proposed timeframe** for progressing a minimum tax (pages 19-20)
   - Seek your **agreement to the key design decisions** that form the 'building blocks' of a minimum tax (pages 21-41)
   - Provide **initial advice on other key design choices** that we will seek your decision on in early 2023 (pages 42-44)
3. The advice in this report has been prepared quickly. This proposal is novel and complex and so this advice should be seen as indicative only. There is a high risk that there are unforeseen issues or impacts that officials have not identified.

Context and objectives

Context

4. Under a minimum tax regime, a person with high wealth pays tax on the greater amount of either their 'deemed income' (calculated as a percentage of their net worth) or the taxable income they have under existing income tax rules.
5. Only four OECD countries have taxes based on net wealth, and none of these are minimum taxes. This is a reduction from 12 countries in 1990. Part of the reason for the repeal of these types of taxes has been due to efficiency and administrative cost concerns compared with the little revenue they generate.

Objectives

6. We understand you are motivated by three main objectives:
   - **Revenue.** The minimum tax should raise revenue to fund personal tax cuts.
   - **Distributional.** The additional tax is paid by those with high wealth and therefore high ability to pay.
   - **Address uneven taxation.** Address how high-wealth individuals can have relatively light taxation primarily due to the non-taxation of most capital gains. We understand that you want to ensure that high-wealth individuals pay an effective tax rate on their economic income at least that of middle-income earners.
7. A minimum tax could support these objectives but would generate a range of **economic costs** and **integrity risks**.
8. The next section provides our initial analysis on the potential impacts of a minimum tax against these considerations.

Assessment of a minimum tax

Revenue considerations

9. A minimum tax will raise revenue. The amount of revenue is highly dependent on design and how taxpayers respond to the tax.
10. Officials have begun investigating how best to estimate the revenue from a minimum tax and will provide further advice in early 2023.
11. However, we expect our revenue estimates to be highly uncertain owing to incomplete data and the uncertain impacts of the tax. These are explained further in Box 1 below.

Box 1. Limitations in our modelling

The revenue and distributional analysis in this report is highly uncertain and we expect this uncertainty to remain for all of our future modelling. This uncertainty arises because of:

- **Incomplete wealth data.** The best source of wealth data is the Household Economic Survey (HES). However, HES undercounts wealth at the top of the distribution, making it less useful for this minimum tax proposal. Officials are exploring alternative methods to estimate the wealth of high-wealth individuals including what is known as “Capitalisation” modelling (see Annex for more information). These approaches are experimental and subject to significant uncertainty[1].

- **Modelling assumptions.** A minimum tax is complex and will likely induce behavioural change from those affected. It will be difficult to link individuals to trusts, unincorporated businesses and companies for the purposes of attributing taxable income and modelling revenue. We will need to make strong modelling assumptions about key variables that are not in our data sources and about how taxpayers will respond to the tax.

Timeframe for revenue estimate

12. Officials will find it challenging to estimate the revenue from a minimum tax in time for Budget 2023. Officials will need key design decisions quickly for this to be feasible. At this stage, we do not expect that we will be in a position to provide a robust fiscal estimate in time for Budget Ministers on 20 February.
13. This timeframe also creates risks for the accuracy of our estimates. The shortened timeframes create greater risks of error and risk that we will change our estimates over time as we refine our approach or incorporate new information.

Distributional considerations

14. One of the main objectives of the minimum tax is to improve the progressivity of the tax system. The minimum tax will only be paid by high wealth families, with the revenue available for use to fund tax, spending, or fiscal changes that may also improve progressivity.
15. The size of the impact on the progressivity of the tax system will depend on design, including whether design choices reduce integrity risks.

[1] Data from the High-Wealth Individual Research Project is still being processed. Note that data from this project can be used to inform policy and we are investigating whether it can be useful for quantifying the revenue effects of the proposal. The data cannot be used for compliance purposes.

16. Officials have begun investigating how to model the potential distributional impacts and the section below provides our preliminary insights from this work. We will provide further advice in 2023. However, we note that this analysis is uncertain and faces limitations, including those outlined in Box 1.

Summary information

17. Table 5 below provides our initial estimate of the number of *individuals* with wealth above certain levels and their aggregate wealth.

Table 5: Estimated number of *individuals* with wealth above thresholds (excluding the family home and durables) and their total wealth (2020, capitalisation methodology)

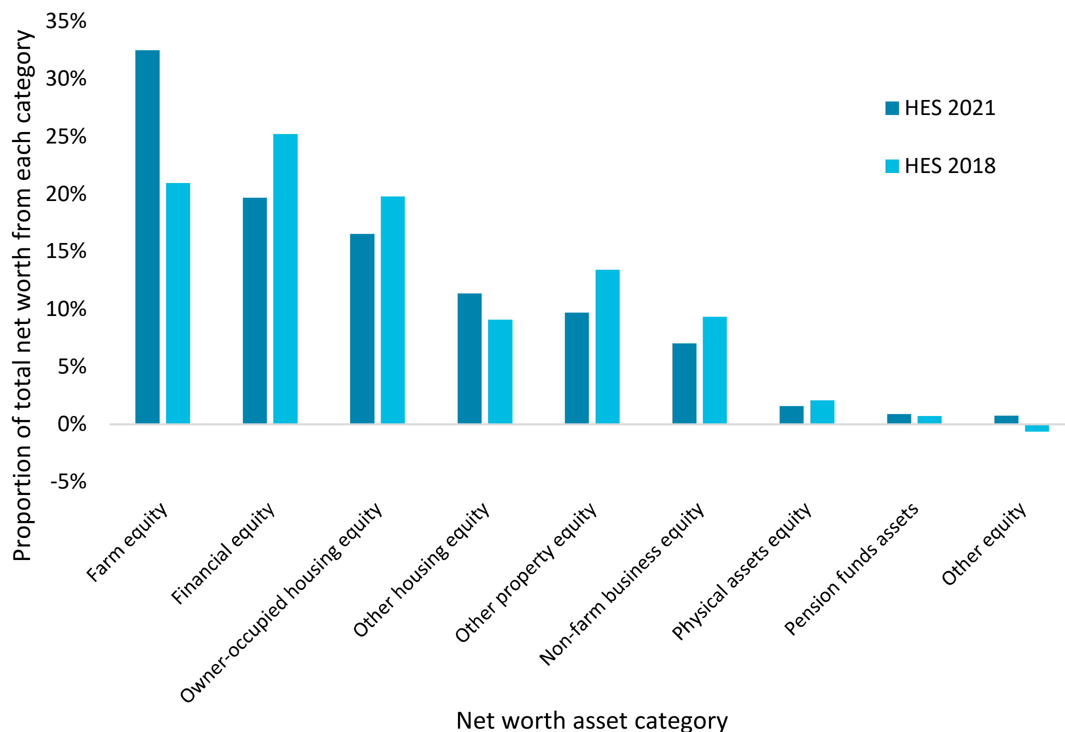
	Individuals with wealth above …				
	$3m	**$4m**	**$5m**	**$6m**	**$7m**
Number of individuals above threshold	59,000	37,000	25,000	19,000	14,000
Individuals as a share of population	1.2%	0.8%	0.5%	0.4%	0.3%
Total wealth held by these individuals	$430b	$350b	$300b	$260b	$240b
Wealth held as share of total wealth held by New Zealanders	38%	31%	26%	23%	21%

Note. This is based on individuals rather than families. The annex indicates that if we looked at families rather than individuals the total wealth held could be 1.3 – 1.5 times greater and number of individuals affected could be approximately 3 times greater. As, outlined on page 23, we are recommending that a minimum tax applies to people whose combined family wealth is above the threshold.

Types of wealth

18. Figure 1 shows that wealthier households tend to hold a significant proportion of their assets in farms, businesses, and property. Although there is high uncertainty in these numbers it indicates that the settings for business assets will be important to achieve your revenue and distributional objectives.

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 of the population. Our conclusion that business assets are important is supported by international experience as well as preliminary analysis based on capitalisation outlined in the Annex.

Characteristics

19. The Annex provides further information on the characteristics of these high-wealth individuals based on the experimental capitalised wealth distribution and HES. This information indicates that those with wealth over $5 million:
    - Tend to be men (66%), when looking at high-wealth *individuals*. However, high-wealth *families* are relatively evenly split between men and women.
    - Tend to be older than the general population (most are aged over 50)
    - Are relatively evenly spread across New Zealand's regions in comparison to the population as a whole.
    - Are likely to be concentrated in some industries, including agriculture and professional services, although our industry data is less reliable than the other demographics.

How a minimum tax will address horizontal equity

20. Your other main distributional objective is to address the potential for high-wealth individuals to have relatively light taxation. A minimum tax could support this objective and increase the tax on some lightly-taxed assets.

21. You currently have two research projects reporting early next year that can inform you as to the scale of this problem. Inland Revenue's research on high-wealth individuals plans to report in the second quarter of 2023, and the Treasury's modelling of effective tax rates across the broader population can be used as a broad comparison to Inland Revenue's research.

A minimum tax can support your progressivity and horizontal equity objectives, however the extent which it does will depend heavily on design

22. If the minimum tax resulted in an uneven impact across high-wealth individuals this could reduce its overall progressivity and create concerns about the overall fairness of the minimum tax. Possible issues include:

    - The minimum tax may be unevenly applied among high-wealth individuals if there are easy opportunities to get around the rules.

    - A tax based on deemed returns will result in uneven taxation where the deemed return rate is greater or less than the economic income being generated from assets. There is likely to be pressure from individuals making losses or whose assets are expected to make relatively low rates of return.

    - Exceptions and boundary issues in designing a minimum tax could create uneven treatment of particular people in relatively similar circumstances. For example, a person with wealth just over the exemption threshold could have significantly more tax to pay than someone just below the threshold.

    - A minimum tax may create cash flow pressures for owners of assets that do not generate regular streams of cash income. Some may consider it unfair that they need to dispose of assets to meet their tax liabilities.

23. These impacts can be reduced through design choices. However, many of these design choices have trade-offs across other objectives for the tax.

Economic considerations

24. The economic impact of a minimum tax will depend on design. However, our initial judgement is that it is likely to have relatively high economic costs per dollar raised. We expect economic costs will primarily arise from the impact on risk and compliance costs, as well as behavioural changes to avoid the tax[2].
25. Paragraphs 26-40 provide an initial assessment of the likely economic impacts of a minimum tax drawing upon the international literature on wealth and other capital taxes.

Impact on entrepreneurship, innovation, and risk taking

26. A minimum tax will likely increase biases against risk and entrepreneurship Taxpayers will be liable for the minimum tax even when they make losses while still being required to apply existing tax settings to any higher income that rewards risk-taking.
27. This means a minimum tax will cause wealthy New Zealanders to undertake fewer risky investments. This will have negative impacts on innovation and entrepreneurship, as innovation and entrepreneurship tend to be high-risk. By distorting investment away from risky activity, we expect it to negatively impact New Zealand's productivity and your objectives in your economic strategy to encourage innovation to unleash business potential.

[2] As outlined below, at this stage we do not consider there would be a significant impact on national savings or investment.

28. The impact on risk will depend on your choice of the deemed income rate, the treatment of businesses making volatile and risky returns, as well as the risk profile of investments. We provide further explanation of these issues on page 42. As outlined in this section, the biases against risk for a minimum tax will be higher if the deemed income rate is set above the risk-free rate[3].

Compliance cost impact

29. A minimum tax will increase compliance costs for taxpayers.
30. International experience with similar taxes, such as wealth taxes, suggests that the key factors driving these costs are the complexity of the tax, the need for regular valuations, and administrative processes (e.g. information requirements).
31. While the overall costs will depend on these design choices, our initial judgement is that a minimum tax is likely to have high compliance costs relative to the revenue raised. This is due to the need for regular valuations and because we expect the rules to be complex.

Impact on savings and investment

32. A minimum tax will change incentives for how much and where high-wealth individuals save and invest their income.

Effect on allocation of savings

33. A minimum tax could reduce incentives for high-wealth individuals to invest in more lightly-taxed assets, and increase incentives to invest in fully-taxed assets.
34. However, whether the minimum tax leads to an overall improvement or reduction in the allocation of New Zealanders savings would depend on how much any reduction in investment by these high-wealth individuals is offset by greater investment by other individuals unaffected by the tax. If there is significant substitution between these investors, there may be no change to New Zealand's overall asset allocation.
35. The overall impact will also depend on design. For example, the minimum tax will not reduce incentives to invest in assets excluded from the minimum tax and could exacerbate existing distortions favouring investment or improvements in some assets, such as the family home[4].

Effect on level of savings and investment

36. A minimum tax will affect high-wealth individuals' decision about how much to save which could impact investment. The total impact for New Zealand is uncertain. However, most evidence suggests that any impact on national savings and investment is likely to be small.

[3] However, we note that a minimum tax set at the risk-free rate will still bias against risk.

[4] Some design choices may also mitigate other efficiency concerns. For example, a cap on the value of the family home that is exempt and rules for start up businesses could mitigate these issues, but probably not solve them.

Effect on migration

37. International evidence suggests that taxes on wealth are likely to lead to some high-wealth individuals leaving the country.

38. The size of this impact is uncertain but experience with wealth taxes overseas suggests that a 1 percentage point increase in tax as a proportion of wealth can lead to approximately 3-8% of affected people migrating to avoid the tax.

39. The risk of migration depends on how mobile the population is and the ease of migration. New Zealand has a relatively mobile population and migration to Australia is not difficult[5].

Consistency with other objectives

40. A minimum tax could potentially conflict with other government objectives if it claws back other tax preferences. For example, it could reverse out some incentives for charitable donations, and the government is considering options such as accelerated depreciation which could conflict with a minimum tax.

Impact on integrity of tax system

41. A minimum tax will create strong incentives for taxpayers to structure their affairs to get around the tax. Such behaviour will undermine your revenue and distributional objectives and create economic costs.

42. International experience with other taxes on capital show that integrity risks are significant. We expect similar risks to arise for a minimum tax, although we note that since the minimum tax is relatively novel, we cannot be certain of the size of these impacts.

43. The international experience indicates that the design of the minimum tax is vital to minimise these risks. For example, international experience is that minimal exceptions and tight rules around valuation are critical to reduce opportunities to avoid the tax.

Administrative impacts for Inland Revenue

44. Building and operationalising a minimum tax will be a significant initiative for Inland Revenue as well as software developers, customers, and their intermediaries.

45. The total impact will depend on design. Officials will advise on implications for Inland Revenue next year when key design decisions have been made. However, we anticipate there could be considerable costs relating to initial implementation and ongoing administration.

46. Therefore, Inland Revenue will seek to discuss funding mechanisms for implementation and operational costs.

Trade-offs across work programmes

47. Inland Revenue forecasts that its current work programme will use up most of its specialist design and delivery capacity over the next three years. Upcoming

[5] We note that the 3-8% estimates for international wealth taxes included situations where individuals could relatively easily migrate to avoid the tax. For example the 8% estimate is from the Spanish wealth tax where taxpayers could easily migrate internally to Madrid to avoid the tax.

proposals in the next two omnibus taxation bills are also absorbing the resource required to deliver this change.

48. If this initiative proceeds, a reprioritisation of Inland Revenue's existing commitments will be required to enable delivery of this initiative in this timeframe. This means Inland Revenue may be unable to deliver on other policy options you have already agreed to or wish to progress. We will advise you further on this in early 2023.

Treaty of Waitangi impacts

49. Depending on design a minimum tax may impact Māori interests under Te Tiriti o Waitangi/Treaty of Waitangi. Key design issues are the treatment of interests in communally held assets managed by Māori authorities and Māori collective entities (see pages 26-27) and the process for implementing a minimum tax and opportunity to consult with Māori (see page 19).

50. Officials will explore these matters further following your choices on these issues. This will include further considering any potential legal risks.

Assessment

51. Decisions on a minimum tax will require balancing your revenue, distributional, and economic objectives. The size of these impacts is highly dependent on design. Design choices can reduce, but likely not fully resolve any negative impacts.

52. These impacts will affect the wellbeing of New Zealanders. For example, our initial consideration is that it could impact:

    - **Social cohesion.** The overall impact on social cohesion will depend on the competing considerations across progressivity, horizontal equity, and any perceived unfairness in how the tax is likely to be applied to some individuals.
    - **Financial and physical capital.** The economic costs of a minimum tax will impact financial and physical capital. These economic costs will have implications for the Government's economic strategy, in particular the goal to support entrepreneurship and innovation.

Inland Revenue view

53. Inland Revenue sees the proposal's main improvement from the status quo as the greater taxation of currently untaxed economic income.

54. However, the main downside is that it creates high compliance costs relative to the revenue raised, and it taxes income in an indirect way that treats risk asymmetrically.

55. If the rate is set at a "risky rate", it absorbs some upside risk but does not absorb any of the downside risk. Compared to including gains and losses in the tax base comprehensively, the proposal asymmetrically pushes risk onto investors. This means it creates a bias against risk that is likely to discourage entrepreneurship and innovation.

56. On balance, Inland Revenue recommends against the proposal for these two reasons (the treatment of risk and high compliance costs), but it notes these issues

can be mitigated to some degree through the design (discussed throughout this report).

Treasury view

57. The Treasury considers whether to progress a minimum tax requires weighing the benefits from supporting the Government's revenue and distributional objectives against the economic costs, particularly the compliance costs and treatment of risk.

58. The Treasury will provide its overall view on the proposal once the design details are further developed early next year, and the size of these competing impacts is clearer.

Timeframes for progressing a minimum tax

59. You need to make design decisions quickly to include a minimum tax in Budget 2023. Including revenue in Budget 2023 requires Cabinet to agree to the key design of a minimum tax and officials need to have estimated the revenue from a minimum tax before the Budget moratorium (estimated April 2023).

60. Meeting these timeframes and designing a minimum tax in time for Budget 2023 is highly challenging. A minimum tax is complex and novel. There is little time to fully assess the design and impacts of a minimum tax before Budget 2023

61. Progressing on this timeframe will mean a minimum tax will progress faster than any international example of tax reform we are aware of with similar complexity. For example, the most recent implementation of capital gains taxes overseas involved development time of 12 months to more than four years.

Officials recommend against progressing a minimum tax as part of Budget 2023

62. This is a highly compressed timeframe and creates significant risk to the quality of policy design and delivery risk. Officials are not confident that we can advise you on the full risks from the proposal and there is a high risk that there will be unforeseen issues and unintended consequences (including potential legal risks).

63. However, if you wish to proceed for Budget 2023, Table 6 outlines our proposed timeframe.

Legislative timeframe for a minimum tax

64. If Ministers wish to announce this proposal at Budget 2023, we recommend providing as much time for consultation and detailed design as possible.

65. As a result, we recommend undertaking public consultation on a minimum tax before a Bill is introduced and having a full Select Committee process. This consultation would be on design details as you will have already made key design choices as part of Budget 2023.

66. Under this approach you would still make an announcement at Budget 2023 and include revenue in Budget 2023 forecasts. Following this announcement, we would release a consultation document at or shortly after Budget 2023 and introduce legislation after the election.

Application date

67. Officials will advise on potential application dates for a minimum tax in early 2023.

68. However, the timeframe for implementing a minimum tax will depend on how long taxpayers need for implementation. We are considering this further; however, we cannot be certain what is feasible without consultation.

Next steps

69. Officials wish to meet with you to discuss this report on 15 December.

70. If you wish to progress a minimum tax for Budget 2023, we then propose the timeframe outlined in Table 6 below. Under this timeframe we need design decisions quickly.

Table 6. Timeframe for progressing a minimum tax

Date	Item
December 2022 – March 2023	Regular meetings with officials and decisions on key aspects
Late March	Officials provide you a draft Cabinet paper
Early April	Cabinet decision
May	Budget announcement and consultation document released
Post-election	Legislation introduced

71. The final section of this report provides our advice on the main building blocks and we seek your decisions on these preferably before Christmas. Following this we propose a series of rolling meetings in early 2023 to get further decisions.

Building a minimum tax

72. We seek your decisions on the key "building blocks" of a minimum tax (pages 23-41). These form the key structural parts of the minimum tax, and we need decisions early to progress the work in time for Budget 2023.

73. We also provide our initial advice on three further key choices around the deemed income rate, exemption threshold, and how to value assets and liabilities (pages 42-44). These three decisions are important for the overall impact of the policy; however, we believe it is possible to leave decisions on them until early 2023 as they are not structural.

Design criteria

74. The design of a minimum tax will be critical for achieving your revenue and distributional objectives and will shape the size of economic and compliance costs.

75. Designing a minimum tax involves balancing five key trade-offs:
    - **Revenue and distributional.** Ensure the design of a minimum tax is robust and not easily avoided so it meets your revenue and distributional objectives
    - **Horizontal equity and fairness.** The rules should have equal treatment for people in similar circumstances and be seen as broadly fair
    - **Economic.** The rules should minimise economic distortions and support your economic strategy
    - **Certainty.** Taxpayers should be able to determine their minimum tax liability in advance with a sufficient degree of certainty
    - **Administration and compliance costs.** The rules should be kept as simple and easy to comply with as possible

76. A common trade-off across the design is between simplicity and accuracy. Simple rules will help reduce compliance and administration costs and may help provide certainty. However, simple rules may be inaccurate. This inaccuracy can create unequal treatment of people in similar circumstances and opportunities for tax planning and avoidance that could undermine your revenue and distributional objectives.

Overview of building blocks

77. We have structured the remainder of this report around the key parts of a minimum tax, as outlined in T2022/478. It is structured as follows:

    1. Exemption threshold. For people with a net worth above a threshold (e.g. $5 million).

    1a. Is exemption threshold calculated on an individual or family basis? (page 23)

    1b. Does the minimum tax apply solely to NZ tax residents? (page 25)

    1c. What assets and liabilities are included? (page 26)

2. Deemed income. Calculate deemed income by taking their net wealth and multiplying by a deemed rate of return. This deemed income is then taxed based on the individual's personal tax scale.

2a. Does the minimum tax compare taxable income with deemed income or tax paid with deemed tax? (page 28)

2b. Do we include wealth below the exemption threshold when calculating deemed income? (page 29)

3. Current tax rules. How much taxable income the person (or related entities) has under existing income tax rules.

3a. Is labour income included in this calculation? (page 32)

3b. How do we attribute income from companies and PIEs? (page 34)

3c. Assets held through trusts (page 37)

3d. Do we carry forward minimum taxes? (page 39)

4. Administration.

4a. Should there be broad discretionary relief from minimum tax? (page 40)

78. This framing is slightly different to how we presented the previous report. This is because we now consider it would be better to compare taxable income with deemed income rather than tax paid. This is outlined further in issue 2a on page 28.

1. Exemption threshold

1a. Is the exemption threshold calculated on individual or family basis?

Recommendation 1a

- The exemption threshold is calculated by combining the wealth of families (partners[6] and minor children).
- However, the deemed income calculation is then calculated by each individual family member.
- There are further exemptions for any individual family member who holds a relatively small amount of assets (e.g. less than $1 million), or in situations where pooling assets is impractical.

Analysis

79. You have indicated that you wish the minimum tax to apply only to people with net wealth above a certain threshold (e.g. $5 million excluding the family home)

80. We recommend this exemption threshold is calculated on a family basis. This is primarily to prevent gaming of the threshold by splitting assets among family members. In addition, we expect most families will share resources and so this is the more appropriate measure of their total net worth.

81. We also recommend that the assets of family trusts be included. This is discussed in section 3c. Unlike for individuals, there would be no separate de minimis for trusts, given the ease of forming multiple trusts.

Situations where pooling wealth is unfair or impractical

82. There are some situations where families may not share resources, for example where property is not included in relationship property. This raises potential fairness concerns for the partner with lower wealth.

83. We suggest two rules to help minimise this concern:
    - *De-minimis.* Individuals with relatively low wealth do not need to calculate the minimum tax or group their assets with others for determining if the application threshold is met (e.g. if less than $1 million of wealth for adults and potentially a lower threshold for minor children, say, $100,000)
    - *Elective alternative.* If there is a legal or practical issue with partners calculating their combined wealth, then each partner could instead choose to halve the exemption threshold. This could occur if the partners refuse to share information about their wealth with each other.

Individual calculation of deemed income

84. We propose that if the family wealth is above $5 million that each individual family member undertake the deemed income calculation separately. We recommend this because our income tax system is calculated on an individual basis.

[6] Partners would include spouses, civil union partners, and de facto partners as defined in the Property (Relationships) Act 1976.

Example scenario 1. Calculating threshold on family basis

Mike has $4.3 million in net assets, while his wife Wendy has just $800,000 in net assets. Their 16 year old son, Karl, has net assets of $5,000. Mike and Wendy have no other minor children and there are no trusts connected to either of them.

The family's total net assets exceed the $5 million threshold. However, because both Wendy and Karl have a net worth below the de minimis, their wealth is excluded from the family's wealth calculation so that only Mike's $4.3 million of net assets is counted. Therefore, no one in the family is required to calculate their deemed income and pay minimum tax.

Example scenario 2. Elective alternative threshold for couple

Sarah and Roger are a de facto couple with no children. Sarah has $1.6 million in net assets but does not know precisely how much wealth Roger has as he will not tell her. She suspects that it is probably more than $2.5 million including assets held in trusts connected to Roger but is unsure whether her wealth and his wealth combined would be above the $5 million threshold. Sarah and Roger agree to elect the alternative option where both apply an individual threshold of $2.5 million each.

As Sarah is below the $2.5 million threshold, she is not required to calculate her deemed income and does not pay the minimum tax.

Roger has net assets of $4 million and all his assets generate deemed income, so he is required to calculate his deemed income and pay minimum tax if his deemed income exceeds his taxable income.

1b. Does the minimum tax apply solely to NZ tax residents?

Recommendation 1b

- The minimum tax only applies to NZ tax residents.

Analysis

85. Given your stated distributional objectives, we have assumed that the intended target of the minimum tax is New Zealanders with high levels of wealth.
86. In addition to not being necessary to achieve your distributional objectives, applying the tax to non-residents would be difficult to enforce and would raise significant complexities around taxing rights. It would also create policy issues around the impact of the tax on inbound investment and productivity.

1c. What assets or liabilities are included?

Recommendation 1c

- All assets are included other than:
  - The family home
  - Consumer durables, small amounts of cash, and defined benefit funds
  - Māori interests in communally owned assets managed by Māori entity structures
  - Collectible assets such as art.
- The family home exception should be subject to a cap.
- Taxpayers can subtract debt (except if the debt is used to fund an excluded asset).
- The same rules for assets and liabilities apply for determining whether a family is above the exemption threshold and for calculating their deemed income.

Analysis

87. The asset and liability base will significantly impact the revenue, distributional, and economic impact of the minimum tax.

88. We recommend a relatively comprehensive asset base when calculating a person's wealth. This will help maximise the revenue and distributional impacts of the minimum tax. It will also improve horizontal equity and efficiency as it means that taxpayers with similar levels of wealth have similar treatment, regardless of how they have chosen to allocate their wealth. A comprehensive asset base also reduces opportunities for "gaming" by ensuring debt is used to fund included assets to the extent possible.

89. However, we recommend some limited exceptions for assets where the compliance costs are likely to be disproportionate to the revenue, or assets that are not expected to generate income. We also understand you wish to exclude the main home from the asset base. These exclusions are outlined further below.

Main home

90. You have indicated that you wish for the main home to be excluded from the proposal.

91. Officials are concerned that excluding the main home could create incentives to overinvest in the main home. We think there is merit to introducing a cap to the main home exemption[7].

92. Capping the main home exception has two main benefits:

    - It would improve horizontal equity and efficiency by providing more equivalent treatment of high-value main homes to other forms of wealth.

[7] Under this approach the value of a main home above the cap is included in the asset base for a minimum tax. (e.g. if the cap is $3 million, then someone who owns a $4 million house will have $1 million of net wealth for the tax).

- It would reduce the incentive to “over-invest” in the main home and reduce the disincentive to downsize to a lower-value property (including retirees moving into a retirement village).

Income generating assets

93. We recommend some limited exclusions for assets that are exclusively held for private use and that are not expected to significantly increase in value. This includes artwork, jewellery, cars, and other transport vehicles.
94. We similarly recommend excluding physical cash below a de minimis. We recommend that large holdings of cash be subject to the rules primarily for integrity reasons. We recommend consulting on an appropriate de minimis for this.

Other exclusions for compliance costs

95. We recommend excluding some assets that would have high compliance costs and where we think including them would not raise much additional revenue.
    - **Defined benefit funds.** These funds provide a person with a fixed, regular, income once the person has retired or when other criteria are met. We do not consider it practical to apply a minimum tax to these funds as it is not practical to allocate assets or income to individual members.[8]
    - **Māori interests in communally owned assets managed by Māori entity structures.** In general, these interests cannot be easily traded, transferred, or attributed to individual Māori. These interests are usually inherited or defined by reference to blood ties. Including these assets would come with disproportionate compliance costs with relatively little revenue or distributional benefits.
96. If you agree with this approach, officials will advise further on technical aspects of these rules in early 2023. For example, we can advise on whether Māori assets and interests should be included in a minimum tax when they are unitised and can be attributed to individuals.

Treatment of debt and assets for threshold versus deemed income calculation

97. We recommend that the minimum tax is calculated on net worth rather than gross wealth. This means taxpayers can subtract debt from assets. Debt would not be included if it is used to fund an excluded asset (e.g. a mortgage to fund the main home).
98. We also recommend the same asset and liability base is used both for calculating whether a family is over the exemption threshold as well as each individual’s deemed income.

[8] Other managed funds, such as multi-rate PIEs, do provide the information for income earned (and taxed) at an individual investor level due to the compliance requirements of the PIE regime.

2. Calculating your deemed income

2a. Does the minimum tax compare taxable income with deemed income or tax paid with deemed tax?

Recommendation 2a

- The minimum tax compares an individual's 'deemed income' against their 'ordinary taxable income' from their net assets (i.e. excluding labour income – see section 3a below).
- If deemed income is greater than 'ordinary taxable income', the deemed income is included in the individual's personal income instead and subject to personal income tax.

Analysis

99. The minimum tax could either:
    - Compare taxpayers' deemed income with their ordinary taxable income; or
    - Compare the tax payable under a deemed income tax with the tax payable under ordinary tax rules

100. The main difference between these two approaches arises when there are different tax rates that apply to the income (e.g. company tax rate, trustee tax rate or personal tax rates).

101. We have assumed that a minimum tax will apply using the first approach where we compare taxpayers deemed income with their ordinary taxable income. Given your objective is targeting undertaxed income, we believe comparing taxable income is more in line with this objective.

102. We also think this approach is more feasible and simpler than the second option of comparing tax paid. Comparing tax paid would raise difficult technical issues around carrying forward minimum taxes (see decision 3d) and tax credits (including foreign tax credits).

2b. Do we include wealth below the exemption threshold when calculating deemed income?

Recommendation 2b

- We recommend including wealth below the exemption threshold when calculating deemed income.

Analysis

103. When people's net wealth is above an exemption threshold, there is the choice of whether they should calculate their deemed income based on either their total wealth or only on wealth that is above the exemption threshold.

Choices

104. We have considered two main options:[9]

- ***"Switch".*** Wealth below the threshold is fully included for calculating their deemed income.
- ***"Discount".*** Wealth below the threshold is excluded through a 'discount' on any deemed income that is above their taxable income.

105. These choices are illustrated in example 3.

Example scenario 3 – switch vs. discount

Tara is a farmer and:

- Has $15 million of wealth;
- Earns $400,000 of taxable income from the wealth; and
- Is subject to a minimum tax which has a $5 million threshold and a 5% deemed rate of return

Her minimum tax liability will depend on whether we take the 'switch' or 'discount' approach.

Switch approach

Under the 'switch' approach, Tara has deemed income of $750,000 (5% of $15m). This is greater than her taxable income of $400,000 and so she pays tax on $750,000 of deemed income instead of $400,000[9].

Discount approach

Under the discount approach Tara is still subject to the minimum tax, however she can reduce her taxed deemed income from $750,000 to $633,333 by applying a discount to the deemed income adjustment[10].

Tara calculates the discount by:

- Working out how much higher her deemed income is than her taxable income ($750,000 minus $400,000 equals $350,000).
- Multiplying this by the proportion of her wealth that is below the exemption threshold (33.33% - $5 million compared with $15 million).
- This leads to a discount of $116,667 which reduces her deemed income adjustment to $233,333, and her taxable income is $633,333 after adding the adjustment.

Trade-offs

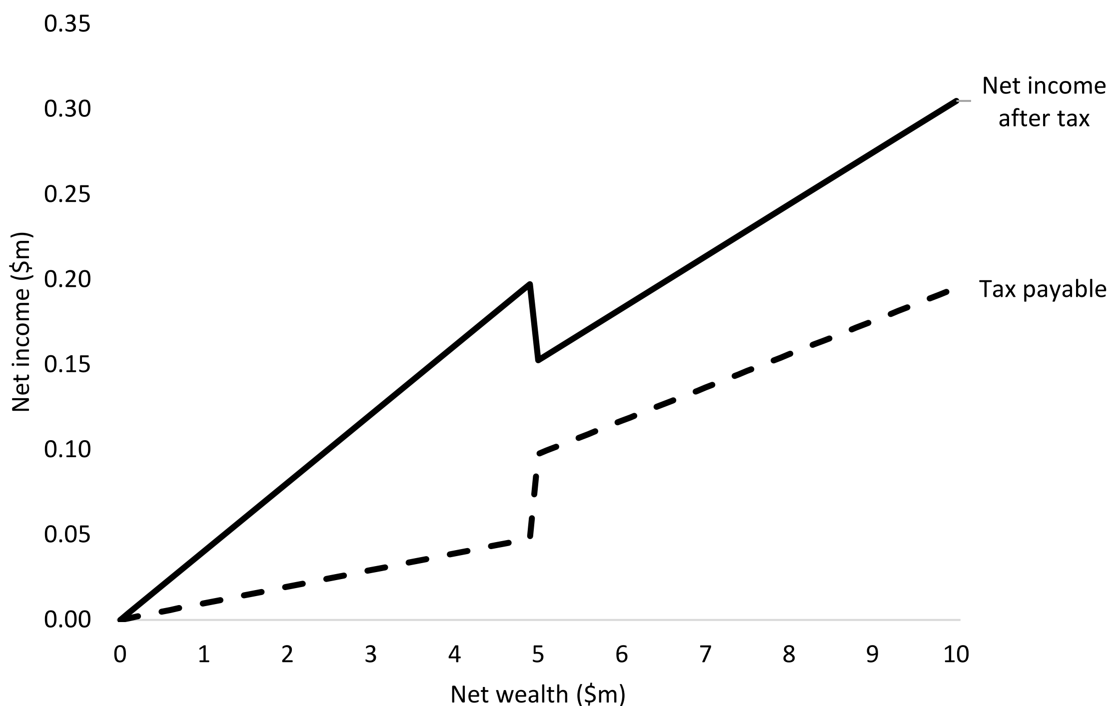
106. The key trade-off between the two is the 'switch' is less complex and increases revenue and distributional gains from the proposal. However, it comes with a 'cliff-edge' incentive effect.

Cliff-edge

107. The 'cliff-edge' incentive effect occurs when someone's tax liability increases significantly if they move above the exemption threshold. Under the 'switch', when someone crosses the exemption threshold all their wealth is subject to the minimum tax, not just the amount above the threshold.

108. This is illustrated through Figure 2 below. This is a stylised example of how a deemed income tax with a 'switch' could impact how much a person's net income increases as their wealth increases. In this scenario, if a person is close to $5 million in wealth (the exemption threshold in this scenario) they have a strong incentive to avoid increasing their wealth above $5 million as it leads to a significant decrease in their after-tax capital income.

Figure 2. "Cliff-edge" example scenario



[9] We have also considered an option where all wealth below the threshold is exempted. However, we have discounted this option as it would likely significantly reduce the revenue and distributional benefits. For example in scenario above it would lead to Tara not being subject to the minimum tax.

[10] Mechanically, the higher taxed amount would be given effect by adding to her taxable income of $400,000 a "deemed income adjustment" amount of $350,000 (the difference between the deemed income and the taxable income (before adjustment)).

Table 7. Assumption for figure 2

Tax rate	Untaxed capital gains as proportion of economic income	Deemed income rate and economic income	Exemption threshold
39%	50%	5%	$5 million

Revenue and compliance cost

109. Option 2 of having a 'discount' avoids this cliff-edge. However, it is complex and leads to a significant reduction in the revenue gains from the proposal.

110. We have not quantified the size of this but Table 8 illustrates how, with a $5 million threshold, exempting the first $5 million of wealth from deemed income calculation would remove approximately 40% of wealth from the deemed income base.

Table 8. Indicative impact of excluding wealth below threshold

Total wealth exempted with $5m exemption	Wealth remaining in base	Proportion of wealth remaining
$123b	$175b	59%

Note. This uses the experimental 'capitalisation' methodology. See Box 1 for limitations and Annex for explanation of this methodology. This estimate looks at individuals rather than families. As outlined on 1a, we are recommending that a minimum tax applies to people whose combined family wealth is above the threshold. In addition, the figures above estimates individuals' total wealth, excluding the family home and durables the family home, which will be excluded from the minimum tax.

Assessment

111. We believe this is a finely balanced decision. On balance, we recommend the 'switch' approach and believe the costs from the discount approach are likely to exceed the gains from avoiding the 'cliff-edge' effect.

112. This is because the discount is complex and the revenue impacts from the discount are likely to significantly reduce the gains from a minimum tax. Our judgement is that the discount approach will mean that many taxpayers that are slightly above an exemption threshold will incur large compliance costs that are disproportionate to revenue gains.

3. How much taxable income the person (or related entities) has under existing income tax rules

3a. Is labour income included in the calculation?

Recommendation 3a

- Only capital income generated by assets are included.
- There are specific rules to disentangle labour from capital income.
- One of these rules is a 'ring-fencing' rule for closely-held businesses. Under this the taxable income from closely-held business assets can only be compared with the deemed income from the business.
- If you agree with this approach, we will advise further on these rules in early 2023.

Analysis

113. For a minimum tax, we need to compare a person's 'deemed income' with how much 'ordinary taxable income' they generated to determine if the minimum tax applies.

114. This is one of the most complex areas of a minimum tax, due to the need to split capital from labour income and attribute income earnt through entities. We recommend the following approach.

Capital income

115. We recommend that the minimum tax focus on taxable income from capital and exclude labour income. This is because:
    - We understand the main objective of the rules is to address situations where the tax paid on some capital investments is low. Including taxable labour income in the calculation is not consistent with this.
    - Including labour income would create anomalies. Taxpayers that earn significant labour income would be more able to shelter lightly-taxed capital income from the tax. This would also mean the minimum tax would likely have disproportionate impact on groups with low labour income, such as the retired.

116. However, limiting the rules to capital income is complex and could create incentives for taxpayers to reclassify labour income as capital. We will advise on options to address this in early 2023.

117. We also recommend a ring-fencing rule for business assets as outlined in the section below.

Integrity risks for companies

118. At a high level, under the proposed approach for some companies (see 3b), income that is retained in a closely-held company would be attributed to the shareholders as income from capital for the purposes of calculating whether they have a minimum tax liability. Salary payments to the owner-operator would not count as capital income (and would reduce the capital income made by the company).

119. This creates a significant integrity risk for the minimum tax, given the relative ease with which owner-operators can reclassify their labour income as income from capital. This shown in example 4 below

Example scenario 4 – how to reclassify labour as capital income

Dean is a doctor and runs a practice

- The practice is worth $5m and earns $125,000 in taxable capital income
- Dean holds other assets worth $5m that also earn $125,000 in taxable capital income.
- Dean currently pays himself a salary of $500,000 a year from the practice.

Dean is potentially subject to a minimum tax with a deemed income rate of 5%. This is because his deemed income is $500,000 (5% of $10 million) which is greater than his capital income from assets of $250,000.

However, Dean can avoid the minimum tax by reducing his salary to $250,000 and instead paying himself $250,000 in dividends from the practice (in addition to the $125,000 of capital income already made by the company). This means his capital income is now equal to $500,000 and so the minimum tax no longer applies.

120. One way to minimise these risks is to 'ring-fence' closely-held businesses' income and assets for the purpose of the deemed minimum income calculation. However, this can be complex and will not fully resolve the risk.

121. We will provide advice on this issue in our advice next year.

3b. How do we attribute income from companies and PIEs?

Recommendation 3b

- Special rules to attribute company income in some cases.
- Taxable income of PIEs is attributed to the investor.

Analysis

122. When an individual invests their wealth into a company, the returns generated by that wealth may be distributed as dividends or retained in the company for future use. Dividends are taxable income, so if returns are distributed, applying the minimum tax is relatively straightforward.

123. However, companies will often retain some level of earnings for future investment. In this case, the individual's wealth may generate a fully-taxed return equal to or higher than the deemed rate – but if the minimum tax rules do not take these undistributed earnings into account, it could overtax the investor.

124. We propose special rules to attribute company income to shareholders in some cases. We will report to you next year on the detail of these rules.

Significant company interests

125. For some significant company interests where the shareholder may be expected have significant knowledge of or control over the company,[11] we propose that any taxable income made by the company is directly attributed to the shareholders (in proportion to their shareholding)[12].

126. We propose this approach as the shareholders for closely-held companies have greater ability to work out the income of the company as they control it. This will also reduce an incentive for an owner of a closely-held company to pay dividends (to reduce the possibility that the minimum tax will apply) when the owner would prefer to retain the earnings to use in the business.

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[11] The exact criteria could be determined following consultation. The nature of the criteria would be establishing whether the shareholder has sufficient knowledge and/or control of the company to have necessary information and view the business of the company to be more integrated with the individual.

[12] This amount is reduced by the amount of dividends paid by the company to prevent double counting.

Example scenario 5. Closely-held companies

Jen:

- Owns 50% of a manuka honey producer and is above the minimum tax threshold because of her other assets.
- Jen's shares are worth $500,000.
- The company earned a total of $20,000 in taxable income and paid gross dividends of $15,000 ($7,500 to Jen).
- Jen's deemed income from the business is 5% of $500,000, or $25,000.
- The taxable capital income from the business includes the gross dividends paid to Jen ($7,500) and Jen's share of the taxable income of the company (50% of $20,000, or $10,000).

In calculating the taxable income from capital, Jen is allowed to include the taxable income of the company (since the company is closely-held), but only to the extent the company income exceeds the dividends (since they are already part of her taxable capital income).

This means the total capital income from owning shares in the company is $10,000. As that is less than the deemed income amount of $25,000, she must pay tax on the shortfall of $15,000. Since that additional income is applied to her individual tax calculation, she must pay the personal tax rate on it.

Other companies

127. For all other companies we propose that only dividends paid by the company are included
128. We propose this as it would be more difficult for shareholders of these companies to get information from the company as they do not control it.

Example scenario 6. Other companies

The scenario is the same as the prior example, except the company Jen owns shares in is widely-held.

Jen's shares are worth $500,000 and she received gross dividends of $7,500. Jen doesn't know what the company's taxable income was, but it is irrelevant since shareholders of a widely-held companies are not allowed to take that into account.

Her deemed income amount $25,000, and the taxable capital income from owning the shares is $7,500, so she would be required to pay tax on an additional $17,500 of income.

PIEs (managed funds such as KiwiSaver)

129. For PIEs we propose that the taxable income of the PIE is attributed to the investor. If minimum tax applies as a result of an investment in a PIE fund returning income at less than the deemed rate, the difference would be taxed at the individual's personal tax rate. This would be combined with all other sources of deemed income and taxable capital income relevant for the individual.
130. IR systems currently enable IR to trace taxable income from PIEs to individual investors.

Example scenario 7. PIEs

Alan is:

- A 39% individual taxpayer;
- Has a managed fund investment worth $600,000 at the beginning of the year.
- The PIE fund earned taxable PIE income of $20,000 (this would be a combination of dividends on Australasian shares, 5% deemed income on foreign shares under the FIF regime, and interest income. Trading income on Australasian shares are not taxed under the PIE rules).
- The PIE paid tax on Alan's behalf at 28% ($5,600).

The deemed income from the PIE investment is $30,000 (5% of $600,000). To calculate the additional tax Alan may take into account the PIE taxable income of $20,000 (in addition to other sources of taxable capital income). From the PIE investment alone, there would be deemed additional income of $10,000, and the tax on that would be $3,900.

3c. Assets held through trusts

Recommendation 3c.

- **Trusts that are excluded from minimum tax:**
  - Charitable trusts, community trusts, Māori authorities, or other similar trusts not for the benefit of specific persons or classes of persons are not subject to the minimum tax.

- **Attributing to fixed income beneficiaries**
  - If the trust has beneficiaries entitled to fixed income interests, the assets of the trust allocated to the fixed income share is grouped with the beneficiary's other assets in applying the exemption threshold test for the beneficiary's family and the trust.

- **Attributing to principal settlor for discretionary trusts**
  - If the principal settlor of the trust is alive, the assets of the trust are grouped with the principal settlor's assets to determine if the exemption threshold applies to the principal settlor's family and the trust.
  - If the principal settlor is dead (testamentary trust), the assets of the trust are grouped with the assets of other trusts settled by the same person to determine if the exemption threshold applies to the trusts.
  - A principal settlor is the person who has made the largest, or largest equal contribution to the trust.

Analysis

131. We consider it essential for a minimum tax to have robust rules around trusts. Trusts are a common way for high-wealth individuals to hold assets and provide a potentially easy way to avoid a minimum tax.

132. We propose that where a trust provides for fixed (non-discretionary) income rights to particular beneficiaries, those beneficiaries are treated as benefitting from the assets of the trust that generate the income. Where there are fixed income beneficiaries, the assets of the beneficiaries are grouped with the allocated assets of the trust to determine if the exemption threshold is met for the beneficiaries' families and the trust.

133. For other trusts (discretionary), we propose to group assets of a trust with the assets of the principal settlor of the trust to determine if the principal settlor's family and the trust meet the exemption threshold. The principal settlor is the person who has made the largest contribution of assets to a trust.

134. This approach prevents people from putting assets into trusts to avoid the tax. This approach is also consistent with the broad approach to trusts in the New Zealand income tax system, which is focused on the settlor.

Example scenario 8. Couple with a family trust

Shepard:

- Has $4.5 million of net assets
- His partner has $800,000 of net assets
- A family trust settled by Shepard has assets of $600,000
- All of Shepard's minor children have net assets below the de minimis

For calculating the exemption threshold amount, Shepard's net assets of $4.5 million must be grouped with the trust's $600,000 worth of assets.

Shepard's partner and his minor children do not need to have their net assets added as they are below the de minimis limits.

As the total net assets of Shepard and the trust are above the exemption threshold ($5.1 million), Shepard and the trust must each do the minimum tax calculation (based on the income and net assets of each separately). Shepard's partner and his minor children do not have to do a calculation based on their own assets and income, since they are below the de minimis.

3d. Carrying forward minimum taxes

Recommendation 3d

- Minimum tax includes carry forward rules to smooth out timing differences.
- The general principle of this approach is that, over time, a person's taxable income should be the greater of their total taxable income or deemed income over the whole period, but not more.

Analysis

135. The minimum tax can have negative impacts on people with lumpy or volatile income. Example scenario 9 below illustrates this

Example scenario 9 – Forestry and minimum tax

Elijah invests $10 million in a forestry business. The forestry business is not expected to be harvested for 20 years and so will not generate any taxable income or cashflow for that period.

After 20 years Elijah expects to sell the forest for $25 million (approximately a 5% rate of return).

If there is a minimum tax with a deemed rate of 5%, then Elijah will effectively be taxed twice if there are no carry-forward rules. Over the 20 years he will pay minimum tax every year and then also pay taxable income on sale of the forest.

136. We propose carry-forward rules to help mitigate this.

137. Under this approach, an account would keep track of how much deemed capital income exceeded taxable capital income over time. In a year when taxable capital income exceeds deemed capital income, then the taxpayer could deduct the carry-forward amount. This is to account for the fact that the taxpayer paid tax on the higher deemed amounts in earlier years.

138. This will help address situations with lumpy or volatile income however, we note this is only a partial solution. A minimum tax will still have negative impacts on risk in situations where the income never reverses (i.e. where it is not just a timing difference, but the investment earned a real loss over time). This is outlined in paragraphs 150-163.

4. Administering a minimum tax and further exceptions

4a. Should there be broad discretionary relief from minimum tax?

Recommendation 4a

- Concerns about fairness are managed with specific legislative rules, or through targeted discretionary powers for defined situations.
- However, if you wish to progress with a broad discretionary power, we wish to discuss further with you the sorts of situations which are likely to be seen as unfair.
- Officials will report back with some principles that best capture these situations and some further advice on how a fairness discretion for defined situations might be made operational.

Analysis

139. We understand you are concerned that a minimum tax could be unfair in some situations such as when there are failed start-ups.

140. You have asked for advice on having a broad discretionary power to change how a minimum tax is applied when it is seen as unfair.

141. A wide discretion would be unusual for our tax system as tax rules are generally set by legislation. The Commissioner has some discretionary powers, however these are relatively well defined in the legislation and targeted (such as for financial hardship).

142. In our view, the inclusion of wide discretionary power comes with three key risks. A wide discretionary power would:

    - *Increase uncertainty:* Tax reviews both in New Zealand and overseas have noted the significance of the value of certainty in the administration of a tax system. It is likely that taxpayers will argue that when they are considering making investments and business decisions, they should be able to focus on those issues rather than entering discussions with a discretionary body on the tax outcomes.
    - *Be difficult to apply and administer:* Applying fairness considerations would differ significantly from other frameworks designed to offer relief (e.g. financial hardship). Applying a wide discretion based on fairness would require subjective value judgements about specific circumstances. This would create the risk of inconsistent decisions on the affairs of taxpayers in similar circumstances (i.e. horizontal equity).
    - *Impose significant administrative cost:* Administering a wide discretionary power would require significant operational resourcing and staffing. We would expect many taxpayers would seek relief from the minimum tax based on fairness. The decisions of the Commissioner would also be subject to judicial review in the High Court.

143. These challenges would increase with the breadth of the discretion. These challenges could be mitigated by including a narrow discretion, or specific carve outs for assets or business models which you consider would be unfair to bring into the regime. However, including carve outs for various assets or business

models could create the perception of unfairness for those whose assets or business models are not carved out.

144. If there is a broad fairness discretion for a minimum tax, there may be pressure to use it for other aspects of the tax system. This will have its own set of costs and benefits.

Alternative options

145. We are considering alternative options to address your concerns such as:

   - Specific legislative rules to address situations you are concerned about (such as start-up businesses); and
   - Targeted discretionary powers for defined situations. For example, allow the Commissioner of Inland Revenue to defer payments of minimum tax in particular circumstances.

146. These could meet your concerns about fairness, without the potential risks of broad, subjective, discretionary powers.

147. We would like to discuss further with you about the specific fairness situations you were concerned about so we can advise further on this.

Issues we will advise on in early 2023

148. Officials will provide advice on further design issues in 2023. This section provides our initial thoughts on issues of deemed income rate, valuation, and the exemption threshold.

149. These three issues are all material for the revenue, distributional, and economic impacts of a minimum tax. However, they are not structural issues and so are less crucial to progressing a minimum tax. We will instead seek your decision on these in early 2023.

Deemed rate

150. This section builds on our prior analysis to show how a minimum tax impacts risk and how the choice of a deemed income rate affects both the biases towards risk, as well as the fairness and revenue outcomes of a minimum tax.

Impact of minimum tax on risk

151. A minimum tax will increase biases against risk. We can illustrate this by comparing a minimum tax with a comprehensive income tax.

152. A comprehensive income tax (that taxes capital gains and gives credit for capital losses) would not tax risky returns more heavily than risk-free returns. This is because such a tax system would absorb some of the risk in years or scenarios where the risky investment failed. That is, while it would capture some of the upside risk, it would also cushion some of the downside risk.

153. Because of this symmetry, a comprehensive income tax is also equivalent in its treatment of risk to a deemed income tax where the rate of deemed income equals the risk-free rate. There is symmetry in the risk-free rate method of taxation because *all* of the risk is put back on the investor, rather than partially absorbed through the tax system, but all of the risky return is also reallocated to the investor.

154. In contrast, a deemed minimum tax still absorbs upside risk (through a higher deemed rate, or through existing taxable income rules), but does not absorb any of the downside risk, thereby asymmetrically pushing risk onto investors. This means it creates a bias against risk that is likely to discourage entrepreneurship and innovation.

Impact on economic rent

155. Note that a comprehensive income tax (that taxed capital gains and gave credit for capital losses) would treat economic rent very differently from a deemed income tax where the rate of deemed income equals the risk-free rate. The comprehensive income tax would tax many more instances of economic rent.

156. Attempting to tax economic rent with a single deemed rate set across the whole economy is unlikely to be successful given the extremely varied rates of return earnt by different individuals with different assets.

Example scenario 10. Minimum tax and risk

Roger, a Queenstown resident, wants to invest $10m. He is deciding between a risky and a risk-free investment and his current tax rates are 40%.

A. *Risk-free investment*: New Zealand Government bonds.
   a. Yields 5% per annum before tax (3% after tax)

B. Moderate-risk investment: Queenstown holiday rentals, which he estimates has an 80% chance of success.
   a. If it succeeds it generates 7% per annum (4.2% after tax)
   b. If it fails it generates nothing
   c. As a result, the moderate-risk investment has an expected return of 5.6% before tax (3.36% after tax)

C. High-risk investment: Queenstown technology hub, which he estimates has a 50% chance of success.
   a. If it succeeds it generates 12% per annum before tax (7.2% after tax)
   b. If it fails it generates nothing
   c. As a result, the high-risk investment has an expected return of 6% before tax (3.6% after tax)

If there is a minimum tax at a 5% deemed income rate, then the risk-free investment will be unaffected by the change as its taxable income is equal to the deemed income rate.

However, both the moderate and high-risk investments will be affected as follows:

a. If the investments succeed, then they will be taxed the same as under existing rules
b. If the investments fail, then they will now be taxed on 5% deemed income and so make a loss of 2% after tax.
c. As a result, the expected return of the moderate-risk investment is reduced to 2.96% and the high-risk investment is reduced to 2.6%.

As a result, the minimum tax ends up reducing the expected returns of both the moderate and high-risk investments, with a greater impact on the high-risk investment. Without the minimum tax, the high-risk investment had the *highest* after-tax expected return of all three investments (3.6%); with the minimum tax, it has the *lowest* (2.6%).

Effect of deemed income rate on risk

157. The minimum tax will have greater biases against risk if the deemed income rate is set at above the risk-free rate of return. This will further disincentivise innovative and entrepreneurial investments, relative to setting the deemed income rate at the risk-free interest rate.

158. Setting a rate that is above the risk-free interest rate would also tax risk-free investments on more than the total income they generate.

159. In contrast setting the deemed income rate at the risk-free rate will lessen, but not remove the biases against risk. This approach would also ensure that risk-free investments that are already fully-taxed (such as investments in New Zealand Government Bonds) would not face any increase in tax liability because of this measure.

Effect of deemed income rate on revenue and distributional objectives

160. The perceived fairness of a particular deemed income rate is also linked to the impact of a minimum tax on risk.

161. A deemed income rate that is set at the risk-free interest rate may *appear* as if it is continuing to under-tax high-wealth individuals when their investments do well and earn risky returns.

162. However, this ignores how a minimum tax applies when investments do poorly. As outlined above a deemed income tax set at the risk-free rate is equivalent to a comprehensive income tax. While in any given year a tax based on the risk-free rate may appear less than a wealthy investors economic income, this ignores the impact over a longer timeframe. When taken over a long timeframe and accounting for how it taxes investors even when they make losses, a risk-free tax is equal to a tax on risky gains and losses.

163. The choice of rate will also impact tax revenues. A higher rate will generate more revenue and a lower rate will generate less.

Threshold

164. The choice of exemption threshold primarily depends on your revenue and distributional goals.

165. A higher exemption threshold will raise less revenue, but mean less people are affected as the policy is more targeted at higher-wealth individuals. Table 5 on page 13 includes our initial estimate of the number of individuals with wealth above different thresholds.

Valuation

166. Valuation rules shape both the total compliance costs of a minimum tax, as well as how evenly the minimum tax is applied to people with different investments. This uneven application could happen if some assets have more generous valuation rules or where there are differing opportunities to get around the tax through undervaluing assets.

167. Officials' initial view is that the rules should aim to ensure assets are valued at their open market value.

168. This approach will be difficult for some assets, such as closely-held businesses, and some property (e.g. commercial or foreign land or where an apportionment is needed between the main home and other land).

169. Officials need to do further work on valuation. This is a significant piece of work that requires an evaluation of approaches taken in other countries and, ideally, consultation with stakeholders and experts in valuation.

Remaining design issues

170. You will also need to make a range of further detailed design decisions for a minimum tax. This includes consistency with our international tax framework, the interaction with the rest of the tax system, and the detailed design of the rules we have outlined in this paper.

171. Some of these may not require decisions as part of Budget 2023 and can be addressed in subsequent detailed design. We will recommend an approach to these issues in early 2023.

Annex: Distributional data

The Household Economic Survey (HES) is known to undercount wealth at the top of the distribution. Officials are working on methods to help understand the top of the wealth distribution:

1) *The capitalised wealth distribution*: 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) *Adjustments to HES*: we are investigating alternative methods to adjust HES to account for underreporting of wealth, particularly for high-wealth individuals.

3) *Inland Revenue's High Wealth Individual Research Project*: this will provide additional distributional insights for the very top of the wealth distribution and plans to report in the second quarter of 2023

This report provides distributions based on HES 2018 and 2021, as well as the experimental capitalised wealth distribution. The capitalised wealth distribution is based on personal taxable income returns for the tax year ended 31 March 2020.

All conclusions in this annex should be seen as indicative and treated with caution, since both data sources have their limitations, notably:

- 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. Further, potential selection biases may affect the demographic aspects (gender, region and industry) of the data, since disclosure requirements may vary by individual.[13]

Note. 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.

[13] For example, industry data is only required from the self-employed, and regional data is based on post codes, which may not fit neatly into regional boundaries.

Table 9 shows how using a family unit instead of an individual unit can increase the applicable wealth and number of people above various wealth thresholds, according to HES 2021. Applicable wealth is total net worth excluding owner-occupied housing, consumer durables (eg vehicles) or valuables.

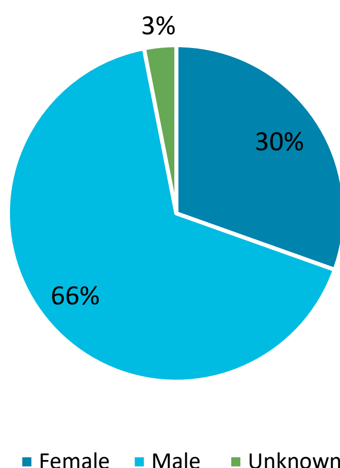
Table 9: Differences in population (aged 15+) and applicable wealth above net worth thresholds when using a family unit compared to individual units (HES 2021)

	Individuals or families with applicable wealth above …			
	$4m	**$5m**	**$6m**	**$7m**
Individuals with applicable wealth above threshold	26,000	20,000	15,000	10,000
People in families with applicable wealth above threshold	79,000	54,000	45,000	32,000
Increase in people above threshold when using families	3 times greater	2.7 times greater	3 times greater	3.2 times greater
Individual applicable wealth above threshold	$210b	$180b	$150b	$120b
Family applicable wealth above threshold	$280b	$230b	$210b	$180b
Increase in applicable wealth when using families	1.3 times greater	1.3 times greater	1.4 times greater	1.5 times greater

Note. The figures here will differ to the capitalisation figures in Table 5 because HES underreports wealth. If wealth is less evenly shared *within* wealthy families who are not adequately sampled by HES, then we would expect a lower increase in wealth from using families instead of individuals for the exemption threshold. However, we still expect using families for the exemption threshold to increase the number of people affected by the approximate ratios in this table.

Figure 3 shows that approximately 66 percent of those individuals with capitalised wealth above $5 million are male. This data is inferred from individual's titles since Inland Revenue does not collect data about gender.[14] HES 2018 and 2021 also shows that most high-wealth individuals are male, but when considered on a family basis there is an even split between males and females in high-wealth families.

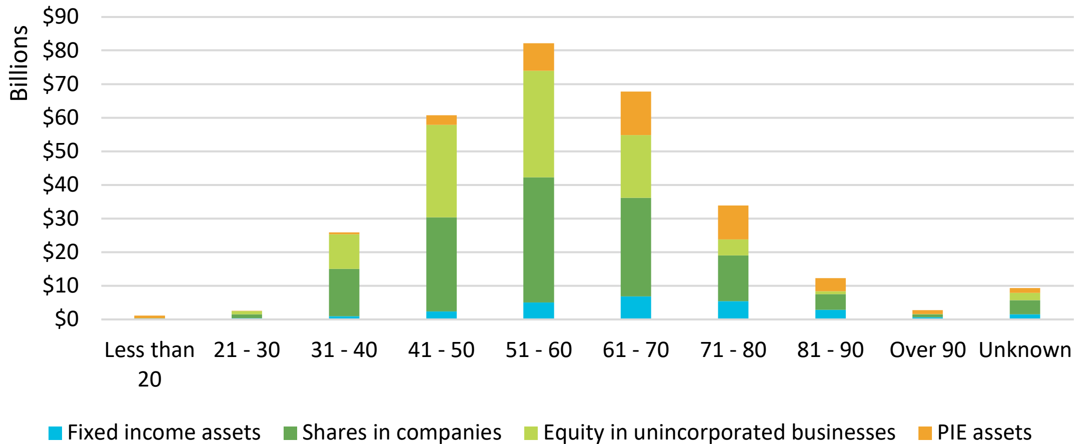
Figure 3. Inferred gender for individuals with capitalised wealth above $5 million 2020



[14] The titles Dame, Lady, Mrs, Miss, Ms, Reverend Mother and Sister are assumed to be female. The titles Lord, Master, Mr, Reverend Father, and Sir are assumed to be male. Everyone else are labelled unknown, for example, Dr, Hon or Mx.

Figure 4 shows the distribution of capitalised wealth according to age. This data is based on taxpayers' birthdays and is likely to be more reliable than the other distributions in this annex. It shows the expected lifecycle pattern, whereby wealth is accumulated during the working years and reduces as people get older. The asset mix also varies by age, with proportionately more PIE and interest generating wealth for older groups.

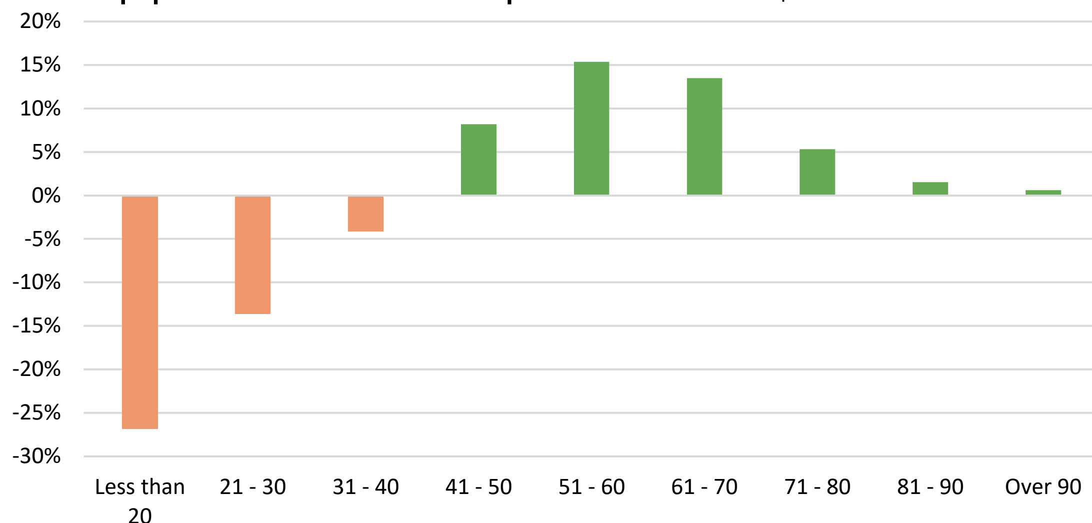
Figure 4. Wealth by asset type and age bracket for capitalised wealth over $5 million in 2020



Note: equity in unincorporated businesses includes sole traders, partnerships, trusts, non-corporate farms and rental properties.

Figure 5 compares the age distribution of those with capitalised wealth above $5 million in 2020 with the general census age distribution in 2018. This shows that the wealthy tend to be older than the general population, with over half of the wealthy individuals aged at 51 or older. Similarly, HES 2018 and 2021 indicates that about 70% of people in families with wealth over $5 million are over 45 years.

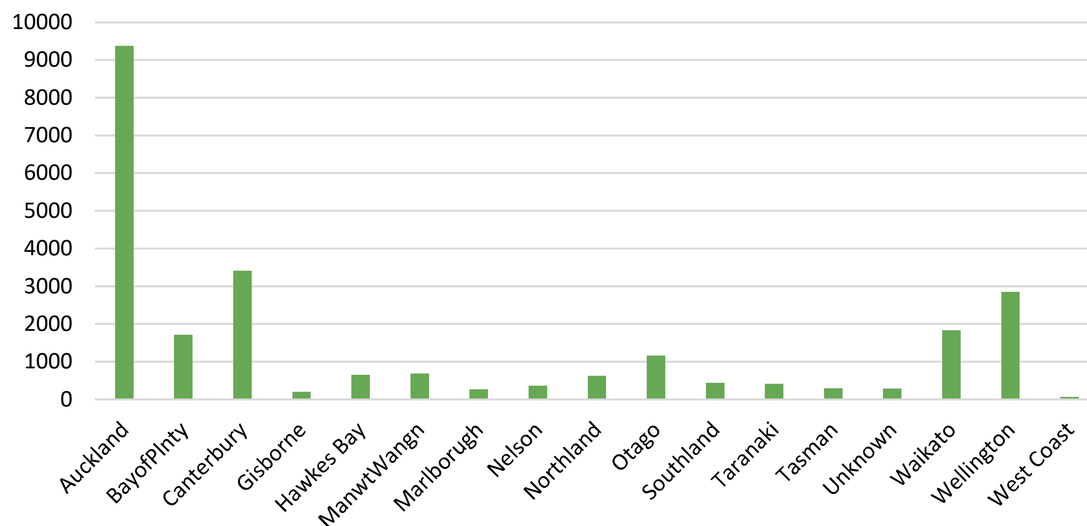
Figure 5. Percentage point difference between the age distribution for the 2018 estimated resident population[15] and those with capitalised wealth over $5 million in 2020



[15] The estimated resident population is based on the 2018 census with updates for missed residents or those counted more than once by census, residents temporarily overseas on census night, births, deaths and net migration between census night and 30 June, and reconciliation with demographic estimates at the youngest ages.

Figure 6 uses postcode data to sort the population by geographical region. This data may be subject to some bias,[16] but appears to indicate that the regional distribution of those with net worth over $5 million is roughly the same as that of the general population.

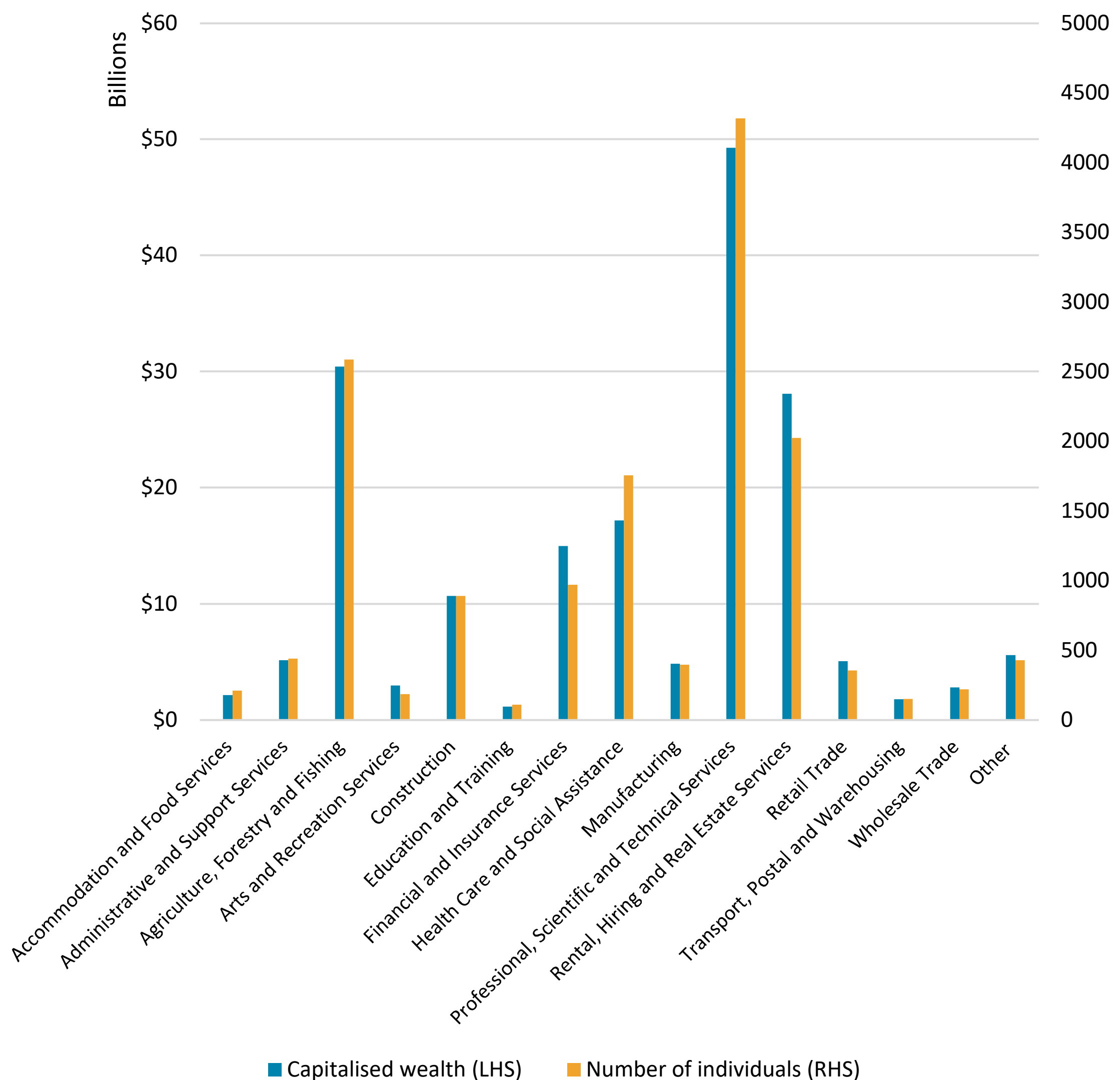
Figure 6. Regional distribution for those with over $5 million capitalised wealth in 2020



[16] For those living at postcodes whose area of coverage crosses a regional boundary we use unweighted randomisation to assign a region. This could downward bias the results for regions with a higher concentration of their population living across a regional boundary.

Figure 7 shows the capitalised wealth (LHS) and number of individual taxpayers (RHS) by industry for those with capitalised wealth above $5 million. Selection bias may mean that this chart does not accurately reflect which industries will be most affected by a deemed minimum tax.[17]

Figure 7: Reported industries for those with capitalised wealth above $5 million in 2020



HES data on industry composition for those with wealth over $5 million are sparse, with most being unspecified. However, 10 – 20% are in ‘agriculture, forestry and fishing’, making this category standout as a significant industry for those with over $5 million.

[17] Approximately 10,000 taxpayers, with over $100 billion in capitalised wealth, did not report an industry on their personal tax return because this is not a requirement unless you are self-employed. This ‘unknown’ group is almost twice as large as any other group shown in Figure 7. The Figure 7 may be biased towards industries that use self-employment structures. The distribution of the unknown entries could significantly alter this distribution, were the information collected.