Inland Revenue
Te Tari Taake

POLICY ADVICE DIVISION **THE TREASURY**

24 July 2000

Mr Mark Peck, MP
Chairperson
Finance and Expenditure Committee
Parliament

Dear Mr Peck

Officials were requested to provide further advice to the Committee on several outstanding issues for your deliberation on the Taxation (FBT, SSCWT and Remedial Matters) Bill. The issues are as follows:

Superannuation fund withdrawal tax issues

- Whether a non-life annuity should be exempt from the withdrawal tax only if it is for a minimum of ten years, rather than five years.
- Whether, in relation to a member who is taking "partial retirement", an objective test of a member's intention not to increase their hours of work is needed.

Officials have also identified several minor changes regarding the superannuation fund withdrawal tax for the Committee to consider.

Multi-rate fringe benefit tax issues

- Whether employers should be allowed to top up their earlier FBT payments retrospectively to 64% if they are unable to undertake the square-up calculation.

Officials have also identified a minor change regarding multi-rate FBT for the Committee to consider.

As outlined further in this letter, ICANZ has now stated that it is fundamentally opposed to the proposed amendment to the multi-rate calculation to add the value of attributed fringe benefits to cash remuneration in this bill. However, officials consider that the rationale for this amendment still stands.

Officials have prepared two slips for the Committee's deliberation, one with the official's recommendation to include the value of fringe benefits in the multi-rate calculation, and the other (Slip #2) without.

Superannuation fund withdrawal tax

Officials consulted on the draft legislation with the Investment Savings and Insurance Association (ISI) as instructed by the Committee. Also as requested by the Committee, officials discussed the issue of a minimum ten-year payment period for annuities and the intention test under the partial retirement exemption.

Extension of the length of exempt non-life annuity payments

In the *Officials' Report*, officials recommended to the Committee that withdrawals in the form of a non-life annuity that provides a payment over not less than five years be exempt from the withdrawal tax (See *Officials' Report,* p.27). The Committee instructed officials to provide further advice on whether the payment period should be increased to not less than ten years.

ISI accepted a ten-year period but requested that the exemption also apply to pensions payable over 10 years or life. This is on the basis that the purchase of a non-life annuity over ten years is identical in substance to a fund paying a pension over similar terms.

Officials recommend the exemption include a non-life annuity for a period of no less than ten years and pensions payable for at least ten years.

Intention test for "Partial Retirement"

Officials were instructed to consider whether an objective test is needed to ascertain employees' intentions not to increase hours of work following partial retirement (See *Officials' Report*, p.33).

The ISI was concerned that a move towards a more objective test to determine intention would place a significant obligation on trustees, would require considerable amounts of information to be provided to trustees, and in the end would still require a judgement on a member's intention.

The approach of requiring a statutory declaration was considered, but rejected, given the sufficient ability to impose penalties under the Tax Administration Act 1994.

The ISI instead recommended that there be a notice in writing provided by the member which includes a statement from the member's employer or employers that there is no understanding to raise the employee's hours of work. Officials agree this provides an increase in objectivity with a lesser compliance cost impact on superannuation funds and members.

Officials recommend that a member be required to provide a statement in writing to the trustee. If the Committee wants more confidence around this election a statement from the member's employers, as suggested by the ISI, could be required.

Other issues discussed

While the discussion with the ISI concerned the draft legislation, it alerted officials for the need to recommend a number of minor changes in policy. These are:

- The transitional provision relating to employers who elect the 39% SSCWT rate after 1 October 2000 should be removed as it is confusing and provides little value given the ability of each employee to decide whether to elect that rate.
- Additional rules relating to superannuation funds who are also members of a superannuation fund or a superannuation scheme are required. These measures reduce the compliance costs imposed on superannuation funds by removing the need for information to be transferred in cases where that information is not necessary.
- To increase the period in which a superannuation fund has to transfer information to another superannuation fund from 20 to 40 days given that the fund required to provide information may in turn have to request that information from a third party.
- The reserves included in the definition of employer contributions to superannuation savings should be narrowed in the case of superannuation funds with ten or more unassociated members.

The ISI also made the comment that the structure of the legislation is clearer and that it is pleased with the opportunity to comment on the draft legislation.

Multi-rate fringe benefit tax

Ability for employers to top-up earlier payments retrospectively to 64% if unable to undertake the square-up calculation.

Officials and the Specialist Tax Adviser were asked to report back to the Committee to clarify and provide an agreed position on the issue of employers who find themselves unable to undertake the square-up calculation. This could occur due to the employer having inadequate records or systems in place with the expected enactment date of the legislation being part-way through the current income year.

The issue was raised in the submission of the New Zealand Law Society (See *Officials' Report*, p.84) and was endorsed by the Committee's Tax Adviser. The submission was that, at least in the first (transitional) year, employers who use the 49% rate instead of the 64% rate in quarter 3 should be able in the final quarter to avoid the mandatory square-up if they find they are unable to undertake the calculation. Such a scenario could occur for the following reasons:

- **The employer may have inadequate records**. Employers can only be informed with certainty over the detail of their obligations and requirements for record-keeping once the legislation has been enacted. The likely date of enactment will not occur until part-way through the current income year which commenced on 1 April 2000; and

- **The square-up calculation is new.** As the square-up calculation is new to all employers and their advisers, employers could use the 49% rate in quarter 3 believing that they can undertake the square-up, but then find their records are incomplete.

The original recommendation by officials was to decline the submission on the grounds the intention of the bill is to provide employers with a broad choice between either using the 64% rate in every quarter or opting into the square-up. Allowing employers to knowingly use the 49% rate and then "top up" in the final quarter would result in revenue loss in the form of use-of-money by those employers who would otherwise use the flat 64% rate (as no use-of-money-interest would apply).

After discussions with the Committee and its Tax Adviser, officials agree that this issue needs to be reconsidered. The extension of the transitional period to quarter 2 means that an employer's decision in quarter 3 whether to use the 49% or 64% rate will determine whether they are required or can choose to undertake the square-up. Some employers may use the 49% but then find they cannot physically undertake the calculation (for the reasons discussed above).

Officials view this as a one-off transitional issue, as employers will in future years have the experience and/or ability to seek advice on whether it is appropriate for them to opt into the square up.

In accepting the submission, the issue could be solved either by an amendment to the bill stating that in the 2000-2001 income year such a top-up could be made where the square-up could not be physically undertaken, or administratively, with Inland Revenue adopting a pragmatic approach and accepting such an adjustment. Employers who did top up their FBT payments would pay either the same or more FBT than they would under the square-up.

Employers will not be subject to a shortfall penalty for lack of reasonable care, as their final quarter liability will be equal to or greater than their liability had they undertaken the square-up calculation. A shortfall penalty can only be imposed if there is a tax shortfall because of a lack of reasonable care.

Officials recommend that this issue be dealt with legislatively and consider that such a transitional rule will not increase the complexity of the multi-rate FBT rules for employers.

Final FBT return when employer ceases employing

Under the bill, an employer is required to undertake the square-up process at the end of the quarter in which the employer ceases employing. Given that employers can continue to provide fringe benefits to past employees, officials recommend that this provision should only apply when the employer ceases employing and does not provide fringe benefits to past employees.

Update on the proposed change to the multi-rate calculation to add the value of attributed benefits to cash remuneration

The proposed amendment to the multi-rate calculation ensures that remuneration, whether in the form of cash or fringe benefits, is subject to the same amount of tax.

In the *Officials Report* (p.76-78) we indicated that ICANZ and the Employers' Federation had indicated their support for the proposal. In further discussions, ICANZ has now informed officials that it is "fundamentally opposed" to the proposed change to the multi-rate calculation being included in this bill. ICANZ considers that including the value of attributed fringe benefits increases compliance costs significantly, and should therefore be subject to further consultation.

Officials disagree with this position as the consequences outlined in the *Officials' Report* of not including the value of attributed fringe benefits still stand. Specifically, the consequences from not amending the legislation to include the value of attributed fringe benefits are that:

- There would be potential inefficiencies in that a $1 increase in cash remuneration could result in more than a $1 increase in FBT liability (owing to fringe benefits being subject to a flat rate at each cash remuneration threshold rather than through progressive rates as would be achieved by the amendment).
- There would be potential for tax avoidance as excluding the value of benefits would result in FBT liability being based on cash remuneration only and not total remuneration. Therefore the exclusion would allow the structuring of remuneration packages below a higher tax threshold (such as $37,999 or $59,999). The remainder of the package would be in the form of fringe benefits taxed at a flat rate based on the band in which the last $1 in cash remuneration falls.

Officials do recognise there will be an increase in compliance costs in undertaking the calculation, but these costs are mitigated to some extent by the removal of the requirement to annualise remuneration under the proposal in the bill.

Officials consider that the change in the multi-rate calculation by adding the value of attributed fringe benefits to cash remuneration will need to be implemented. By delaying implementation, employers and Inland Revenue will have to go through systems changes twice. Officials consider it more practical to implement the proposal fully so there is only one change to employers' and Inland Revenue's systems.

Furthermore, officials consider that the proposal is developed to such an extent that further consultation will not result in any substantial changes. Officials therefore recommend that the proposal to include the value of attributed fringe benefits in the multi-rate calculation proceed in the bill.

Officials have prepared two slips for the Committee's deliberation, one including the value of fringe benefits in the multi-rate calculation, and the other without.

Officials recommend that a copy of this letter should be made available when the bill is reported back to the House to indicate that ICANZ did not support including the value of attributed fringe benefits.

Yours sincerely

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The Treasury

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