Inland Revenue
Te Tari Taake

Supplementary Briefing Papers

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Preface

Inland Revenue has prepared two volumes of briefing papers on tax policy issues to supplement its briefing.

The first volume, comprising four chapters, outlines the functions of, and the types of issues addressed by, the Policy Advice Division.

Chapter 1 discusses the ***policy process***. Its purpose is to outline the types of services supplied by the division to assist you to perform your important role in tax, social, and fiscal policy. It highlights the need for you to develop a protocol with the Treasury Ministers to clarify the precise role you are expected to play in these important policy areas.

Chapter 2 then discusses ***tax design issues***. Its purpose is to assist you in understanding your tax policy role as Minister of Revenue by discussing a number of topical tax policy issues. The chapter outlines the objectives of the tax system and highlights a number of important constraints to the process of tax reform.

Chapter 3 discusses the ***tax policy work programme***. The focus of tax reform has shifted over the last decade from an emphasis on fundamental tax base issues to an emphasis on base maintenance (anti-avoidance measures) and tax simplification. This chapter outlines and discusses the main issues that comprise the current tax policy work programme. A review and update of the work programme is a priority issue for you to discuss with the Treasury Ministers.

Chapter 4 provides an ***overview of the New Zealand tax system.*** It illustrates how the tax system has changed since the early 1980s as a result of the process of tax reform. It describes personal taxation, company taxation, GST, and international tax, as well as the taxation of savings, and outlines the manner in which those taxes are assessed and collected. It also provides statistics on the revenue collected by the tax system.

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Chapter 1

The Policy Process

Operation of the Policy Advice Division

Role of Inland Revenue in the policy process

Inland Revenue advises the Government on all aspects of tax policy. This is the responsibility of the department's Policy Advice Division. The division is a small, multi-disciplinary team of professionals that includes lawyers, accountants, economists, statisticians, and other people with experience in tax and business. The division has 31 tax policy analysts out of 65 total staff members. It comprises eight units, in addition to its internal management support unit:

- The **GST Unit** is responsible for the review of GST, codifying taxpayer self-assessment, and several income tax base maintenance issues.
- The **Business/International Unit** is responsible for policy issues related to tax simplification, the review of the compliance and penalties legislation, and the timing of business income and deductions. It is also responsible for international tax policy issues; negotiating, maintaining and interpreting New Zealand's double tax agreements with other countries; and contributing to international organisations involved in tax issues, including the OECD and APEC.
- **Company Tax Projects** is responsible for projects such as company interest deductibility for tax purposes.
- The **Tax and Social Policy Unit** is responsible for business and personal tax policy and social policy measures that interact with the tax system – such as family support, the family-plus package of tax credits, child support and the student loan scheme.
- The **Law Drafting Unit** drafts all tax legislation except regulations and assists with the passage of bills through Parliament. The specialist unit was set up in 1995 on the recommendation of Sir Ivor Richardson (now President of the Court of Appeal), who headed the organisational review of Inland Revenue. In many cases tax legislation had become very difficult to read and understand, which added to the costs of administering and complying with the law. The new Law Drafting Unit was set up to overcome these problems. The Richardson review considered it highly desirable that tax law drafting be carried out by the same organisation that provided tax policy advice.
- The **Rewrite Project Team** is responsible for rewriting the Income Tax Act 1994. The aim is to improve the Act's structure, make the interrelationship between the parts of the Act explicit, and use a plain language style of drafting. Clarification of the law will minimise the compliance costs faced by taxpayers. The team consists of a number of legislative drafters as well as policy analysts.
- The **Forecasting and Analysis Unit** forecasts future tax flows independently of the Treasury, and appraises Treasury forecasts before they are finalised. It also forecasts other Crown Revenues and Expenses administered by Inland Revenue, reports

monthly on accrued revenues and cash receipts against forecasts, and analyses the revenue implications of tax and social policy proposals.

- The **Ministerial Services Unit** provides staff for the Minister of Revenue's office to act as an interface with the department, and co-ordinates the drafting of responses to correspondence and parliamentary questions received by the Minster of Revenue. It also provides services to the Commissioner of Inland Revenue relating to correspondence with individual taxpayers, including official information and privacy issues and dealings with the office of Ombudsmen.

The Finance and Expenditure Committee in its report, *Inquiry into the Powers and Operations of the Inland Revenue Department*, recommended that consideration be given to transferring our legislative drafting functions back to Parliamentary Counsel's Office. The report does not refer to Sir Ivor Richardson's review, nor the reasons given in that review for establishing tax law drafting responsibilities within Inland Revenue. Any decisions to alter current tax law drafting responsibilities would have a significant impact on our Law Drafting Unit and Rewrite Project Team, as well as on the functions of the Policy Advice Division.

The policy development process

Since 1995 tax policy has been developed in accordance with the Generic Tax Policy Process (GTPP), a process designed to produce better, more effective tax policy. The main objectives of the GTPP are to:

- encourage earlier, explicit consideration of key policy elements and trade-offs by Ministers;
- provide opportunities for substantial external input into the policy formulation process, which is intended to increase transparency and to provide for greater contestability and quality of advice at both the conceptual and detailed design stages;
- clarify the responsibilities and accountabilities of participants in the process;
- improve the management of the tax policy process; and
- ensure that the performance of tax policy initiatives, as well as the process of reform, is reviewed regularly.

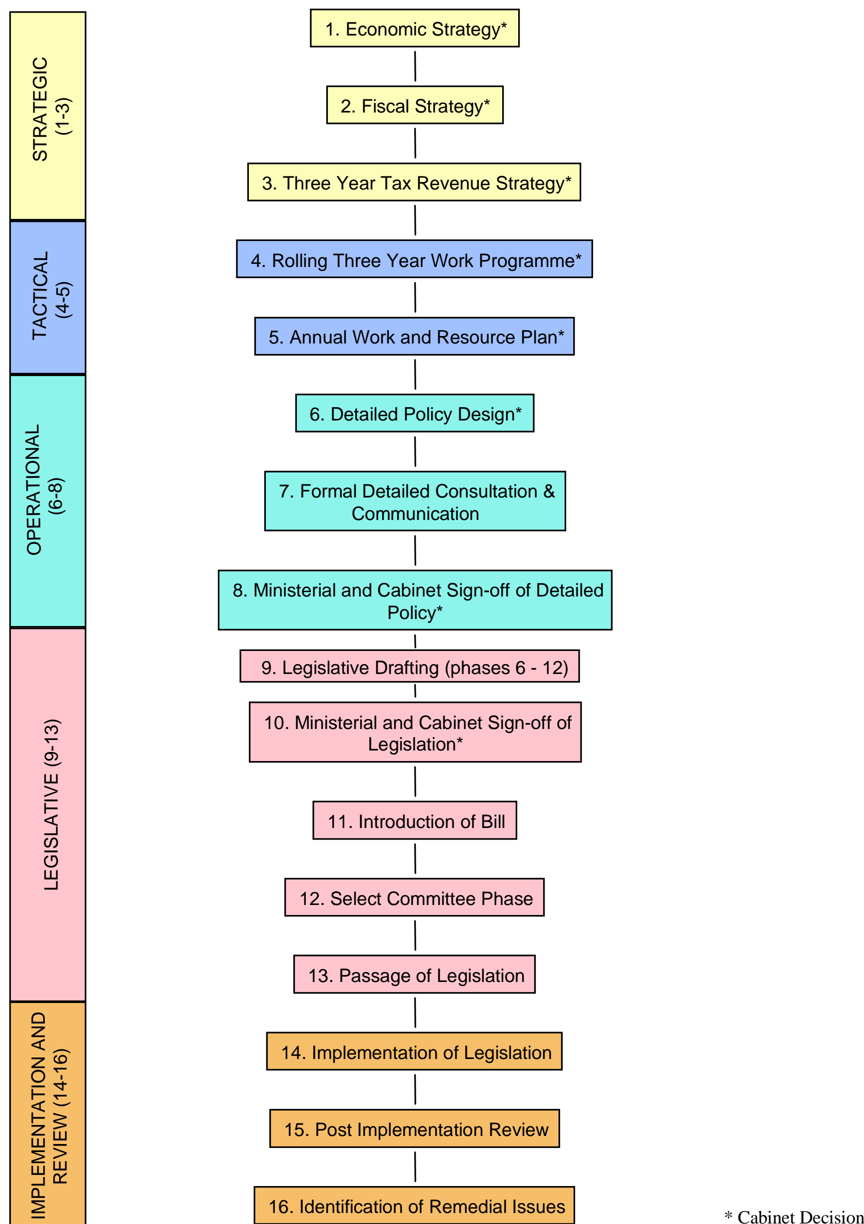
The GTPP represents a significant improvement in the way tax policy is developed and in tax reform generally. Major tax initiatives are now subjected to much greater public scrutiny at key stages in their development. The process enables us to develop more practical options for change, through consultation with professional associations, tax practitioners and those who will be affected by the proposed reforms.

The ability of the GTPP to produce better tax policy than prior processes has been recognised domestically and internationally. For example, the key theme of establishing processes for consultation has been adopted as a recommendation by the Ralph Committee's 1999 report reviewing the Australian tax system.

The GTPP, detailed in figure 1, has five key development stages:

- **Strategic**: This involves the development of an economic strategy, a fiscal strategy and a three-year revenue strategy.
- **Tactical:** This involves the development of a three-year work programme and an annual resource plan.
- **Operational:** This involves detailed policy design, formal detailed consultation, and Ministerial and Cabinet approval of detailed policy recommendations.
- **Legislative:** This stage, which can occur concurrently with the operational stage, involves the translation of the detailed policy recommendations into legislation.
- **Implementation and review:** This involves the implementation of legislation, the post-implementation review of legislation, and the identification of remedial issues.

FIGURE 1: GENERIC TAX POLICY PROCESS



* Cabinet Decision

Consultation and communication

A key feature of the GTPP is the emphasis it places on communication and consultation at each of the main stages of the process.

As manager of the process, Inland Revenue devotes a large proportion of the Policy Advice Division's resources to:

- facilitating discussions between Ministers on tax issues;
- preparing discussion documents and issues papers that identify problems with the tax system and evaluate alternative options for reform;
- ensuring that interested parties are consulted and their concerns are taken into account in the policy development process;
- publishing commentaries on taxation bills before Parliament
- drafting legislation and assisting the passage of bills though Parliament and parliamentary select committees;
- reviewing the effectiveness of new legislation after it is implemented; and
- keeping the interested public informed of policy and legislative developments through various means, including our specialised tax policy web site at **http://www.taxpolicy.ird.govt.nz**.

Respective roles of Inland Revenue and the Treasury

One of the main aims of the GTPP is to clarify the responsibilities and accountabilities of all participants in the process of tax policy development, particularly the respective roles to be played by Inland Revenue and the Treasury.

The Policy Advice Division has been primarily responsible for the detailed design, implementation and review of tax policy, meaning the operational, legislative, implementation and review stages of the process. We manage the policy process through these stages.

The Treasury has been primarily responsible for the strategic stage of the process, although we take part in it. This involves integration of the Government's economic, fiscal and three-year revenue strategies. The revenue strategy sets the Government's broad objectives in the tax area and this establishes priorities for setting the tax policy work programme. The last revenue strategy, agreed in 1996, is included as Appendix A.

Within these broadly defined roles, it is up to the two departments and their respective Ministers to determine where the comparative advantage of each department lies, and to ensure that the roles and responsibilities of the two departments are defined in accordance with those comparative advantages.

An important aspect of this is the need for Ministers to develop a protocol between themselves, establishing their respective policy roles. The protocol between Inland Revenue and the Treasury could then be updated to reflect Ministers' respective responsibilities. Because there have been a number of Ministers with overlapping responsibilities in the tax area, the early development of protocols has been important to ensure the smooth functioning of tax policy development. Past protocols have emphasised the need for information-sharing on joint advice and decision-making. Included as Appendix B is the protocol between Inland Revenue and the Treasury that has been applicable to date.

Tax policy work programme

The objective of the tactical stage of the GTPP is to develop a tax policy work programme that gives effect to the Government's three-year revenue strategy.

The preparation of the rolling three-year work programme involves:

- The initial scoping and conceptualisation of broad policy proposals. External input can be useful at this stage of the process.
- Prioritising and sequencing the development of tax policy initiatives.

In the course of refining the rolling three-year work programme, the annual work and resource plan is developed. This involves consideration of:

- the budgeted resource requirements to develop the initiatives specified in the rolling three year work programme;
- the estimated time-frames for developing, legislating and implementing these policy initiatives in the year ahead; and
- the strategy for obtaining external input through the public release of a more detailed "white paper" and communicating policy decisions.

The tactical stage of the GTPP culminates in a joint report by Inland Revenue and Treasury to the Treasury Ministers and the Minister of Revenue that provides a detailed outline of the tax policy work programme proposed by officials. Officials will report to Ministers on a proposed work programme as soon as possible.

Once approved by Ministers and Cabinet, that joint tax policy work programme in effect becomes a detailed tax policy purchase agreement between Treasury Ministers and the Minister of Revenue and their respective departments.

Chapter 2

Tax Design Issues

The issues facing the Policy Advice Division

Introduction

The past few years have seen considerable public debate over the appropriate direction of tax reform in New Zealand. There is a reasonable consensus that New Zealand needs a tax system that is capable of raising sufficient revenue to finance expenditure and debt repayment in a manner that is consistent with the economic and social policy objectives of the Government of the day. However, there is considerable debate about the precise nature of a tax system that is capable of achieving such objectives.

Much of the debate arises from the inherent conflict between the objectives of the tax system. The most efficient tax systems, which raise money at the least cost to the nation as a whole, such as poll taxes, are not necessarily the most equitable. Similarly, simpler taxes may be inefficient and unfair.

As a result, complex trade-offs need to be made between the conflicting objectives of efficiency, simplicity and equity. This requires the exercise of considerable judgement, and inevitably results in differences of opinion over where to strike the appropriate balance.

The purpose of this chapter is to illustrate the complex nature of some of these trade-offs by reference to some topical tax policy issues.

Changing rates of personal income tax

Appropriate tax scale design, a prominent issue in the lead-up to the election, raises three very important matters. The first is the time required for any changes to the personal tax rates to be enacted. The second is the appropriate progressivity of the personal tax rate structure. The third is the relationship between individual tax rates and the rest of the income tax system.

Timing of personal income tax rate changes

The introduction of a tax rate change requires a minimum of two months between enactment and implementation. This period of time is required by businesses to make necessary administrative changes to allow them to comply with the law (although some private sector payroll firms have indicated that even this minimum time is really too short, and three to four months is the desirable lead-time). Payroll software developers require this time to incorporate Inland Revenue’s new payroll software specifications into their payroll packages and to test and market the new products. Employers also need to make changes to and test their payroll systems.

From a policy perspective, this means that legislation for tax rate changes needs to fit within a tight timeframe. For example, legislation changing tax rates from the 2000-01 income year would have to be enacted by late January 2000 for the new scale to apply from 1 April 2000 and for retrospective legislation to be avoided.

A similar process is required for resident withholding tax collected by banks if tax rate changes affect these rates. Payers of interest such as banks would then need to modify their resident withholding tax systems. If a new withholding rate needs to be implemented, payers of interest may also be required to seek elections from account holders.

A tax rate change also has consequences for provisional tax payments, particularly if the rate change takes effect part way through an income year. Provisional taxpayers are able to determine their provisional tax payments either by direct reference to the amount of tax payable in a proceeding year, or by estimating their liability. If tax rates are changed part way through a year, use of money interest implications could arise for payments that have already been made.

A tax cut could result in the Government paying interest to taxpayers who overestimate their tax liabilities. A tax increase could result in taxpayers underestimating their tax liabilities, thus incurring interest. The Government would not receive the full amount of tax revenue until terminal tax is paid (for the 2000-01 year, generally 7 April 2002).

Therefore the Government should exercise caution when deciding on the timing of any changes to tax rates. Consideration should be given to administrative measures required for the introduction of tax rate changes, the impact on taxpayers and the effect on the timing of Government revenue.

For these reasons, if changes in tax rates are to be effective by 1 April 2000, and if retrospective effect is to be avoided, tax rate changes need to be legislated by late January 2000.

Tax scale design

Ideally, tax reform should improve the ability of the tax system to raise and redistribute income in an equitable and efficient manner. Attempts to improve efficiency, however, may result in a reduction of the overall equity of the tax system. Conversely, increasing the progressivity of the tax scale may decrease the efficiency of the tax system.

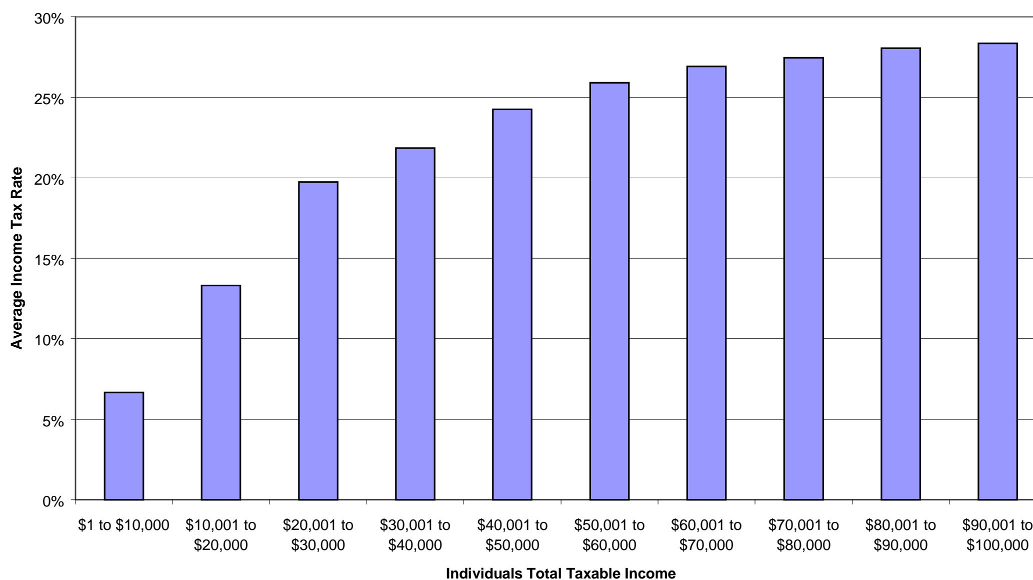
Although raising marginal tax rates for individuals may be seen as resulting in greater equity, it may also cause:

- increased disincentives to save and invest;
- distortions in patterns of investment and choice of organisational form (that is, lowering the quality of investment);

- increased compliance costs, because of:
  - the increased incentive for high-income taxpayers to increase their involvement in tax planning schemes (see, for example, the section on schemes targeted at high income individuals in chapter 3);
  - the likelihood that tax law will be more complex in attempting to reduce the scope for such schemes, which is inconsistent with the objective of simplifying the tax system;
- the increased administrative costs associated with the increased need to audit high-income taxpayers, exercise anti-avoidance provisions and introduce additional provisions in the Income Tax Act to reduce the scope for tax planning schemes.

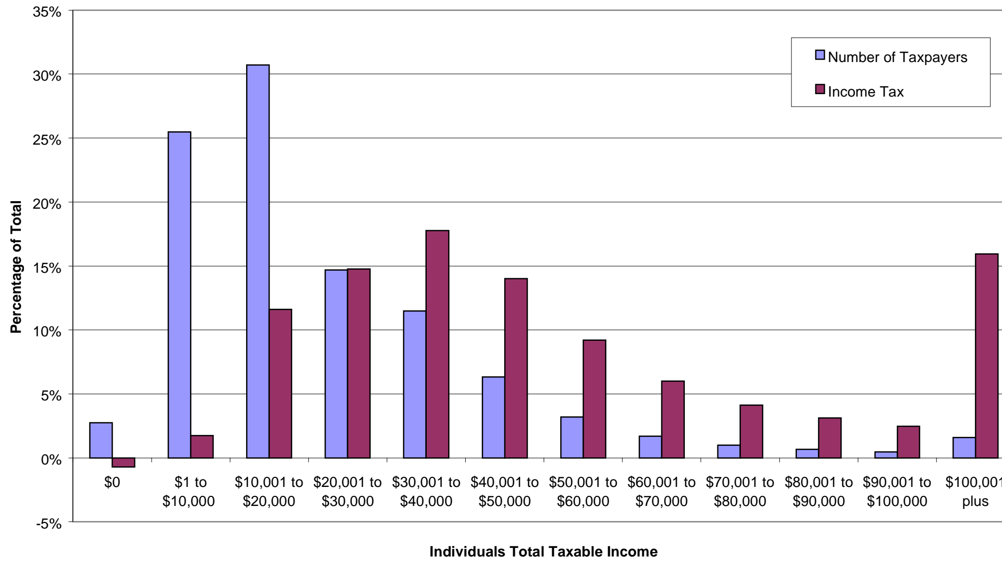
Figures 2 and 3 illustrate the progressivity of New Zealand's income tax system. As individuals' income rises, so does their average income tax rate, reflecting the higher marginal income tax rates for income earned over $38,000, and the abatement of family assistance.[1]

FIGURE 2: AVERAGE INCOME TAX RATES OF INDIVIDUALS FOR YEAR ENDED MARCH 1998



[1] Income tax is net of family assistance, hence the existence of taxpayers with no taxable income and negative income tax (income tax refunds).

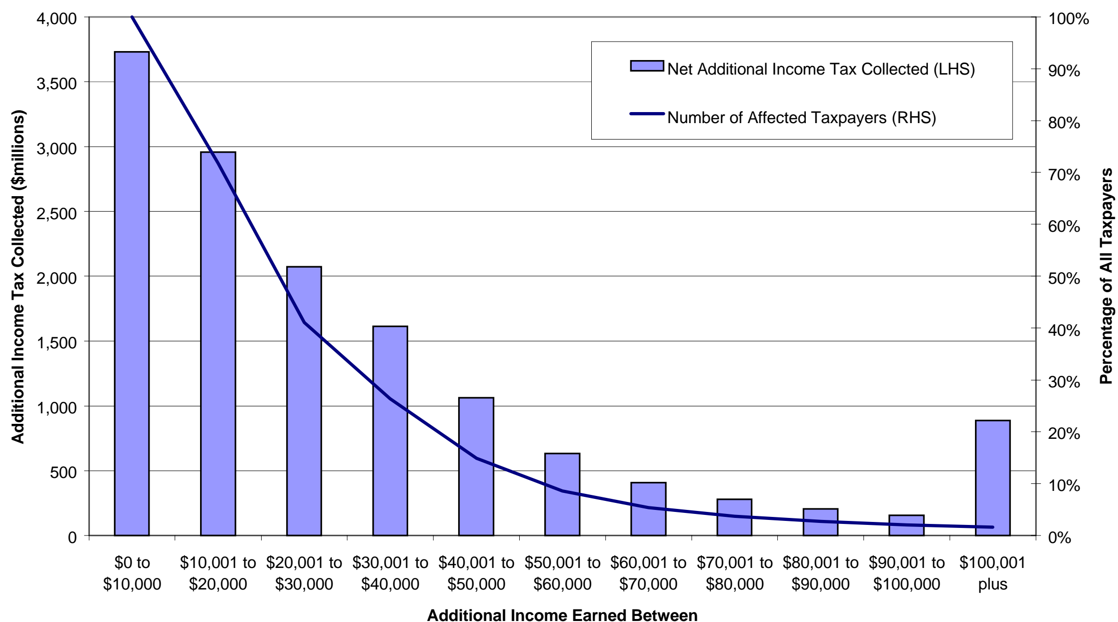
FIGURE 3: INCOME TAX COLLECTED FROM INDIVIDUALS FOR YEAR ENDED MARCH 1998



Most personal income tax is collected from individuals whose incomes exceed $30,000. They comprise 26% of all individual taxpayers, but pay 73% of the personal income tax collected. It should be noted, however, that only about half of this tax relates to income over $30,000.

The greatest amount of revenue raised by income band is on the first $10,000 of taxpayers' income, which raises $3,730 million, or 27% of all personal income tax collected. This is illustrated in figure 4.

FIGURE 4: ADDITIONAL INCOME TAX COLLECTED FROM INDIVIDUALS BY TAXING THEIR NEXT $10,000 OF INCOME FOR THE YEAR ENDED MARCH 1998



Relationship with the rest of the tax system

In determining tax scale design, consideration must be given to the interaction of personal income tax rates with tax rates on other forms of income. The top personal marginal tax rate is currently aligned with withholding tax rates on interest and dividends. It is also aligned with the company, trustee, fringe benefit and superannuation contribution tax rates. Changing the top personal marginal tax rates while leaving these other tax rates unchanged could affect the efficiency, simplicity and equity of the tax system.

Although alignment could be preserved by changing the tax rates on other forms of income, this would also entail efficiency costs and increased complexity, and may not meet the equity objectives that alignment is designed to achieve. In particular, the administrative and compliance costs from the introduction of a greater number of statutory tax rates would be higher. Resident withholding tax on interest income, for example, is currently collected by banks. Increasing the number of statutory tax rates on interest income would require banks to withhold either at the varying tax rates or at one rate, with taxpayers filing a tax return at the end of the income year under the later option. Inland Revenue would then reconcile any overpayment or underpayment of tax. This would re-introduce the requirement for a large number of salary and wage earners to file returns.

Taxes and economic growth

The adverse effects of taxation

There is a growing concern internationally about the adverse effects of taxation on domestic savings and investment, and potentially on economic growth. The general trend amongst OECD countries has been towards lower rates of tax on income from capital. There remains, however, uncertainty surrounding the effects of taxation on economic growth. This uncertainty is highlighted both in Inland Revenue's report on research commissioned by the department (see the *Report on Research Commissioned by Inland Revenue* in Volume 2 of this Supplementary Briefing) and in a 1997 OECD report on taxation and growth[2].

Although the precise relationship between taxes and growth is unclear, taxes can and do have significant unintended effects on decisions. Such unintended effects are likely to affect adversely New Zealand's economic performance.

It is well recognised that taxes impose costs on the community by:

- discouraging saving and investment, consumption and production; and
- encouraging inefficient patterns of consumption, production and resource use (including the costs that Inland Revenue incurs in administering the tax system, as well as the costs taxpayers incur in order to comply with their obligations under the tax system).

[2] Leibdfritz, W., Thornton, J. & Bibbee, A. (1997) *Taxation and Economic Performance*, Economics Department Working Paper No.176, Organisation for Economic Co-operation and Development, Paris.

Although some of these costs are difficult to measure, analysis to date indicates that the overall costs of taxation are high. Tax reform may be reducing those costs to some extent, but there remains a concern that the costs of taxation may be rising as a result of an increased sensitivity of decisions to taxation. These sensitivities arise from factors such as:

- the opening up of world markets and the removal of obstacles to trade and foreign investment; and
- the increasing mobility of financial, human and physical capital – hence the increasing relevance of tax disparities.

It is important, therefore, that tax reform be aimed at improving the efficiency of the tax system, and that it recognise the costs of raising tax revenue when evaluating the benefits of further Government expenditure financed through taxation.

Effects of taxing the income of non-residents

It is reasonable to seek to impose taxes on non-residents on income sourced from New Zealand. This recognises that domestic resources (including infrastructure) are being used to generate profits. Taxing non-residents, however, deters inbound investment. It is also possible that the cost of the tax may be passed on to the domestic economy, distorting domestic production and investment decisions such that the economy may be potentially worse off than if no tax were imposed.

The issue, therefore, is how to raise a given amount of revenue at minimal cost to the New Zealand economy. This in turn raises the question of the appropriate rates at which to tax foreign investment. There is a trade-off between the desire to raise a given level of tax revenue from investment while still attracting that foreign investment.

The sensitivity of foreign investment to income tax rates will depend on the availability of alternative investments. Foreign portfolio investment, which is highly mobile, is likely to be very sensitive to New Zealand tax rates. Foreign direct investment, by contrast, is likely to be less sensitive to New Zealand tax rates, because of the longer-term nature of such investment – tax is only one factor amongst many that are considered in the decision to locate such investments in New Zealand, and may not necessarily be the most influential factor.

Most foreign investment into New Zealand is in the form of debt or corporate equity. Interest paid to foreigners is generally taxed at a very low rate (1.34%) under the approved issuer levy rules. The tax on corporate equity investment (shares owned by foreigners) is determined by a combination of the company tax rate and withholding taxes on dividends. Because of the foreign investor tax credit rules, the maximum tax rate on foreign equity investment from the combination of company and withholding taxes is set at 33% – the company tax rate. It is important to note, therefore, that the real rate of tax on foreign investment is not set by reference to the company tax rate alone, but is a combination of the tax impost on debt and equity investment. This allows more room for the company tax rate to be set to meet domestic tax policy objectives.

The proper balance for appropriately taxing inward foreign investment is an ongoing issue requiring careful analysis. For example, a recently released discussion document on interest deductibility proposes an increase in the minimum equity financing of companies controlled by a single non-resident.

Taxing consumption by non-residents

New Zealand's goods and services tax (GST) aims to tax consumption that occurs in New Zealand. To a limited extent, this will deter the consumption of goods and services in New Zealand by non-residents. Again, there exists a trade-off between raising the required revenue and minimising the deterrent effect of New Zealand's GST.

At issue is the appropriate rate at which to apply GST to goods and services consumed in New Zealand by non-residents. This rate depends upon the sensitivity of consumption by non-residents to New Zealand rates of GST.

The GST rules zero-rate goods and services destined for consumption by non-residents while they are overseas. This is because demand for most New Zealand exports is expected to be highly price-sensitive. If GST were imposed on exports, most of the incidence would be shifted back onto New Zealand exporters since New Zealand is a price taker in world markets.

New Zealand does, however, impose GST on imported goods. Just as goods exported from and consumed outside New Zealand should not attract GST, goods imported and consumed within New Zealand should be subject to GST. Since GST taxes consumption in New Zealand, this prevents imports being tax-favoured over domestically produced goods.

Imported services (other than domestic freight and insurance services associated with imported goods) were not originally included in the GST base because of the practical difficulties in doing so and the limited volume of services imported into New Zealand in the late 1980s. However, the consequences of not taxing imported services are that some businesses and consumers may have a preference for purchasing imported rather than domestically supplied services. The relative price of imported services as consumer products or as inputs into production is lower than domestically supplied services.

The effect of this distortion on relative prices will depend upon the degree to which imported and domestically supplied services are substitutes and the sensitivity of consumers and producers to the difference in the relative prices. For example, New Zealand's telecommunications sector is particularly sensitive to the decision not to impose GST on imported telecommunications services because of the high degree of substitutability of their products. The tax policy work programme includes work identifying the advantages and disadvantages of introducing GST on imported services (see chapter 3).

Options for reducing the adverse effects of taxation

Targeting taxation at certain activities

Generally, the objective of targeted taxation is to change the level of investment, production or consumption of a certain activity in a way that provides net benefits to the economy. For example, the current tax system imposes specific excises on certain goods such as alcohol and tobacco. The aim is to use the tax system to penalise the consumption and reduce the production of these goods because of the adverse externalities they cause, such as higher health care costs.

Similarly, lower tax rates are often proposed for certain activities to:

- reduce the adverse effects of the tax system on New Zealand's economy (such as distortions caused by too-high rates of tax on the income of non-residents, or on consumption in New Zealand by non-residents);
- address some perceived failure in the market mechanism to allocate sufficient resources to a particular activity (such as the provision of explicit tax concessions to stimulate certain activities such as research and development).

To evaluate whether initiatives for tax relief are necessary, detailed information is required on just how sensitive such activities are to changes in tax rates.

When evaluating the use of tax concessions as a means of addressing perceived market failure, a threshold question is whether there is a case for Government intervention. If a case does exist, the question must then be asked: are tax concessions the most appropriate instrument with which to achieve the Government's objectives? In theory, tax concessions may encourage investment and production in a certain activity. In practice, however, they may not achieve this objective. Tax concessions tend to be relatively inefficient instruments because of difficulties associated with:

- monitoring and controlling the amount of the subsidy provided – tax concessions can provide an open-ended and non-transparent form of assistance; and
- restricting access to the subsidy to the intended recipients – it is extremely difficult to prevent the benefits of the subsidy from flowing to unintended persons (for example, to high-income taxpayers in the form of increased tax deductions).

Research and development has recently been highlighted as an area where tax concessions might provide benefits to the economy as a whole. This area forms part of the current tax policy work programme (see chapter 3). Again, the general problem in contemplating tax concessions for research and development is that they can be difficult to target. For example, tax credits tend to favour more established firms over new firms because the latter are more likely to be in a tax loss position and will not be able to take advantage of the incentives. Similarly, accelerated depreciation allowances favour investment in capital goods that depreciate quickly because frequent investment results in greater claims on the allowance.

It is necessary, therefore, to weigh the advantages and disadvantages of tax concessions against other forms of assistance, such as direct subsidies.

Similar considerations apply when looking at using the tax system to discourage certain activities. Analysis of carbon taxes falls into this category.

Simplifying the tax system

Administrative and compliance costs also form part of the economic costs of the tax system. Minimising the adverse effects of these costs can be achieved by simplifying the tax system, which is an important part of the current tax policy work programme (see chapter 3).

It should be noted, however, that simplification often conflicts with the neutrality and equity of the tax system. This was recognised by the Committee of Experts on Tax Compliance in its report *Tax Compliance* (December 1998). An example highlighted in that report is the taxation of income from superannuation funds. Income in a savings institution that belongs to an individual whose marginal tax rate is less than 33% is still taxed at the highest marginal rate. Proposals last year to tax individual savers at their appropriate marginal rate were necessarily complex because superannuation funds pool the contributions of their members and do not regularly pay dividends. Ultimately, they were not enacted. This case illustrates the trade-off that often exists between the equity of the tax system and the need for simplicity.

The Committee of Experts on Tax Compliance (at Paragraph 1.11) noted that the efficiency costs of the tax system far exceed the more visible compliance and administrative costs imposed by taxes. Care needs to be taken before simplifying taxes at the cost of a less efficient tax system.

Work is being undertaken on initiatives to simplify the tax system aimed at reducing the compliance costs faced by small businesses. It is anticipated that this will best be achieved through reducing the costs imposed on businesses in meeting their day-to-day tax obligations, such at those imposed by provisional tax, PAYE, GST and fringe benefit tax. For example, better aligning tax payment dates with businesses' cash flows may reduce compliance costs while potentially also easing cash flow management. Seeking to reduce the stress associated with tax is also of considerable importance.

Current tax simplification initiatives are discussed further in chapter 3.

Base maintenance

Maintaining the integrity of the tax base from erosion arising from tax planning schemes is also a means to reduce the unintended effects of taxation. This is true regardless of the tax scale. Base maintenance protects the tax revenue required by the Government to meet its expenditure commitments. It also prevents the inefficient allocation of resources to the design and use of tax planning schemes, and the resultant undermining of the effectiveness of targeted tax policy. For this reason, base maintenance issues form an important part of the current tax policy work programme (see chapter 3).

The Policy Advice Division collates information from Rulings and other areas of Inland Revenue on base risks. Although we have maintained an active base maintenance legislative programme, identified risks tend to exceed the ability to legislate against them.

The New Zealand company tax base is especially susceptible to base erosion. That is because it is especially reliant on the banking/finance sector (see chapter 4), a sector that has the cash flow and technical resources to implement sophisticated tax planning.

There is also evidence in more recent times of increased tax planning by high-income individuals. Examples of this were the film schemes legislated against in September this year.

The tax treatment of savings

The taxation of savings is commonly perceived to encompass only the taxation of long-term, low-risk investment schemes, namely superannuation and life insurance policies. In fact, such schemes form only part of the income from capital available to individuals. Other forms of investment include the purchase of residential housing, shareholdings or bank deposits. When considering the tax treatment of savings, it is important to do so in the context of all other investment alternatives.

The taxation of savings is efficient if investment decisions are not driven by their respective tax treatment. That is, the tax treatment of savings should be consistent with the tax treatment attributed to all forms of income from capital. To avoid distortions in investment decisions, savings must be taxed at the same rate at which other forms of investment are taxed.

Under a comprehensive income tax system, all income from savings is taxed as it is derived. Savings are taxed on a *taxed-taxed-exempt* basis. This approach operates as follows:

- Contributions by an investor to an investment entity are made out of taxed income.
- The investment entity is subject to tax on income derived from the use of the investor's funds.
- Withdrawals and distributions of the tax-paid investment income are non-taxable in the investor's hands.

Our tax system broadly applies this approach, whether investors' funds are invested in superannuation funds, life insurance funds, banks or companies. Other forms of investment, however, are treated differently. For example, the tax system favours investment in owner-occupied housing (as it does in many OECD countries) because, generally, neither any capital gain arising from the investment nor the imputed rent is taxed. Most investment gains, such as the gains from shares on revenue account by a company, are taxed. However, when a person holds shares on capital account, any gains are untaxed capital gains. This encourages individuals to invest in their own assets rather than through collective investment vehicles (such as funds managed by financial intermediaries).

As a practical matter, determining the boundary between non-taxable capital gains and taxed investments can be difficult because of the ease with which investors can substitute one form of investment for another. The base maintenance section of the tax policy work programme addresses problems of this kind, such as arrangements in which high-income individuals invest in schemes that yield non-taxable capital gains. Schemes that highlight the relative ease in some cases with which income from labour can be recharacterised as capital gains are also on the base maintenance work programme. An example of this is the use of restrictive covenants to replace remuneration.

Although taxing capital gains would address the boundary issue, Government policy to date has been not to tax such gains. Instead, the aim has been to improve the efficiency of the present income tax system. Taxing capital gains in a more systematic and comprehensive manner than the current system would provide some benefits, including possibly increased revenue. The main advantage, however, would be to improve the neutrality, fairness, and efficiency of the current system.

Taxing capital gains would not, however, be without its difficulties. For example, if capital gains were to be taxed comprehensively, it would be necessary to impose tax on gains on an accruals basis. In practice, such an approach is unlikely to be feasible. The main difficulty associated with taxing capital gains is the measurement of the changes in asset values on an accrual (unrealised) basis. Such measurement involves considerable compliance costs from valuing assets on a regular basis, and it may be necessary to continue to tax some forms of income only on a realisation basis. Capital gains also implicitly include some measure of inflation that could potentially be captured by taxation.

The issue of how to tax savings, and investment generally, is therefore complex. Whether the tax system exempts certain forms of capital gains does not alter the fact that income tax discourages savings by reducing the return that the saver or investor receives. The current tax policy work programme focuses more on minimising the effect of taxation on favouring some forms of investment over others, rather than trying to influence the overall level of investment.

International trend towards lower rates of tax on income from capital

Given the difficulties associated with taxing capital gains, and the adverse effects of taxing income from capital, many countries have sought to reduce tax rates on income from capital. Amongst the range of methods that have been suggested for taxing income from capital are:

- The split rate system, introduced by the Nordic countries in the early 1990s, in which:
  - "Personal income", which includes labour income, private and public pensions and government transfers, is taxed at progressive rates; and
  - "Capital income" such as interest, dividends and some forms of capital gains, is taxed at a uniform proportional rate equal to the corporate tax rate.

- The reduction of tax rates on certain forms of income from capital. The United States, and more recently Australia, have reduced (or are proposing to reduce) tax rates on some forms of capital.
- Exempting certain forms of income from capital such as the disposal of land, shares and other assets.

All these approaches to taxing income from capital result in adverse effects on the quality of investment. Providing exemptions or lower tax rates for certain forms of income causes inequities and inefficiencies. Individuals who can choose the form in which they derive their income will be able to take advantage of any preferential treatment of income from capital. These inequities may then be capitalised into the value of assets, creating distortions in the patterns of investment.

Ultimately, however, it is the increasing mobility of factors of production in the modern age that is responsible for many of the difficulties. Because factors of production, and capital in particular, are increasingly mobile, investment in different assets is becoming increasingly sensitive to their respective tax treatment. In taxing income from capital, there is a need to be concerned not only with the effect of the tax system on the level of investment, but also the quality of that investment. Our approach to date has been to apply uniform taxation on income from capital and deal with the international mobility issue by taxing New Zealanders on their worldwide income, while carefully constructing rules for the taxation of foreign investment into New Zealand.

Australian tax reform

Within the past 18 months, the Ralph Committee has undertaken an extensive review of Australia's business taxation. The Committee released its recommendations to the Australian Government in September 1999. The Australian Government has signalled that it will adopt most of the review's recommendations, with implementation expected incrementally over three years. The recommendations are linked to the introduction of GST and Australia's recent overhaul of withholding and provisional taxes.

The proposed Australian tax reforms generally mirror New Zealand's reforms since 1984. However, because of our close economic connections, it is important that developments in Australia be monitored.

Some of the more notable proposals in Australia are to:

- Reduce the corporate tax rate progressively from 36% to 30% by 1 July 2001. A large part of the resulting revenue loss will be funded by replacing accelerated depreciation with effective life depreciation. Given that New Zealand has a 20% loading to depreciation rates, it may be possible to make a similar trade-off here.

- Introduce a simplified system of calculating tax for small businesses, where eligible businesses will be able to calculate income tax on a modified "cash accounting" basis rather than on an "accrual" basis and to pool and depreciate assets on a concessionary basis.

- Make substantial changes to future tax policy development. Broadly, the review's approach is patterned on our own Generic Tax Policy Process.

The Ralph Report also raised the possibility of Australia allowing at the shareholder level credits for Australian tax paid by New Zealand companies (and vice versa). The review recognised that a bilateral solution would be preferable to a unilateral solution. We expect to continue working with our Australian counterparts to see if a practicable and mutually beneficial mechanism can be developed.

Chapter 3

Tax Policy Work Programme

The work of the Policy Advice Division

The precise role that the Policy Advice Division plays is determined largely by the priorities of the Government. The Policy Advice Division is accountable for commenting on and assisting with the implementation of tax policy directed by the Government.

However, a lot of the work of the Policy Advice Division, such as reviewing the effectiveness of existing legislation and seeking to address weaknesses that compromise the integrity of the revenue base, is internally generated, and is a natural and critical function of the policy advice role.

Given that resources are finite, the Government will need to direct how the division's resources are employed, based on the Government's revenue priorities. This will involve trade-offs, and could result in the Government needing to choose between a number of worthwhile policy initiatives in determining what work is to be pursued. One of the priorities for the new Government, therefore, will be to confirm or amend the work programme. This will also involve considering the priority of a number of remedial issues on which the private sector expects early action.

You should also be aware that you will have to consider several issues in your first three months as Minister of Revenue. One example is the statutory obligation to set the interest rate for student loans.

We will provide you with a full briefing of current issues, including those that need attention in the immediate future, in our report on developing a tax policy work programme. This report will be sent to you shortly.

Focus of current work programme

Government focus in the 1980s and early 1990s was on general tax reform. With that significant reform now completed, the focus has shifted more recently to:

- addressing issues that might otherwise compromise the integrity of the tax base;
- making the tax system more efficient and simpler to comply with; and
- resolving tax issues that arise from broader economic reforms, such as the restructuring of various government agencies.

This chapter focuses on the nature of the work currently undertaken by the Policy Advice Division:

> ***Part One*** deals with ***maintaining the integrity of the existing tax system***. This is a critical role of the Policy Advice Division, regardless of what broader direction the tax system might take, as it is central to preserving the credibility of existing tax law.
>
> ***Part Two*** discusses work being undertaken on ***initiatives to simplify the tax system***. These initiatives aim to make it easier for taxpayers to comply with the law, as well as seeking to reduce the adverse effects imposed by the tax system, such as compliance and administrative costs.
>
> ***Part Three*** considers various ***tax strategy initiatives***. These initiatives seek to give policymakers a better understanding of the effect of certain tax policies, particularly in relation to entity taxation and savings and investment. The conclusions drawn will enhance the formulation of coherent tax policy in the future.
>
> ***Part Four*** canvasses the ***day-to-day work*** of the Policy Advice Division which, although not always high-profile, is important to the continuing health of the tax system. It also highlights the important role that the Policy Advice Division can play in Government initiatives that superficially may not appear to fall under the tax umbrella.

Part One: Maintaining the integrity of the tax system

A key feature of tax policy work is the importance of maintaining the integrity of the tax system. Enacting new policy as legislation is not the end of the process. If taxpayers can restructure their affairs to circumvent the intended effect of legislation, all that is achieved is that resources that might more productively be used elsewhere are committed instead to avoiding tax, while the Government and the broader economy reap no benefits from what might otherwise be very effective policy. A significant role of the Policy Advice Division is, therefore, to monitor the effectiveness of tax legislation that has been implemented.

The Policy Advice Division is in a unique position to undertake this function. As well as employing the staff that have been involved in the process of developing much of existing tax policy and law, our links with the Operations and Rulings Divisions within Inland Revenue, and with numerous tax professionals outside the department, give us access to information other parties are unable to access, and allow us to readily develop an up-to-date picture of potential threats to the tax base.

It must be noted, however, that it is not the Policy Advice Division's responsibility to apply the anti-avoidance provisions in the Tax Acts, nor to police tax evaders. Our role is to identify policy features within the law that are deficient, and to develop solutions to address any weaknesses that are identified.

To this end, an important aspect of the process is consultation. An underlying principle of effective tax administration is that taxpayers are encouraged to comply voluntarily with their tax obligations. If the Government is open about its reasons for pursuing certain policies, the result is a better understanding in the taxpayer community, and better compliance. Thus, as far as is practicable without compromising the tax base, the Policy Advice Division consults widely, within both the private and public sectors, on any tax policy initiatives. Having said this, there is a limit to how far the consultative process can successfully be pursued – consulting on some base maintenance concerns could, for example, open a window of opportunity for those being consulted, which would be inappropriate.

Measures to maintain the integrity of the tax system fall into two broad categories – base maintenance work and remedial amendments. These are discussed in more detail below.

Base maintenance work

"Base maintenance" initiatives are designed to protect the tax base from erosion arising from tax planning schemes. This should be distinguished from "base broadening", the latter being the result of a deliberate policy decision to expand the tax base to include forms of income that were previously excluded. In practice, however, this distinction can become blurred as it may be necessary in some cases to broaden the tax base in order to close a particular loophole in the tax system.

When base maintenance problems are identified, they are quantified, prioritised and fed into the tax policy work programme, the preparation of revenue forecasts and the Government's fiscal risk estimates. However, because the number of base maintenance problems exceed immediately available resources, the only practical course of action is to prioritise them to ensure that the most severe, solvable problems are addressed first.

A number of base maintenance concerns have been addressed by legislation this year. In recent years, some base maintenance issues have been included in each tax bill considered by Parliament.

A number of base maintenance issues remain, however, to be addressed. The following discussion focuses on two key issues: schemes targeted at high-income individuals, of which films have been an example, and goods and services tax (GST). These issues have been selected because they are ones the Government will need to consider closely in the near future. The discussion highlights features of the tax system that have given rise to the specific concerns, and outlines work that has been undertaken on the issues to date and is still required to be done in the future.

Schemes targeted at high-income individuals

Recently, evidence suggests an increase in the number of tax planning schemes being widely marketed to high-income individuals. These schemes have involved forestry, computer software, insurance and films.

The schemes seek to exploit weaknesses in the Income Tax Act, such as the non-taxation of certain income from capital, or timing mismatches created by deliberate Government policy (as in forestry and films). Deductions are taken for expenditure under the schemes. However, the recognition of income is typically deferred (as in forestry), if it is recognised at all. (For example, the income is shifted outside the tax base.) It is also common for taxpayers who benefit from the deductions not to have to risk their own capital to claim the deductions.

Some of the schemes may fall within the current anti-avoidance provisions, or otherwise fail to meet the requirements of the Income Tax Act. This is being tested as tax returns are filed and assessed. We are, however, working on more comprehensive solutions to the schemes. These could involve recommendations for significant change to specific features of the Income Tax Act. The schemes operate by exploiting boundaries in the Act (such as the non-taxation of certain forms of income from capital, and the active/passive income boundary). An initial question is whether these boundaries should be retained. If they are, the question becomes how they should be preserved so that they cannot be exploited inappropriately.

We are continuing to work on developing a comprehensive solution to tax planning schemes. To some extent, what has been done to date, such as the legislative changes made this year to address film schemes, is best described as "sand in the works" – it makes the threshold more difficult to meet if such schemes are not to be struck down by the anti-avoidance rules. However, a comprehensive solution remains the most desirable response to the issue.

GST

GST is designed to be imposed on all goods and services that are consumed in New Zealand. To effect this, GST is imposed on any taxable supply made in New Zealand by a registered person in the course or furtherance of a taxable activity.

An amendment was made in the Taxation (Remedial Matters) Act 1999 to ensure that GST continues to be charged on "exported" services that are actually performed and consumed in New Zealand. The change was aimed at services that are contracted for overseas by non-residents, but consumed in New Zealand. An example here is travel vouchers which are sold outside New Zealand to non-residents, but redeemed for services consumed in New Zealand.

Technological developments have, however, created new difficulties for the design and application of the GST rules, and we are considering these further. For example, when GST was introduced, imported services were not subject to the rules. This was because they were not common at that time (legal and technological constraints meant that services were typically consumed in the jurisdiction where they were produced). Furthermore, there were – and still are – practical difficulties associated with levying and collecting GST on them.

Deregulation of the telecommunications and financial services market, coupled with rapid advances in communication and computer technology, mean that it is now possible to consume a wide range of services in New Zealand that have been produced offshore. For example, telephone call-back services are consumed by New Zealanders, but because the service provider is outside New Zealand, GST is not currently imposed.

This raises issues of competitiveness between taxed and untaxed services consumed in New Zealand. We are continuing to work on the issue, which includes consideration of whether it might be feasible to introduce a "reverse-charge" mechanism (one that requires the consumer to account for the tax, rather than the supplier) in relation to imported services.

A number of other base maintenance issues in the GST area (relating to second-hand goods, deregistration and deferred settlements) were included in the discussion document *GST: A Review*, released in March this year. It is intended that legislation on these issues will be ready for inclusion in a tax bill next year.

Other base maintenance issues

There are other base maintenance issues, but the ones discussed above are the most significant. Other issues to be addressed include reviews of:

- the use of passive investment funds by superannuation funds; and
- the taxation of restrictive covenants and lease inducement payments.

Remedial amendments

In the course of redesigning and reviewing the tax system, and discussing the operation of the tax system with other areas of the department and practitioners, the Policy Advice Division identifies a large number of unintended effects of tax legislation.

These problems are considered when formulating the tax policy work programme. Issues relevant to projects currently on the work programme are included in those projects. By contrast, issues that are outside the scope of the current work programme are prioritised and added to the existing work programme if sufficiently important. In that regard, it is useful to consult with the private sector and professional bodies (such as the Institute of Chartered Accountants) about their priority concerns.

In contrast to base maintenance initiatives, "remedial amendments" to legislation are not directed primarily at protecting the tax base and the Government's fiscal position. Rather, they are directed at correcting the unintended consequences of legislation. These can be due to either a legislative error, or effects that were not envisaged at the time the legislation was designed.

Once again, the distinction between base maintenance initiatives and remedial amendments can become blurred where an unintended consequence of legislation is being used to erode the tax base. In these cases, the correction of that legislative anomaly can be viewed as being both a remedial and a base maintenance initiative.

This year, a large variety of remedial amendments have been enacted.

Other considerations

The Policy Advice Division also conducts post-implementation reviews of new legislation. This enables us to check whether the legislation is working effectively, and that it is achieving its policy intent. An important review that is being undertaken at present is the post-implementation review of the compliance and penalties legislation. As well as reviewing the effectiveness of the current rules, the review will also consider a number of the recommendations in the report of the Committee of Experts on Tax Compliance, and the report of the FEC Inquiry into the Powers and Operations of the Inland Revenue Department, both released in the past 12 months.

Part Two: Simplification of the tax system

The Policy Advice Division is currently working on a number of initiatives to simplify the tax system. Under a simplified tax system, taxpayers will find it easier to comply with the law. The adverse effects of the tax system, such as compliance and administrative costs, will also be reduced.

It is important, however, that simplification initiatives be consistent with improving the overall tax system. Although compliance and administration are significant "deadweight" costs of the tax system (costs that are not expended directly on consumption or wealth-generating activities), the implications the tax system has for individuals' decisions on improving their skills, participating in the labour force, working, saving, investing, and taking risks can be even more significant.

Tax simplification is best advanced, therefore, as part of an overall tax strategy, not as a series of ad hoc, discrete measures. The approach that has formed one of the central themes of recent tax policy has been to consider simplifications in terms of a wider strategy of improving the tax system. It involves moving to statutory self-assessment on the basis that taxpayers are in the best position to calculate their income and determine their tax liability. Revised penalty rules were introduced in 1996 to provide incentives for taxpayers to calculate their tax liabilities correctly.

The rewrite of the Income Tax Act aims to make it easier for taxpayers to self-assess. Nevertheless, it is recognised that there will always be areas of legal uncertainty, and the binding rulings system, introduced in 1995, provides a mechanism for gaining certainty. Although this will produce a more efficient tax system, the need to self-assess does place

considerable burdens on taxpayers. These were lifted for wage and salary earners by removing the requirement for most of this group to file tax returns from the 1999-2000 year onwards.

Tax simplification work such as that set out in the recent *Less Taxing Tax* discussion document aims to reduce the compliance burden on small businesses, in particular, while continuing to improve the efficiency of the tax system.

This overall strategy of simplifying and improving the tax system is reflected in continuing policy work in four key areas:

- the rewrite of the Income Tax Act;
- tax simplification;
- codification of self-assessment; and
- the GST review.

These projects are discussed in greater detail below.

Rewrite of the Income Tax Act

The Rewrite project is a major tax policy initiative aimed at simplifying and clarifying existing tax legislation through the introduction of a coherent structure and plain language drafting. The project is an important initiative for simplifying the tax system, and the rewritten Act is expected to minimise the costs to taxpayers, tax professionals, the judiciary and other groups of using the legislation.

The first phase of the project was completed with the enactment of new Core Provisions in July 1996. The project is now working on Parts C, D and E of the Act (Income, Deductions and Timing), which might appropriately be described as the "engine-house of the Act".

The enactment of the Core Provisions left a number of issues unfinalised, such as ensuring the use of consistent terminology throughout the Act. Although such deficiencies are not fatal – the Act can still be applied effectively – it is important that the second stage of the project be completed as soon as possible. This would make the Act far simpler to read and apply, and would mean that the greater part of the aim of the Rewrite project, namely the minimisation of the costs faced by taxpayers because of the way the law is expressed, would largely have been achieved.

The Assistant General Manager of the Policy Advice Division is dedicated to managing and ensuring the successful completion of Phase II of the Rewrite project. Work is well advanced, and legislation is expected to be ready to be introduced into Parliament by 31 August 2001.

This introduction date is far later than anticipated when the project first began and has, not surprisingly, been the subject of criticism. The main reason for the later introduction date has been that the project has generated far more work than initially contemplated. It has, for example, identified a number of areas where the policy intent of existing law is unclear and

needs to be clarified to enable the legislation to be written plainly. In a couple of cases, this has resulted in significant new projects being initiated – on interest deductibility, distributions and the tax consequences of death.

Interest deductibility

A significant number of New Zealand companies pay interest on money they borrow to further their activities. However, how much of that interest expenditure can be deducted for tax purposes has long been an area of uncertainty, because the law itself often lacks clarity. As a result, companies frequently structure their dealings in such a way as to ensure that the interest expense they incur can be deducted, which leads to increased compliance costs and economic inefficiencies.

The discussion document *Interest Deductions for Companies*, released on 20 September 1999, set out proposals for clarifying and simplifying the rules for interest deductibility for companies. Submissions have now been received, and we expect to report to Ministers on their content early next year.

We are also looking at whether the rules for interest deductibility for taxpayers other than companies can be clarified and simplified. We expect to develop proposals in this area over the next two years.

Distributions and the tax consequences of death

The application of current income tax law to “in kind” distributions of assets, as well the tax consequences on death, are unclear, and have been the cause of uncertainty in the taxpaying community.

We have been consulting with selected private sector representatives on proposals we have developed for dealing with these issues. We will be reporting to Ministers on the outcome of these proposals early next year.

Tax simplification

The tax simplification project is working on measures to reduce the compliance costs faced by taxpayers. Significant progress has already been made – for example, recent legislation removed the obligation of many salary and wage earners to complete tax returns. The focus of the project is now shifting towards business initiatives.

The discussion document *Less Taxing Tax*, also released on 20 September 1999, proposed a series of tax improvements aimed at individuals and small businesses. Three key themes had emerged from the consultation undertaken in preparing that discussion document:

- Simplification for business taxpayers is unlikely to come from eliminating the forms businesses have to complete. The major problems for business taxpayers do not lie in filling in the forms, but in the amount of work required to obtain the necessary information to calculate tax liabilities.
- For tax purposes, businesses are not a homogenous group like salary and wage earners. Any consideration of tax-related problems of businesses must span a variety of different entities with vastly different processes and systems.
- Some specific taxes and elements of the tax system impose high stress costs on taxpayers. Many of the issues businesses feel strongest about concern tax rules which they neither like nor perhaps understand, such as the depreciation rules, which in fact impose relatively low compliance costs. In other words, there is a strong link between a taxpayer's view of an aspect of the tax system and the perception of the burden that aspect places on the business.

Specific concerns were expressed in relation to provisional tax, calculating year-end income tax requirements, fringe benefit tax, the timing of tax payments, and the compliance and penalties rules.

Submissions have been received and we expect to report to Ministers on their contents early next year.

Next steps

A further, potentially more significant round of small business tax simplification is also under way. This work aims to reduce compliance costs imposed on small businesses by:

- reducing compliance costs imposed on these businesses in meeting their day-to-day tax obligations, such as those imposed by provisional tax, PAYE, GST and fringe benefit tax;
- making it easier to calculate and pay tax, which may involve considering the introduction of minimum thresholds for the application of tax rules, such as for the valuation of trading stock;
- better aligning tax payments and businesses' cash flow, which could ease cash flow management and thereby reduce taxpayer default; and
- reducing the likelihood of penalties being imposed on small businesses that act honestly and in good faith.

To achieve this, consideration is being given to ways that businesses' tax affairs might better be integrated into their business activities. Taxpayers could then meet their tax obligations as a by-product of running their business rather than it being a dedicated activity in itself. It will be important to recognise, however, that business taxpayers are not homogeneous and that one approach will not work for all. For example, many businesses are interested in more technologically-based solutions in relation to payments, while others consider the current payment systems satisfactory.

Consideration is also being given to the possibility of expanding, within the tax system, the role of intermediaries such as tax agents, payroll firms and financial institutions. The advance of information technology and the ability to move information at low cost may have created scope for intermediaries to help small businesses meet their obligations, resulting in a potentially new approach to lowering compliance costs.

As part of the proposal development process, we will be considering in detail the simplification proposals contained in the Ralph report on Australian tax reform.

Codification of self-assessment

The 1994 Organisational Review of Inland Revenue identified the adoption by the department of a “substantial” system of self-assessment as a major reform in tax administration, but one that was not reflected in legislation. Rather, existing tax legislation is still written as if it were the Commissioner who actually performed all assessment activities.

Most of the major administrative changes necessary to support a self-assessment system have been implemented in the form of the binding rulings system and the new compliance and penalty rules. The Income Tax Act and Tax Administration Act do, however, need to be amended to reflect the manner in which the tax system is now administered. In doing this, it will be important to ensure that the Commissioner retains overall responsibility for assessing and collecting tax on the Government’s behalf, while reflecting the reality that taxpayers and other entities now play an important role in the performance of those activities.

A discussion document outlining the legislative amendments that would be necessary to codify the practice of self-assessment was released in August 1998. A key objective of the proposals set out in the document was to ensure that disputes are dealt with fairly and more quickly. Consequently, the document proposed to reduce to some extent various time periods for taxpayers and the Commissioner to alter assessments.

It is intended that legislation to effect self-assessment will be available for inclusion in a tax bill next year.

GST review

As well as dealing with a number of base maintenance issues, the discussion document *GST: A Review*, released in March 1999, contained the following proposals to simplify GST:

- increases to the registration, simplified tax invoice, payments basis accounting and other thresholds;
- simplification measures for change-in-use adjustments; and
- numerous remedial matters.

It is intended that legislation on these issues will be ready for inclusion in a tax bill next year.

Part Three: Tax strategy initiatives

New Zealand's tax and benefit systems are very complex and interrelate with each other. This can, however, be a significant barrier to:

- Effective policy development. If policy developers do not have a full picture of how things fit together and the consequences of adjusting a small part of the whole, changes that are made to the system could prove to be counter-productive.
- The effective operation of the tax/benefit system. The system is not transparent to taxpayer-beneficiaries because of the complexity of the combined tax and benefit system.

The Policy Advice Division is undertaking work in three key areas that will assist in our understanding of the operation of the tax/benefit system. These are:

- the composition of households' wealth and its relation to the tax system, in conjunction with the Treasury and the Investment Savings and Insurance Association;
- the interface between the taxation and the benefit system; and
- the effect of taxation on the type of entity used for conducting investment.

Savings and investment

The focus of our work on the savings and investment project is not the level of savings in New Zealand, but the forms in which households hold their wealth – housing, shares, bank accounts or otherwise. If the tax system were working efficiently, the risk-adjusted rates of return would be equalised across all forms of holding householder wealth. In practice, however, taxation rules tend to favour some forms of assets over others. For example, a person not subject to the top marginal tax rate faces a lower effective tax rate on a bank deposit than for an investment in superannuation.

Our work on savings and investment is reviewing the impact of tax law on the portfolio of assets held by New Zealand households. This should lead to a better appreciation of the effect of different tax policies on the composition of household wealth.

Tax/benefit interface

The Treasury is looking at the interface between taxes and the benefit system, and the effect of the combined system on work incentives. Policymakers are increasingly aware that tax and benefits are essentially a single system, and that policy should have regard to the effect of the system as a whole. At present, however, the effects of the combined tax/benefit system lack transparency.

The Policy Advice Division is contributing to the Treasury's work.

Entity taxation

Several types of entities in New Zealand are subject to their own specific taxation rules. Examples include Maori authorities, qualifying companies, mutual associations and co-operatives, and charities.

One way to encourage efficient savings and investment is to ensure that there is a stable and neutral investment environment. This means that one type of entity should not receive more preferable tax treatment than any other. Consequently, we are working on developing a standard framework for entity taxation – instead of having a number of entity-specific rules, it may be feasible to have a generic taxing framework, with specific rules to address situations where it may be desirable to diverge from the normal pattern.

A related issue concerns the appropriate treatment of charities, and other tax-exempt entities. Chapter 4 of the report by the Committee of Experts on Tax Compliance, released in December 1998, makes a number of recommendations on the tax treatment of such entities. We are reviewing the recommendations in that report.

Maori authorities

Maori authorities are still subject to tax rules that were developed in the 1950s and have not been reviewed since. We are reviewing the current tax treatment afforded to Maori authorities to determine whether it distorts Maori social and economic development and, if so, how those distortions could be addressed. The review will also clarify the public benefit test of charitable status as it applies to iwi and hapu-based structures.

The terms of reference for the review have been issued, and preliminary discussions with national Maori organisations have confirmed their support for such a review. At present, we are consulting with Maori authorities and tax practitioners as part of the policy development phase of the review to gain a better understanding of how Maori authorities operate in practice. The Maori community is, therefore, expecting further developments to occur in this area. We are working toward preparing a discussion document on the issues for release by June 2000.

Research and development and carbon charges

The Policy Advice Division has also been involved in an inter-departmental project for reviewing New Zealand's investment in research and development (R&D).

The review is intended to consider a range of issues, including whether there is underinvestment in R&D in New Zealand, and if so, why and how this may be addressed, the contribution that R&D makes to firm innovation and the performance of the economy, and the tax treatment of R&D in New Zealand and overseas. If the review continues, a steering group that includes private sector representatives will be convened, and it will report to the Government by 31 March 2000.

The division is also contributing to inter-departmental analysis of a possible charge or tax on carbon emissions.

Part Four: Other Policy Advice work

A number of important functions undertaken by the Policy Advice Division are critical to the continuing health of the tax administration.

Role in implementing major economic reform initiatives

One area that has the potential to consume significant policy resources is our role in assisting in the implementation of major Government reform initiatives. Typically, these involve the restructuring of Government assets, where assets are shifted from one type of entity to another. Recent examples include the accident compensation, electricity and producer board reforms.

It is easy to underestimate the extent to which such reform initiatives commit our tax policy resources. Tax implications should not be considered as an afterthought, but as an integral part of the reform development process. Our role is most effective and efficient if we are party to Government reform initiatives at their development stage.

Social policy role

Over the last decade, Inland Revenue has been given responsibility for administering key social policy initiatives, including making payments under the Family Support and Family Plus schemes to 185,000 families, administering child support, and collecting student loan repayments. The Policy Advice Division advises the Government on these major social policy mechanisms.

International tax initiatives

Since the late 1980s international tax reform has reduced the extent to which the international tax rules distort the nature of cross-border investment. A key feature of this reform has been to address aspects of the tax system that deterred investment into New Zealand. This has involved reducing the effective marginal tax rates applying to non-resident investment into New Zealand, which has in turn reduced the extent to which these taxes increase the domestic cost of capital.

This has been achieved through a range of initiatives, including:

- The **approved issuer levy rules**, which eliminate non-resident withholding tax when an issuer pays a 2% levy on interest paid on certain registered securities.
- The **foreign investor tax credit (FITC) rules**, which ensure that the total New Zealand tax (company tax plus NRWT) on non-resident equity investment does not exceed 33% (the company tax rate). Before the rules were introduced, foreign investors had to pay full New Zealand company tax as well as non-resident withholding tax.

- The **transfer pricing and thin capitalisation rules**, which improve the accuracy with which the New Zealand sourced income of non-residents is measured, and reduce non-residents' ability to transfer profits out of New Zealand free of tax.
- The **conduit rules**, which reduce the tax paid by non-residents in relation to investments made through New Zealand into third countries.

One issue we are continuing to work on is the implementation of the new transfer pricing rules, which came into force on 1 April 1996. The Policy Advice Division, in consultation with the business community, is continuing work on developing transfer pricing guidelines for New Zealand. It is anticipated that draft guidelines on the remaining issues to be covered (other than the treatment of branches, which has yet to be resolved by the OECD) will be issued early next year.

Negotiation and maintenance of DTAs

As the significant international tax reforms have now been concluded, the international tax team has recently been reorganised into a smaller specialist treaty team. The team is responsible for the negotiation and maintenance of New Zealand's network of double tax agreements (DTAs) with other countries, much of New Zealand's input into tax policy initiatives of the OECD, and the finalisation and publication of New Zealand's transfer pricing guidelines.

New Zealand has a network of 26 DTAs with its main trading and investment partners. The most recent agreement was one concluded with Thailand in 1998.

The focus of DTAs is wider than the elimination of double taxation. They are aimed at reducing tax impediments to cross-border trade and investment and assisting tax administration by:

- eliminating certain forms of double taxation;
- reducing withholding taxes on cross-border investments;
- exempting certain short-term activities in the host state from income tax;
- providing certainty of treatment;
- providing dispute resolution procedures; and
- enabling information to be exchanged between tax administrations.

We are in the process of negotiating agreements with Japan and Russia. The negotiations with Japan are seeking to replace the 1963 agreement between the two countries, which has become outdated. The negotiations with Russia have resulted in an agreed text between the two countries, and all that remains for the agreement to come into force is for it to be signed and ratified by the respective Governments.

We expect negotiations in the near future to focus on Latin America. At present, we do not have any DTAs with countries in this region, but it is becoming an increasingly important area in New Zealand's international trade developments. We also anticipate that there will be an increasing demand for mutual assistance in the collection of tax agreements – this is where we assist another country to collect its tax and it in turn assists in collecting ours. An agreement with the Netherlands for the collection of tax is in the process of being completed. It is possible, however, that future agreements might also deal with child support and/or student loans. (An agreement with Australia for the reciprocal collection of child support becomes effective from 1 July next year.)

A large part of our treaty team's DTA work involves negotiating remedial amendments to our existing treaties, at either our request, or the request of our treaty partners. For example, we have recently negotiated protocols to revise existing DTAs with China, India and Korea. These protocols removed the ability of investors to exploit tax sparing provisions[3] in those treaties in an unintended manner. The protocol with India also reduced the withholding rates faced by New Zealand investors into India, which has positive benefits for our business community. A number of other protocols are awaiting finalisation or are being negotiated.

As well as maintaining our agreements, the treaty team also provides a range of treaty services including notifying our treaty partners of changes in tax law in New Zealand, documenting our existing DTAs, and enhancing our DTA interpretation services.

The treaty team is also involved in:

- contributing to OECD initiatives; and
- monitoring developments on the implications of cross-border electronic commerce.

Other day-to-day work of the Policy Advice Division

The Police Advice Division provides advice in a number of other areas.

Advice on the tax implications of other legislation

We are responsible for providing advice on the tax consequences of a range of Government initiatives. In 1999, for example, we commented on:

- the tax implications of various Government payments to Maori;
- New Zealand Defence Force Operational Allowances: East Timor;
- the Children's Health Camps Board Dissolution Bill 1999;
- the insolvency review and priority debts; and
- producer board reform.

[3] Tax sparing provisions permit foreign tax credits to be claimed in certain situations where tax has not been paid to the foreign state. Their purpose is to prevent tax concessions aimed at attracting foreign capital, which are granted in developing countries, being clawed back by the country of residence of the investor.

Advice on other initiatives

The Policy Advice Division is responsible for providing advice on a range of Government initiatives that do not have purely tax implications. In 1999, for example, we commented on:

- the local government funding review;
- the review of credit unions;
- the implications of the Human Rights Act for the Revenue Acts; and
- Public Trust Office restructuring.

Continuing work

Other continuing work of the Policy Advice Division includes:

- the preparation of taxation amendments, including the drafting of legislation;
- the development of accrual determinations, which explain how the rules for determining income and expenditure from financial arrangements apply to specific financial instruments;
- the provision of policy advice on applications for binding rulings;
- revenue forecasting and analysis;
- operating the Ministerial Services Unit;
- assisting the Government to meet various statutory obligations including:
  - confirmation of annual tax rates;
  - setting the deemed rate of return for foreign investment fund rules; and
  - setting interest rates for the "use of money", fringe benefit tax, and student loans;
- answering questions on tax and social policy.

Reports on the tax system

Two reports that have featured prominently in the media in the last 12 months are the report by the Committee of Experts on Tax Compliance (December 1998) and the report on the Finance and Expenditure Inquiry into the Powers and Operations of the Inland Revenue Department (October 1999).

A number of tax policy recommendations were made in these two reports. In most cases, these recommendations have been readily incorporated into existing tax policy projects. Only in a couple of cases has it been necessary for recommendations to be considered outside of existing projects.

Chapter 4

Overview of the New Zealand Tax System

The tax system the Policy Advice Division works with

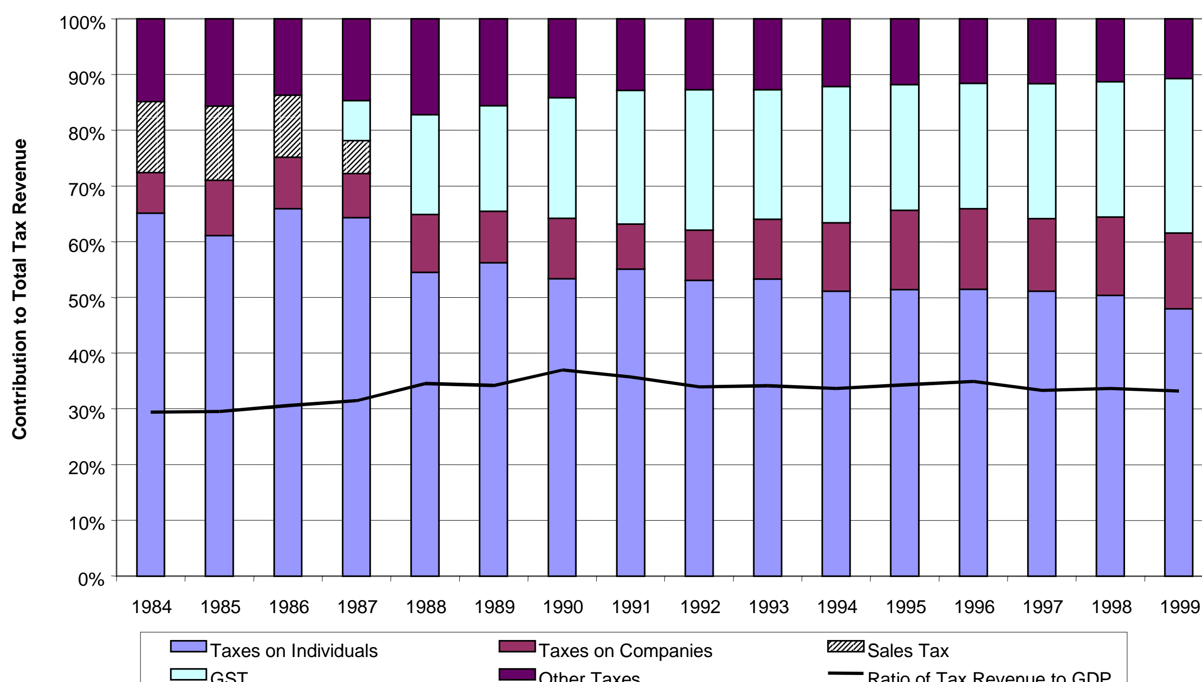
Developments since 1984

Since 1984 successive Governments have introduced a wide range of reforms to the New Zealand tax system. The reform process was driven by the recognition that the New Zealand tax system was not delivering sufficient revenue to finance the Government's expenditure initiatives, the tax system created significant economic distortions, and it consisted of a range of sales taxes that were complex and cumbersome to administer.

The principles that have been followed in reforming the tax system included:

- The economic decision-making process should be determined by economic substance rather than tax considerations.
- The tax system should minimise the opportunities for avoidance.
- The tax system should have low administrative and compliance costs.

FIGURE 5: THE CHANGING COMPOSITION OF THE NEW ZEALAND TAX BASE FROM 1984 TO 1999



Reform of the tax system has resulted in a fundamental shift in the composition of the tax base. The tax base has changed from relying on taxes on individuals' income to generate two-thirds of total revenue in 1984, to one by the early 1990s in which taxes on consumption and companies played an increasingly important role. By the end of this reform period, the contribution to total revenue of taxes on individuals' income had dropped to just over half, while the introduction of GST raised the contribution of taxes on consumption from 13% to 25%. The changing composition of the New Zealand tax base is shown in figure 5.

Through the nineties the process of continuing reform focused on maintenance of the company tax base, so that by the mid-1990s taxation from companies had grown from 7% in 1984 to 14% in 1995. Since 1995 tax reform has primarily involved decreases in the marginal income tax rates of individuals, to the point where in 1999, only 45% of total revenue was from the direct taxation of individuals.

Over the period 1984 to 1999 the ratio of tax to GDP increased from 29% to 33%. Total tax revenue rose from $10.7 billion to $32.9 billion.

Broadening the tax base and lowering marginal income tax rates

The main focus of the tax reform programme in the late 1980s was on broadening the tax base and lowering marginal income tax rates. Broad-base tax systems reduce the economic distortions between different forms of earnings, savings, investment and consumption decisions and are an effective defence against tax avoidance. A low marginal income tax rate reduces the incentive for tax planning schemes and increases the reward from increased work effort.

The company income tax rate was aligned to the same level as the top rate for individual income tax. Aligning the corporate income tax rate with the top individual income tax rate encourages entrepreneurs to focus on expanding the profitability of their businesses rather than designing and using tax planning schemes.

Broadening the individual income tax base involved:

- removing most income exemptions and tax rebates such as the First Home Mortgage Interest Rebate;
- introducing rebates and assistance measures that are income or family targeted;
- reducing marginal income tax rates – for example, reducing the top income tax rate from 66 cents in 1984 to 33 cents in 1988; and
- introducing a fringe benefit tax.

For companies, broadening the income tax base involved:

- abolishing a wide range of business incentives that were administered through the tax system, such as export incentives;
- removing the general income tax exemptions for inter-company dividends;

- introducing comprehensive rules for taxing financial arrangements (the accrual rules) and accounting for foreign-sourced income; and
- introducing an imputation credit scheme for company dividends to eliminate the double taxation of company income distributed to shareholders.

Replacing wholesale taxes with a comprehensive GST

In October 1986, New Zealand replaced its diverse range of wholesale taxes with a comprehensive goods and services tax (GST) at a rate of 10%. GST was increased in July 1989 to 12.5%, in response to the need to raise greater revenue to finance the Government's expenditure initiatives.

Greater use of withholding taxes

In the late 1980s and early 1990s the tax reform programme started shifting into initiatives aimed at improving the overall efficiency with which the tax system operates.

The use of withholding taxes recognises that collecting tax at the source of income reduces the scope for tax evasion and non-payment and that entities such as financial institutions and employers are often in a better position than Inland Revenue to collect tax.

New withholding taxes introduced during the reform process comprised:

- a withholding tax on residents' interest (now levied at 19.5% or 33%);
- a withholding tax on residents' dividends levied at 33%; and
- a dividend withholding payment levied at 33% on dividends paid by foreign companies to resident companies.

These new withholding taxes, in conjunction with non-resident withholding tax (NRWT) on dividends, interest and royalties, comprise 5% ($1.7 billion) of the total tax revenue for the year ended June 1999. Each of the withholding taxes has been included in either taxes on individuals or taxes on companies, depending on where their incidence falls.

Reforming other taxes

Reforms to other tax types have included:

- repealing estate and stamp duties;
- repealing land taxes;
- progressively removing and reducing import tariffs and customs duties; and
- increasing excise rates on alcohol and tobacco.

Simplifying and clarifying the tax system

By the early 1990s, increasing concern was being expressed about the complexity of tax legislation and its implications for administrative and compliance costs.

The process of tax reform had produced numerous piecemeal amendments to the Income Tax Act, significantly increasing its complexity. This not only increased administrative costs, but it also increased compliance costs in view of the increasing role that taxpayers were playing in the assessment and collection of tax.

As a result, since the early 1990s the tax reform programme has included initiatives aimed at reducing compliance costs.

In the early 1990s this involved the implementation of a range of initiatives recommended in 1989 by the Tax Simplification Consultative Committee.

More recent initiatives have included:

- restructuring the Income Tax Act and rewriting its Core Provisions in order to assist taxpayers to determine, calculate and satisfy their tax obligations;
- introducing a binding rulings system to clarify the manner in which tax legislation applies to the particular activities of taxpayers; and
- removing the need for many salary and wage earners to file income tax returns.

The incentives for taxpayers to comply with their tax obligations have also been enhanced through the implementation of:

- base maintenance and anti-avoidance measures;
- improved compliance and penalties legislation; and
- improved procedures for resolving disputes between Inland Revenue and taxpayers.

Aspects of the current New Zealand tax system

Taxation of individuals

Salary and wage earners

Taxation of salary and wages is by source deductions (PAYE, for "pay as you earn"), which account for $12.3 billion (37.3%) of all taxes collected. Employers are required to forward to Inland Revenue PAYE deductions made on behalf of their employees. Until 1999, many salary and wage earners were required to file an IR5 income tax return to reconcile their annual income, if their main sources of income were from salary and wages, interest, or dividends.

For the 1999-2000 income year, most of the 1.2 million salary and wage earners will no longer have to file an IR5 return. Because most taxpayers have tax withheld at source from salary and wages, interest and dividends, Inland Revenue has enough third party information to generate a tax return without input from the taxpayer. Some of those involved in the student loan, child support and family support schemes will, however, still be required to furnish Inland Revenue with information, given the additional information required under these schemes.

Changes to individual statutory tax rates occurred in June 1996 and June 1998. Before the 1996-97 income year, individuals' rates were 24% up to $30,875, and 33% beyond. The current tax scales are 19.5% up to $38,000, and 33% beyond. These changes are estimated to have reduced income tax from individuals by $2.5 billion.

"Other Persons"

This category consists of revenue collected from individuals who have sources of income other than salary and wages. These comprise the self-employed, shareholder employees, partners and anyone who has significant other income that has not had tax withheld, such as rental income. Such persons may be required to pay provisional tax in the form of three equal payments made throughout the year based on the previous year's income, provided their residual income tax liability exceeds $2,500. Of the 800,000 taxpayers in this category, approximately 200,000 pay provisional tax, while the rest have relatively small sources of other income.

Rebates

New Zealand has a minimal number of rebates available to individuals. Those that are available include:

- the **low income earner rebate**, which has the effect of generally reducing the effective tax rate to 15% on income below $9,500;
- a **transitional tax allowance** for certain employees working more than 20 hours per week (maximum of $728 reducing by 20 cents per dollar of income between $6,241 and $9,880);
- a **charitable donations rebate**; and
- a **housekeeper/childcare rebate**.

Taxpayers who are children are exempted the first $1,040 of non-investment income.

Family assistance

Family assistance is provided to low-income families with dependent children by way of Family Support and the Family Plus package. Family Support is administered by both Inland Revenue and Work and Income New Zealand, with entitlement depending on the number and ages of the children. Family Plus entitlement entails a further degree of independence from welfare-related state support, and is administered entirely by Inland Revenue. The Family Plus package has three separate components:

- The family tax credit is available to families where one or both parents are in full-time work. It provides a guaranteed income level, net of tax, below which a family's income cannot fall. If a family's income falls below the guaranteed level, the Government tops up the difference.
- The child tax credit is $15 per child per week, provided the family is not in receipt of a welfare benefit, and has not received accident compensation for a period greater than three months.
- The parental tax credit is a new initiative which took effect from 1 October 1999. For families who also qualify for the child tax credit, it provides a payment of $150 per week for eight weeks after the birth of each child.

Family assistance targets low-income families, so the combined entitlements are abated for incomes exceeding $20,000. Entitlements may be received fortnightly based on estimated earnings, or as a lump sum at the end of the year.

Inland Revenue administers payments of $600 million to 185,000 families through these schemes. The average payment in 1998 was $3,400.

Student loans

Inland Revenue is also responsible for collecting student loan repayments, primarily through the PAYE system for salary and wage earners. Those who are earning over the repayment threshold ($14,716 for 1999-2000) are required to pay 10% on the portion of their salary over the threshold. For income over $50,000, the rate rises to 15%.

Child support

Inland Revenue also administers child support. Non-custodial parents are assessed for child support payments based upon their taxable income minus a living allowance according to their current living status (whether they are single or married, have dependants and so on). The repayment rates are 18% for one dependant child, rising to 30% for four or more. Inland Revenue forwards payments to the custodial parent when she or he is not in receipt of a social welfare benefit.

Company taxation

Company taxes are levied on all New Zealand resident companies, local government trading enterprises (LATES), unit trusts, superannuation funds and on non-resident companies that derive income from New Zealand in the form of business profits, dividends, interest income or royalty payments.

The are four types of company taxes.

Income tax

Company income tax is levied at 33% of taxable income. New Zealand resident companies are taxed on their world-wide income, with a credit allowed for tax paid overseas. Non-resident companies operating and investing in New Zealand are taxed only on their New Zealand-sourced income.

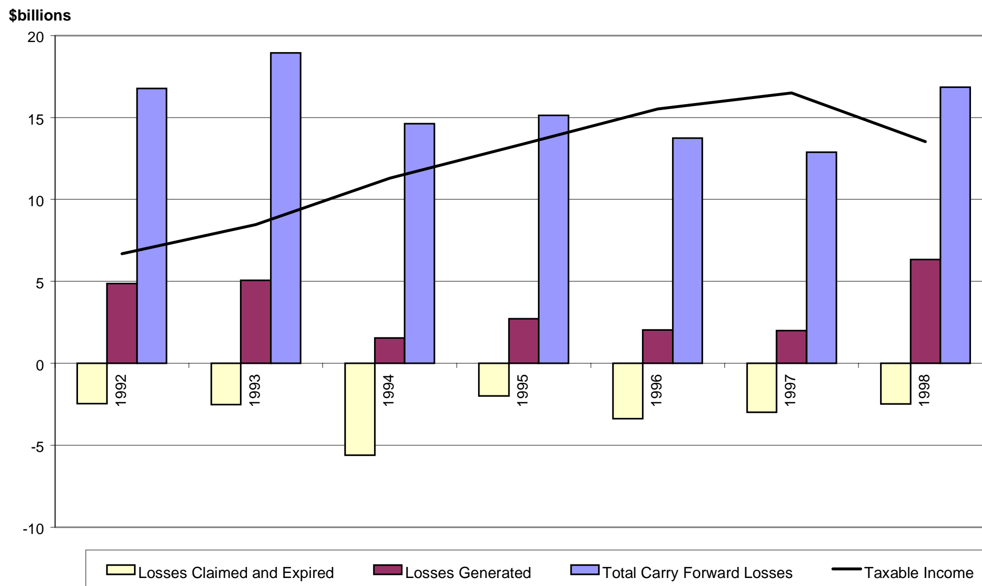
New Zealand operates an imputation credit system to prevent the double taxation of company profits, once when earned by the company and then again when the profits are distributed to the shareholder. Imputation credits are provided to the company when income tax is paid, which can be attached to dividends to offset tax payable by that shareholder.

About 160,000 companies, LATES, unit trusts and superannuation funds file income tax returns. Of these, 50,000 pay no tax because they are able to offset any income against losses, and 60,000 have no income. Income tax from the remaining 50,000 companies totalled $3.7 billion in the year to June 1999.

Tax losses

Provisions in the Income Tax Act 1994 allow companies, unit trusts and superannuation funds to offset losses generated in previous income tax years against income in future income tax years. Figure 6 shows the make-up of corporate tax losses in New Zealand since 1992. The ability to use previous losses is subject to continuity requirements for shareholder ownership. If these provisions are breached the losses expire.

FIGURE 6: TOTAL TAX LOSSES FOR COMPANIES, UNIT TRUSTS AND SUPERANNUATION FUNDS IN 1999 DOLLARS

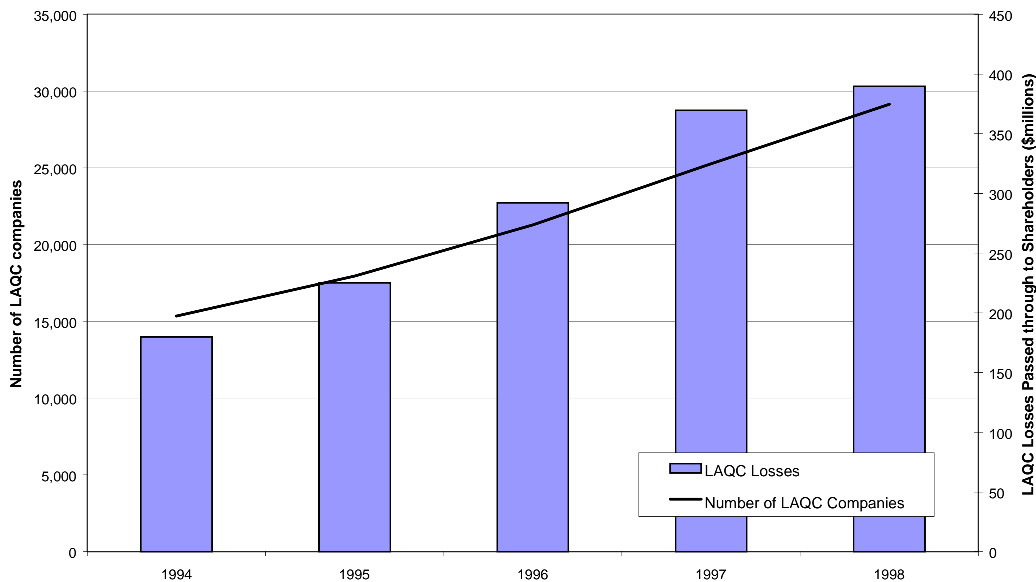


The total tax losses carried forward at the end of the 1997-98 income tax year were $16.8 billion. Although the value of tax losses is high, the ability of the business community to use them is limited. Many of the losses are sitting in companies that have no income and cannot be used. A fair indication of the value of losses that can be offset against income in future income tax years is the total value of losses generated in the most recent income tax year. In the 1997-98 income tax year, $6.3 billion of losses were generated.

Loss attributing qualifying companies (LAQCs)

The rules on loss attributing qualifying companies (LAQCs) allow companies meeting defined criteria to pass losses generated in the income tax year on to their shareholders. The objective of the LAQC rules is to place the shareholder in a LAQC in the same tax position as a partner in a partnership.

FIGURE 7: LOSSES PASSED THROUGH FROM LOSS ATTRIBUTING QUALIFYING COMPANIES (LAQC) IN 1999 DOLLARS



Since the introduction of the LAQC rules in the 1993-94 income tax year, there has been substantial growth in the number of companies using them and in the total value of losses passed through to shareholders, as illustrated in figure 7. In total, $1.4 billion in losses have been passed through to shareholders since the introduction of the rules.

Non-resident withholding tax (NRWT)

NRWT is levied at either 10, 15 or 30% on interest, royalty and dividend payments made to non-residents. About 3,000 companies pay NRWT on behalf of non-residents.

Relief from double taxation on dividend distributions to non-resident shareholders (company profits first subject to income tax and the dividend distribution subject to NRWT) is provided through New Zealand's foreign investor tax credit (FITC) rules. They extend the benefits of New Zealand's imputation system to non-resident shareholders of New Zealand companies through the payment of a supplementary dividend.

For certain registered securities, resident borrowers are subject to an approved issuer levy (AIL) of 2%. There is then no obligation to deduct NRWT from interest paid to offshore investors on these securities.

For the year to June 1999, revenue from NRWT totalled $717 million, and revenue from AIL totalled $46 million.

Foreign dividend withholding payments

When companies, unit trusts and superannuation funds derive dividend income from overseas, they are required to deduct a dividend withholding payment on behalf of their shareholders. The withholding rate is 33 cents in the dollar. A credit for the foreign dividend withholding payment is deducted from the shareholder's liability once the dividend is passed on. This is similar to the way imputation credits can be passed on to shareholders.

Revenue from foreign dividend withholding payments totalled $8 million for the year to June 1999.

Withholding tax on residents' dividends

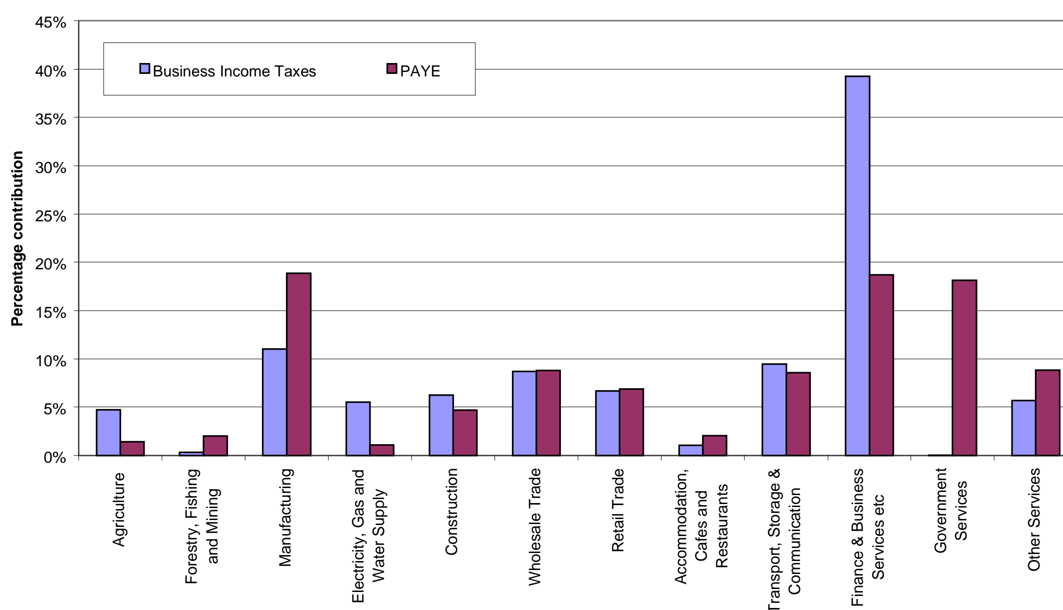
Companies deduct withholding tax when dividends paid to New Zealand shareholders have insufficient imputation or dividend withholding payment credits attached to offset the tax liability in the hands of the shareholder. Withholding tax on residents' dividends is levied at 33%.

Withholding tax on residents' dividends totalled $63 million in the year to June 1999.

Sources of New Zealand's income tax revenue by industry sector

The size of the productive industries in New Zealand and the contribution that these industries make to the total business income tax[4] collected varies widely, as shown in figure 8. The largest productive industry in New Zealand, as measured by Statistics New Zealand production statistics, is the manufacturing industry. This industry comprises approximately 20% of the total GDP[5] of New Zealand in the year to March 1998. It contributed 11% of the total business income tax and 19% of the total PAYE.

FIGURE 8: INDUSTRY DISTRIBUTION OF NEW ZEALAND'S INCOME TAX REVENUE YEAR ENDED MARCH 1998



The finance and business services industries made the largest contribution (39%) towards business income tax and 19% of the total PAYE. This sector contributes 16% of New Zealand's GDP. This suggests that New Zealand's business income tax base is very sensitive to the health of our banking sector and the income derived by superannuation funds, life insurance companies and unit trusts

Taxation of savings

The New Zealand tax system is designed to minimise distortions to the investment choices of investors, by taxing all savings on a *taxed-taxed-exempt* basis, which operates as follows:

[4] Business income tax includes company income tax and income tax levied on self-employed income, partnership income and shareholder salaries.
[5] GDP excluding estimates for Owner Occupied Dwellings and Unallocated.

- Contributions by an investor to an investment entity are made out of ***taxed*** income.
- The investment entity is subject to ***tax*** on income derived from the use of the investor's funds.
- Withdrawals and distributions of the tax-paid investment income are ***non-taxable*** in the investor's hands.

This ensures that income earned from investing in superannuation funds, unit trusts and life insurance products is taxed on the same basis as income earned from investing in companies.

In the year to 30 June 1999, taxation of superannuation funds, unit trusts and life insurance products raised $720 million.

Goods and Services Tax

The rate of GST is 12.5%, and GST accounts for just over 25% of Crown Revenue. About 450,000 entities are registered for GST.

All persons or businesses who are engaged in a taxable activity on a continuous or regular basis must register for GST, if their annual gross income from their taxable activity is over $30,000. Below this level, registration is voluntary. Those who register must forward to Inland Revenue on a regular basis their net GST (GST charged on supplies made minus GST claimed on costs incurred). If the net figure is negative, this amount is refunded. Those who do not register cannot charge GST or claim GST refunds.

GST has a comprehensive base, in that few goods or services are exempt. Imports are subject to the same GST rate as domestically produced goods. Exports are zero-rated.

Other taxes and duties

Fringe benefit tax

Fringe benefit tax is payable at a rate of 49% on the value of fringe benefits employers provide to employees and shareholder-employees. This rate was set so employers face the same cost in providing fringe benefits that they would in making an equivalent taxable payment to an employee on the top 33% marginal tax rate.

There are four main categories of taxable fringe benefits:

- motor vehicles;
- low-interest loans;
- free, subsidised or discounted goods and services; and
- employer contributions to sick, accident or death benefit funds, superannuation schemes, and specified insurance policies.

Fringe benefit tax raised $323 million in the 1998-99 year.

Gaming duty

Gaming duty consists of totalisator duty, lottery duty, gaming machine duty and casino duty. These duties raised $157 million in the 1998-99 year.

Totalisator duty is payable at the rate of 20% of the betting profits of a racing club or totalisator agency board. Lottery duty is payable at the rate of 5.5% of the nominal value of all gaming activities carried out by the New Zealand Lotteries Commission. Gaming machine duty, at the rate of 20%, is payable on the profits from a gaming machine or dutiable game. Casino duty is payable by licensed casino operators at the rate of 4% on the "casino win" of all authorised games conducted or played in the casino.

Other duties

In recent years, estate, stamp and credit card transaction duty have been repealed, while revenue from gift duty has fallen to $2 million. Cheque duty, levied at 5 cents per cheque, raises $12.5 million.

Appendix A

Revenue Strategy Agreed in 1996

Aims of the Government's tax policy

New Zealand's best interests are served by a tax system which:

- secures the revenue the Government needs to pay for its expenses, to reduce its debts and to allow future cuts in tax rates;
- reduces economic growth as little as possible, consistent with the need to raise revenue. This means that it interferes as little as possible with the decisions of individuals, companies and other entities;
- is fair, with all taxpayers making an equitable contribution, based on their ability to pay;
- minimises opportunities for avoidance and is vigorously enforced, with effective penalties for non-compliance; and
- has low compliance and administration costs.

The tax system

To achieve the above aims, the Government believes that both direct and indirect taxes should be made as broad-based as possible, as far as compliance costs allow. Broad-based taxes reduce distortions between different forms of earnings, saving, investment and consumption and are an effective defence against tax avoidance.

The Government will:

- actively maintain the current income tax and GST tax bases. This involves stopping opportunities for abusive tax behaviour by identifying and closing tax loopholes, and by vigorous enforcement. It may also involve broadening the tax bases where that is desirable for maintaining the bases or for reducing any significant economic distortions;
- review penalties for non-compliance;
- clarify tax laws so that honest taxpayers can more easily calculate their correct tax liability; and
- simplify the tax system and reduce filing requirements.

Tax rates

Tax rates will be kept as low as possible, subject to budget requirements. Tax cuts will focus on lowering the rates of tax on income.

The tax policy process

The Government will apply the Generic Tax Policy process recommended by the review committee chaired by Sir Ivor Richardson. In particular, consultation will continue to be part of the implementation of all major initiatives.

Appendix B

Protocol between Inland Revenue and the Treasury

Set out below is the protocol agreed between Inland Revenue and Treasury for the preparation and presentation of tax policy advice by officials:

- Officials' process will be based on the GTPP proposed by the IRD Review Committee, adapted as appropriate to meet the circumstances of a particular issue. This will ensure that all departments are aware of, and working to, the same work programme timetable, and that the responsibility of the departments for leading or supporting through all phases of particular projects will be allocated according to the comparative advantages of the departments, and consistent with the generic process. While the process is intended to be generic, the presumption should be that it be followed unless a good case can be made in the particular instance for an alternative course of action. The aim will be to ensure that both the accountabilities are clearly defined and that Ministers can be assured of contestable advice throughout the process.
- Officials' primary duty is to provide Ministers with free and frank advice and not to represent the view of any particular Minister. In dealing with parties outside Government, for instance in the course of consultative processes, the duty of officials is to describe accurately the views of the Government and the rationale for Government policy.
- On all tax policy issues it is essential that Ministers have available to them the information and perspectives of both the Inland Revenue Department and the Treasury, of the Department of Prime Minister and Cabinet as chair of the Officials Tax Committee, and on occasions of other departments that have a legitimate interest in the particular policy issue. It will be the responsibility of whichever of Inland Revenue or the Treasury is leading on a particular issue to ensure that other relevant departments are consulted.
- On all matters of significant policy content, officials' advice should be presented to both the Treasurer and the Minister of Finance and Revenue at the same time and in a joint paper, normally prepared by the Officials Tax Committee under the chairmanship of the Department of Prime Minister and Cabinet. Such papers should contain all relevant information and options relating to the particular issue, officials' analysis of that information and those options, and officials' advice. Where officials wish to offer differing advice on a significant issue, the reasons for the differences should be clearly identified.
- No surprises. Each department concerned will keep the other(s) informed on work for which it has primary responsibility. On matters which departments agree are of administrative or minor detail, the department with the lead responsibility may report directly to Ministers but, in doing so, will ensure the other department(s) has adequate opportunity to consider the issue and provide comment.

- Dispute resolution. Day to day responsibility for the operation of the protocol rests with the General Manager of the Policy Advice Division of Inland Revenue, and the Deputy Secretary of the Regulatory and Tax Policy Branch of the Treasury. In the event of any disagreement arising between the departments concerning the way this protocol is working, the two Chief Executives will meet to resolve it.
- Communication. The Commissioner of Inland Revenue and the Secretary to the Treasury will meet from time to time, generally three times a year, to review the workings of this protocol and the associated relationships.