The Treasury

Budget 2023 Tax Initiatives Information Release

July 2023

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Inland Revenue
Te Tari Taake

POLICY AND REGULATORY STEWARDSHIP

Tax policy report: **Broader context for considering decisions on the trustee [33] tax rates**

Date:	10 November 2022	**Priority:**	High
Security level:		**Report number:**	IR2022/483 T2022/2474

Action sought

	Action sought	**Deadline**
Minister of Finance	**Discuss** the contents of this report with officials **Note** the contents of this report	21 November 2022
Minister of Revenue	**Discuss** the contents of this report with officials **Note** the contents of this report	21 November 2022

Contact for telephone discussion (if required)

Name	**Position**	**Telephone**
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10 November 2022

Minister of Finance
Minister of Revenue

Broader context for considering decisions on the trustee [33] tax rates

Executive summary

1. In August 2022, you requested further advice on possibly raising trustee [33] [33] tax rates for Budget 2023. This report sets out the broader policy context for considering those decisions and should be read alongside the two accompanying reports on trusts [33]

2. Growing fiscal pressures may make it challenging over the medium term for the Government to meet its fiscal objectives without raising revenue or reducing expenditure. However, the integrity pressures which currently arise from misalignment between the company, trustee, PIE and top personal tax rates make it very difficult for the Government to raise significant additional revenue in a way that is progressive and economically efficient. This is because having lower tax rates on income derived through certain entities means that those earning income through these lower-tax entities will not be affected by any increase in personal tax rates, reducing the revenue gain from such a rate increase and undermining the Government's distributional objectives.

3. There are sound policy reasons for the company rate to be lower than the top personal rate. The need for foreign investment makes a high company tax rate difficult to sustain. However, the current structure of the system is likely to have higher than necessary wellbeing costs overall including by undermining perceptions of fairness in the system and imposing higher economic costs than a more coherent system.

4. [33]

5.

6. [33] we consider that changes to trust taxation are likely to be beneficial [33]

7. [33]

[33]

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9.

10.

11.

Recommended action

We recommend that you:

1. **Discuss** with officials how decisions on the taxation of trusts [33] fit with your underlying objectives and intended direction for the tax system

2. **Note** that officials will continue stewardship work on assessing a broader range of options that could help meet medium-term revenue strategy objectives

   Noted   Noted

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Manager
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Hon Grant Robertson
Minister of Finance
/ /2022

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/ /2022

Purpose

1. You have asked for advice on options to raise revenue for Budget 2023. This report sets out how any resulting decisions on those options fit within the broader structure of the tax system. It is part of a suite of three reports. The other reports are:

   1.1 IR2022/484, T2022/2469: *Taxation of trustee income* ("the trusts report"); and

   1.2 [33]

   We suggest reading this report before decisions are taken on the above reports.

2. We wish to discuss with you your longer-term goals for the tax system. For the purposes of this report, we have assumed that you want to maintain a lower company tax rate than the top personal tax rate.

Background

3. We have previously reported to you on revenue raising in both the short and medium term, and on integrity measures to support the new 39% rate.

Revenue raising in both the short and medium term

4. Treasury officials have previously advised the Minister of Finance that, under central forecasts and projections, over the medium term, it may be challenging for the Government to maintain operating surpluses and achieve its OBEGAL[1] fiscal rule (T2022/1284 refers). With this context, in July 2022 the Treasury provided the Minister of Finance with its initial thinking on the medium-term revenue strategy (T2022/1565 refers), including ways to respond to medium-term pressures to ensure the tax system is sustainable.

5. Treasury will separately provide advice to the Minister of Finance in December on medium-term fiscal sustainability, which will be based on preliminary fiscal forecasts for HYEFU[2] 2022 and final economic and tax forecasts. That advice will reflect the decisions on your fiscal strategy for the Budget Policy Statement 2023.

6. In August 2022 (T2022/1765, IR2022/387 refers), we outlined several options that might be feasible for Budget 2023. You requested further advice on two of those possible options: increasing the trustee rate to 39% [33]

   they could support you in keeping within or setting annual Budget allowances but would not significantly alter your medium-term outlook. However, they could support the integrity of the tax system and the ability to raise more revenue in the future if this were necessary.

7. Future revenue-raising options that would enable the government to manage medium-term fiscal pressures by raising the tax-to-GDP ratio will likely involve structural decisions about the tax system. Some of those are mentioned in this report.

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[1] Operating Balance before Gains and Losses.
[2] Half Year Economic and Fiscal Update.

Integrity measures

8. In August 2022, we recommended discussing with you the longer-term direction of reform before further progressing any integrity measures to buttress the top 39% tax rate (IR2022/352, T2022/1837 refers). One reason for this was so that we could better understand your thinking on long-term directions for taxing trusts and PIEs, because increasing tax on some closely-held companies creates horizontal equity issues when the same income is taxed at 33% in a trust or at 28% through a PIE or widely-held company.

9. This report sets out some broader context around the structure of the tax system and current limitations on its ability to raise revenue effectively. It is intended that this broader context should help guide decisions relating to the trustee [33] tax rates. Without a holistic approach, reducing a pressure in one area may just cause it to emerge in a different form in another area — like damming half a river.

Towards a robust and sustainable tax system that can raise sufficient revenue and support the Government's distributional and economic goals

10. The Government's stated long-term revenue objective is to "ensure a progressive taxation system that is fair, balanced and promotes the long-term sustainability and productivity of the economy, consistent with the debt and operating balance objectives".

11. As noted above, medium-term fiscal pressures may require the Government to have the flexibility to raise more revenue in future. The primary way of doing this is through adjusting rates on the Government's chosen tax bases, rather than piecemeal reforms through the base maintenance work programme.[3]

12. The Government currently raises revenue from three main tax bases: personal income tax, company tax and GST. The personal income base is a key tax base, raising around 50% of total tax revenue. The system of personal tax rates and thresholds is designed to reflect the Government's view on how progressive the tax system should be. However, misalignment, combined with the current tax rules for companies and shareholders, makes it difficult for governments to raise tax through the personal tax base in a way that is consistent with your revenue strategy and your economic strategy objectives.

13. Misalignment arises when the marginal tax rate that applies to an individual's income is higher than the tax rate that applies when income is earned through an entity such as a company or trust. There is therefore a significant incentive to shift income to lower-taxed entities. Even absent further change, this creates wellbeing costs by reducing perceptions of the fairness of the system and potentially imposing higher economic costs than in a more coherent system. This sort of misaligned tax system also tends to generate higher compliance and administration costs.

14. One way to address this is to *reduce misalignment* directly by reducing differences between the top personal tax rate and the rates applying to companies, trustees and PIEs. There are, however, sound policy reasons for retaining some misalignment within the tax system, given the distributional, investment and efficiency objectives that can be achieved by having, for example, different personal and company tax rates. As a small, open economy, New Zealand relies on foreign investment, which makes a high company tax rate difficult to sustain. As noted

[3] The aim of a base maintenance programme is to repair and maintain our tax rules so that existing tax bases are as fair and efficient as they can be. While base maintenance measures will sometimes raise revenue, their primary aim is to improve the efficacy of the tax system. Base maintenance requires progressing revenue negative measures as well as revenue positive ones.

above, we have assumed in this report that you want to maintain a lower company tax rate than the top personal tax rate.

15. An alternative approach for companies and shareholders is therefore to accept some difference between the company tax rate and the top personal rate and build a tax system that *manages misalignment* better than our current system does.

16. A key factor to consider for decisions in the accompanying reports on trustee [33] rates is whether they move in the direction of a **robust** and **sustainable** tax system. A "robust" system is one where higher personal tax rates cannot be circumvented simply by using a trust, company or PIE. A "sustainable" system is one that is flexible enough to raise revenue as required by the government through straightforward rate changes, without the need for a major restructuring of the tax system.

17. [33]

[33]

[33]

Linkages to decisions on the trustee [33] tax rates

24. In August 2022, you requested advice on the trustee tax rate [33] Our advice on the particulars of these options is contained in the accompanying trust [33] taxation reports. In this report, we outline at a high level how decisions on trusts [33] fit within the broader context.

25. [33] However, we consider that trust changes would be beneficial to progress even as a standalone reform. [33]

Trustee tax rate

26. In broad terms, trustee income is currently taxed at 33%, with no further tax when a distribution is made to the trust's beneficiaries. A taxpayer on the 39% rate can therefore achieve a final 33% tax rate by diverting their income through a trust.

27. [33] we consider that the options in the trusts report would:

    27.1 reduce misalignment pressures;

    27.2 increase the progressivity of the tax system; and

    27.3 be a positive step towards a robust and sustainable tax system.

28. If the trustee rate is increased to 39% [33] taxation, it is likely that some taxpayers will shift from using trusts to private companies. However, trusts are a completely different legal structure from companies and offer non-tax benefits that companies do not. For example, trusts can be used for asset protection in a way that companies cannot, as beneficiaries of a discretionary trust do not have any equitable interest in the trust's assets until a distribution is made to them. This is not true for shareholders of a company. Trusts can also stream distributions to different beneficiaries, whereas companies must pay dividends equally to all shareholders of the same class. Additionally, trusts are not listed on any public register while companies and their shareholders and directors are. Accordingly, there are important non-tax benefits that would counteract, to a degree, the incentive for taxpayers to shift income from trusts to

[5] Compared to the OECD average, New Zealand has a lower top personal tax rate, a higher company rate and a smaller gap between those two rates.

companies. Despite this, we expect that some income-shifting behaviour will occur and this is built into the revenue estimates.

29. [33]

[33]

Next steps

34. Officials propose to discuss the contents of this report with you at the Joint Ministers' meeting on 21 November.

35. Officials will continue to undertake stewardship work, assessing a broader range of options that could help meet medium-term revenue strategy objectives. We can report further as we progress this work.

ANNEX: DIFFERENT TAX OUTCOMES IN DIFFERENT ENTITIES

1. The current tax system applies different effective tax rates to the same income, depending on the entity through which it is earned. For a taxpayer on the top 39% personal tax rate:

   1.1 Income earned directly is taxed at 39%.

   1.2 Income earned through PIEs is taxed at a capped tax rate of 28%.

   1.3 Income earned through a company is taxed at a rate of 28% while it is accumulating. If it is paid out as a fully imputed dividend, there will be a top-up tax of 11% at that stage, making the total tax 39% (assuming the shareholder is on the top 39% rate when the dividend is paid). However, because tax is only topped up to the top personal rate when dividends are paid, there is a tax benefit from deferral. The size of that tax benefit increases as the period the income accumulates increases.

   1.4 If dividends are not paid, gains can instead be realised by way of a tax-free capital gain. This creates a larger tax advantage as in this case the 28% company tax rate is a final tax.

   1.5 Income earned through a trust and taxed as trustee income is taxed at a final rate of 33%. There is no top-up tax when this income is subsequently paid out to beneficiaries. This allows the 39% rate to be avoided altogether.

   1.6 Another possibility is for a company to be owned by a trust. In this case, income is taxed at the company rate of 28% while it is accumulating. If a fully imputed dividend is paid and taxed as trustee income, the top-up tax that applies will be 5%. It can then be distributed to a beneficiary on the 39% rate without any further tax being paid, so the total tax is only 33%.

2. **Table 1** illustrates these tax implications for $1,000 deposited into a number of different possible entities. The $1,000 earns a pre-tax return of 5% each year. It is assumed that the savings are by a taxpayer who is taxed at a marginal rate of 39% throughout their lifetime. The individual accumulates savings for different possible periods of up to 40 years before the proceeds are withdrawn to fund consumption.

Table 1: Amounts accumulated if $1,000 is invested in different entities for different years

Year	Personal	PIE	Company (dividend paid)	Company (untaxed capital gain)	Trust	Company owned by trust (dividend paid)
0	1,000	1,000	1,000	1,000	1,000	1,000
1	1,031	1,036	1,031	1,036	1,034	1,034
10	1,350	1,424	1,359	1,424	1,390	1,395
20	1,824	2,029	1,871	2,029	1,933	1,957
40	3,326	4,115	3,639	4,115	3,736	3,899

3. The table above shows the amounts that can be accumulated by saving through different entities by a taxpayer on a 39% rate when savings are invested at a pre-tax interest rate of 5%. As the highlighted row shows, if $1,000 is invested in year 0 and withdrawn in year 40, the taxpayer would have:

   3.1 $3,326 if the income was being taxed as personal income,

3.2 $4,115 if earned through a PIE,

3.3 $3,639 if earned through a company and the dividend pays a fully imputed dividend in year 40,

3.4 $4,115 if earned through a company and the gain is realised through an untaxed sale of shares.

3.5 $3,736 if earned through a trust and taxed as trustee income at 33%, and

3.6 $3,899 if earned through a company owned by a trust and a fully imputed dividend is paid in year 40 and taxed as trustee income.

4. As the table shows, if a taxpayer invests through a company and is able to withdraw their funds as an untaxed capital gain, they receive the same amount as for PIEs. In both instances, income is taxed at the 28% rate and there is no further tax. A tax on share sale gains, even at a partial rate, would make the amounts accumulated in a company that does not pay dividends equivalent or closer to that for a company that does pay dividends. It can therefore eliminate the current tax disincentive for companies to pay out dividends.

5. **Table 2** shows the effective tax rate (ETR) of savings accumulated in different entities for different time periods, using the same assumptions as in Table 1 (5% pre-tax return, 39% personal rate). The ETR is the tax rate which, if levied each year as the income accumulated, would have led to the same accumulations after different periods of time.

Table 2: ETRs on savings accumulating in different entities

Year	Personal	PIE	Company (dividend paid)	Company (untaxed capital gain)	Trust	Company owned by trust (dividend paid)
1	39%	28%	39%	28%	33%	33%
10	39%	28%	38%	28%	33%	32%
20	39%	28%	36%	28%	33%	32%
40	39%	28%	34%	28%	33%	31%

6. As the above table shows:

6.1 If income is taxed as personal income, it is being taxed at a 39% ETR.

6.2 If income is taxed as PIE income or income accumulating in a company where gains will be realised as a tax-free capital gain, the ETR is 28% because the PIE or the company rate are the only tax rates that are relevant.

6.3 If income is accumulating in a trust, the ETR is 33% because the income is being taxed at the trustee rate.

Tax benefits accrue to high income earners

7. The tax benefits of a lower ETR for income earned in trusts, PIEs and companies are largest for high income earners on the 39% marginal rate. Such earners can lower their ETRs by 11% by using a company or PIE, or 6% by using a trust. Taxpayers on the 33% marginal rate can lower their ETR by 5% using a company or PIE, but not by using a trust.

8. In contrast, taxpayers on the bottom two marginal rates do not benefit at all from using a PIE or trust. In fact, they would suffer a tax penalty by investing through a

company unless dividends are paid because the income is taxed in the company at 28% as a final tax, rather than on the shareholders' marginal rates of 10.5% or 17.5%.

Size of deferral benefits in a company

9. The highlighted column in Table 2 shows there are deferral benefits to accumulating savings in a company, even if a dividend is paid and top-up tax eventually collected. If the income is paid to its 39% marginal rate shareholder after one year, it is taxed at an ETR of 39%. The income is fully taxed as personal income in that year and there are no deferral benefits. However, as the period between when the income is earned and when the dividend is paid increases, the ETR falls. If the income is accumulated in a company for 40 years before being paid out as a fully imputed dividend, the ETR drops to 34%.

10. It is worth noting that the clawback of tax benefits when dividends are paid may be quite substantial if dividends are paid even after quite lengthy periods. For example, if a dividend were paid after 20 years to the shareholder on a 39% marginal rate, the ETR is 36%. While this is below the shareholder's marginal rate, it is much closer than the 28% ETR that applies if the taxpayer can realise their investment through an untaxed capital gain.

11. The tables above suggest that concerns about deferral benefits are likely to be small relative to concerns about dividend taxes being avoided altogether. We note that deferral benefits would increase if a higher interest rate were used. For example, a 10% rate would result in a 35% ETR if a dividend were paid out after 20 years and a 32% ETR if a dividend were paid out after 40 years.