REGULATORY IMPACT STATEMENTS

for the

TAXATION (ANNUAL RATES, RETURNS FILING, AND REMEDIAL MATTERS) BILL 2011

- ***Simplifying filing requirements for individuals and record-keeping requirements for businesses***
- ***Tax treatment of profit distribution plans***
- ***Making KiwiSaver more cost effective***
- ***Tax minimum equity rules for foreign-owned banks***
- ***Non-resident film renters' tax***
- ***Extending eligibility for the in-work tax credit to certain shareholder-employees***
- ***Liquidators and receivers changing GST accounting basis***
- ***GST and late payment fees***

Hon Peter Dunne
Minister of Revenue

Prepared by Inland Revenue and the Treasury

September 2011

Regulatory Impact Statement

Simplifying filing requirements for individuals and record-keeping requirements for businesses

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

The problem that this statement addresses is the increasing number of contacts with taxpayers that Inland Revenue is required to process. Along with an increase in volume, there has been an increase in the complexity of these contacts.

This statement provides an analysis of options to transform the way in which Inland Revenue delivers its services and with a view to reducing contacts. A major focus of the policy project has been to examine ways in which Inland Revenue can administer its responsibilities in a more efficient manner. The proposed approach adopts electronic services as the main method of service delivery and seeks to reduce compliance costs for businesses and individuals.

The increase in contacts has been driven by a number of policy settings, such as the requirement for social policy recipients to file a tax return. Also driving this increase is the current ability for certain taxpayers to access refunds of over-deducted PAYE without having the reciprocal requirement to pay under-deducted PAYE. Although the proposals are intended to reduce these contacts, the extent to which they do this can be established only once they are made operational.

The most significant dependency of the analysis is the ability of Inland Revenue to deliver significant operational change, particularly given its commitment to other major changes such as student loan redesign and the child support review. The design and information technology commitments to these two projects mean that there is limited ability for Inland Revenue to deliver other initiatives in the short to medium term. As a consequence, design and implementation of the proposals would be staggered from July 2011, with full implementation occurring 1 April 2015.

The analysis summarised in this document has been the subject of public consultation via a Government discussion document and associated online forum, *Making tax easier*, released in June 2010. The proposals have been developed in light of the feedback received, and they strike a balance between the concerns raised in the submissions and the efficiency of tax administration. As the proposals were developed, more focused consultation was carried out with key selected stakeholders and interest groups. This feedback was also reflected in the policy design.

The recommended policy proposals are intended to reduce compliance costs for businesses and individuals. They do not impair private property rights, although one of the proposals may reduce the net amount of refunds. They may also affect the business of the personal tax intermediary market, as one of the proposals will impact on the current business model used by these firms by reducing the net amount of refunds by requiring returns to be squared across four years. The policy proposals recommended do not override fundamental common law principles.

Dr Craig Latham
Group Manager, Policy
Inland Revenue

25 July 2011

STATUS QUO AND PROBLEM DEFINITION

1. The problem that this Statement addresses is that Inland Revenue's increasing number of contacts with taxpayers and the resulting processing is creating pressure on the administration of the tax system. The increase in contacts is due in part to the expansion of Inland Revenue's responsibilities into social policy administration through initiatives such as KiwiSaver, student loans, Working for Families tax credits and child support. Businesses and individuals find tax processes time-consuming and uncertain.

2. At a high level, the underlying causes of the problem can be categorised as the following:

- ***Lack of certainty, due in large part to frequent changes to the tax rules:*** Although this is generally due to changes in Government policy, and is typically accompanied by public consultation, the frequency of tax changes has led to substantial increases in the number of taxpayers who require assistance from Inland Revenue.

- ***Meeting the expectations of taxpayers:*** As the volume of tax returns and queries increases with changes to policy and the expansion of Inland Revenue's responsibilities, service delivery standards necessarily come under pressure. This expansion has also increased the expectations that taxpayers have of Inland Revenue. Because of the heavy reliance on paper (with around 26 million letters per year being sent to taxpayers), Inland Revenue's response times have come under pressure.

- ***System integrity:*** Inland Revenue's FIRST computer system has been substantially added to and modified as a result of policy change, which has added to the pressure on the core strengths of New Zealand's tax system. It is integral to taxpayer trust that tax administration systems do not fail.

3. These problems are exacerbated by:

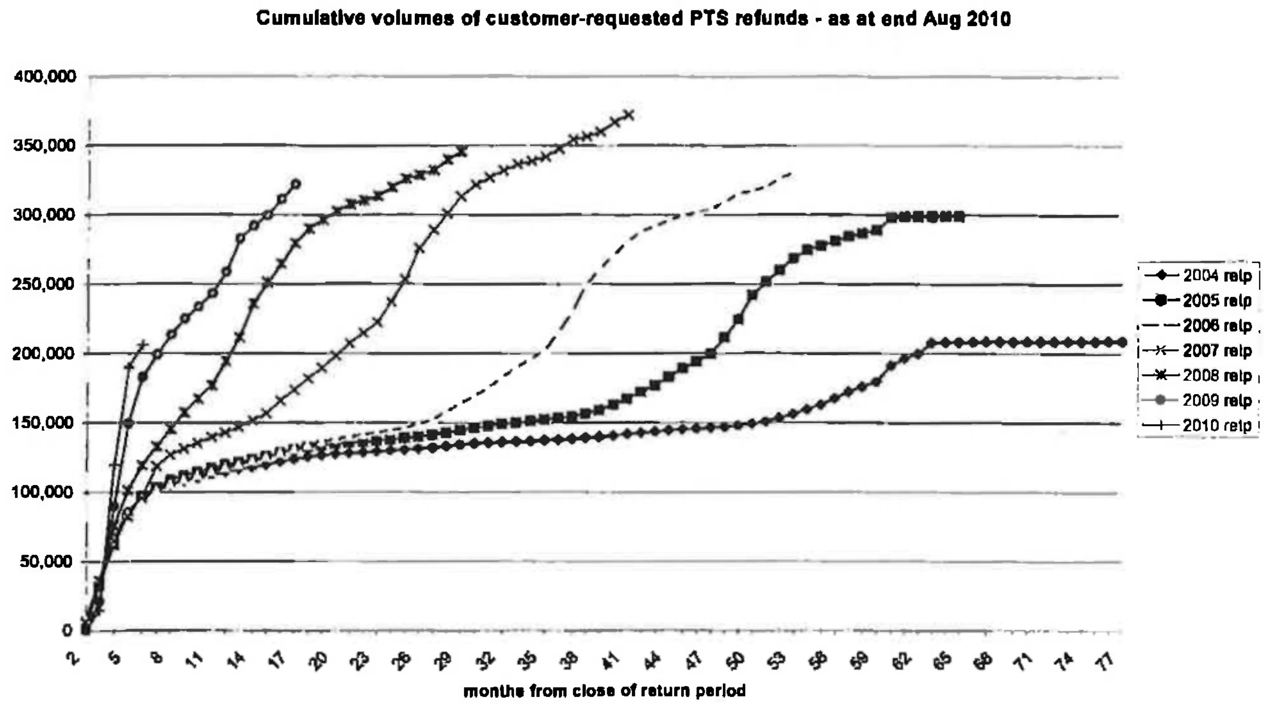
- Inland Revenue's systems are designed to be as accurate as possible with minor variations generally netting out over time. For PAYE, deductions are based on current rates, and the annualising of the pay amount for individual pay periods may be out of line with individuals' annual income tax liabilities on their employment income (ignoring social assistance) in various situations. However, for PAYE, refunds can occur in a number of circumstances such as:

    - o when individuals enter employment part way through the year,
    - o have PAYE deducted at the non-declaration rate because they have not yet obtained an IRD number and tax code,
    - o have deductions made at the incorrect code for whatever reason (including employer error),
    - o change jobs during a year at different rates of pay,
    - o have lumpy income (those in part time or casual employment based on hourly pay rates, where the amount may vary considerably from pay period to pay period),
    - o hold more than one job at a time,
    - o receive extra pays, and

o do not earn uniform amounts of employment income in each pay period throughout a full tax year, for whatever reason, when personal tax rates change during the year.

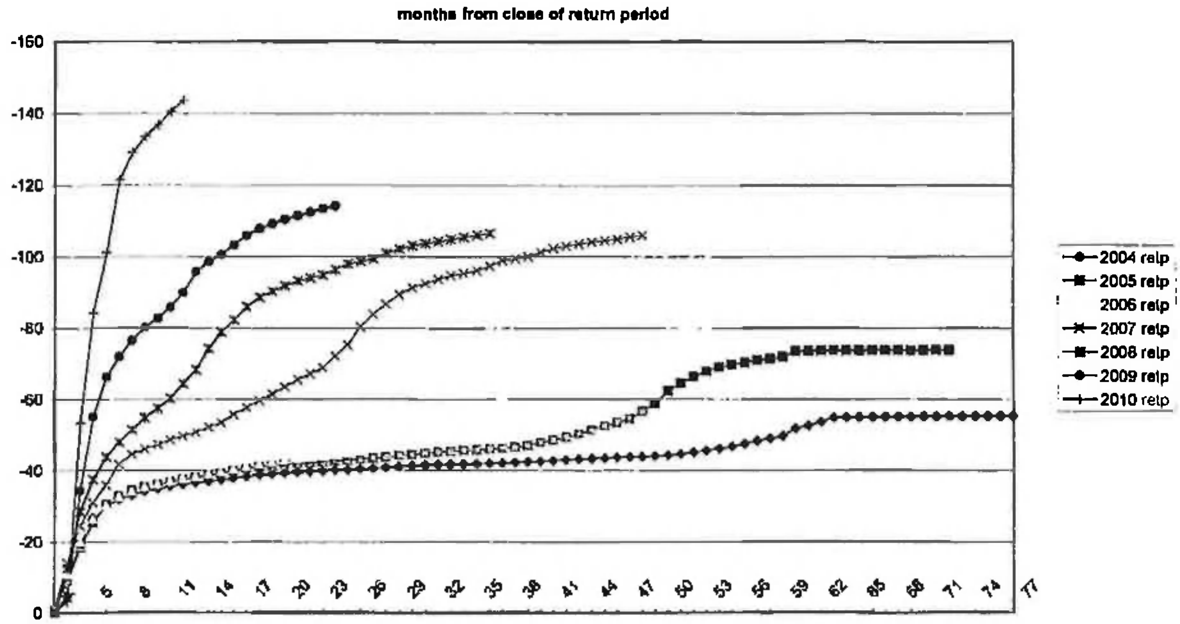
- Large numbers of individuals self-select to file an income tax return or receive a personal tax summary (also known as an income statement) in years in which they are due a credit. This has resulted in a significantly increased workload for Inland Revenue as people re-enter the annual filing system. This is in large part due to the ability of taxpayers to choose to file only when they are due a refund and not in years when they have tax to pay.

- The graph below shows the increase in customer-requested personal tax summaries. In 2004, it took 60 months (from the close of return period) for the volume of self-selected personal tax summaries to reach 200,000. In 2008, it took only 14 months to reach this level.



- The ability for some taxpayers to access refunds of over-deducted PAYE, but not pay their under-deducted PAYE, has resulted in a situation where large amounts of revenue are being paid out, without a reciprocal obligation on taxpayers to pay potential shortfalls as evidenced in the graph below.

Cumulative value $M (excluding WFF) of customer-requested PTS refunds



- The requirement of people who interact with social policy programmes to file a tax return has also contributed to the increase in the volume of contacts. For example, large numbers of Working for Families tax credits recipients are required to file an income tax return because they receive these tax credits. However, all that is needed to assess their entitlement is their income and family details, rather than the amount of tax they have paid.

- Electronic filing needs to be streamlined to remove the barriers that are currently discouraging businesses and individuals from using it. Specifically, some of the barriers that we can address immediately are:

  - A person who carries on business or derives income in New Zealand must also keep sufficient records in New Zealand. This is a problem for the increasing number of taxpayers who are choosing to use payroll or accounting software that uses offshore data storage. The Commissioner of Inland Revenue's discretion to exempt this requirement only extends to a "person", and this means that each individual needs to seek the exercise of discretion. Requiring individual applications for exemption is increasingly impractical given the rise in use of offshore data storage.

  - When information in a taxpayer's return has been provided to Inland Revenue electronically, the taxpayer is required to retain a paper copy of the information for seven years. Similarly, other information that is submitted electronically also needs a hard-copy transcript. To ensure consistency with policy objectives in the Electronic Transactions Act 2002, which in essence provides that the existence of readable and reliable electronic copies would satisfy a requirement to retain paper copies, this requirement needs to change.

4. The proposals have also been developed in light of submissions received on a Government discussion document and online forum, *Making tax easier*, which was released in June 2010.

OBJECTIVES

5. The desired Government outcome is to have a tax administration that delivers value-for-money services and is sufficiently flexible to change and grow. This is in line with the Government's six economic policy drivers, one of which is a world-class tax system.

6. The options have been assessed against the following objectives:

(1) they reduce tax compliance obligations for individuals and/or businesses,
(2) they facilitate a move to using electronic services as the main form of service delivery by Inland Revenue, and
(3) they are fair and equitable.

7. The move to electronic services is important because it is Inland Revenue's preferred method of delivery to deal with the increasing number of contacts with taxpayers. These services are in line with the expectations of taxpayers and would increase Inland Revenue's agility and flexibility. They would also potentially decrease the number of contacts, and make those contacts quicker and easier to deal with and lead to efficiency savings in the future.

REGULATORY IMPACT ANALYSIS

8. Two streams of policy initiatives have been developed to address the policy problems outlined above. These two streams can be broadly broken down into those that relate to individuals and those that relate to businesses.

9. Our preferred options are:

Individuals

- Require taxpayers who self-select to file an annual return (either an IR 3 or PTS) to be squared up across the previous four income tax years (Option 3).
- Remove the requirement for Working for Families tax credit recipients to file an income tax return (Option 5).
- Amalgamate the two major income tax return forms (that is the IR 3 and the PTS) and replace them with one consolidated web-based income tax return form (Option 7).
- Move to the use of electronic services as the primary mode of service delivery, using a phase-in approach (Option 11).

Businesses

- Allow the Commissioner of Inland Revenue to authorise, and also revoke permission for, certain "classes of persons" to keep their records outside of New Zealand (Option 13).
- Remove the requirement for taxpayers who submit electronic returns or information to Inland Revenue to retain paper copies (Option 14).

Option	Negatives	Positives	Consultation	Net impact	Implementation issues
INDIVIDUALS					
Options for reducing the number of taxpayers required to file an income tax return					
1. Make PAYE full and final at the point of deduction for employees in stable employment for 11 or more months in the year.	• Taxpayers in stable employment for 11 or more months per year and who have PAYE over-deducted, would not be able to get the over-deducted PAYE refunded to them. • Many taxpayers may disagree with this (as seen in consultation) mainly due to the potential for error in the PAYE system. • If there was an exemption from this rule for major over-deductions, this could be difficult to define and to administer.	• Major administrative efficiencies for Inland Revenue (528,000 people would be taken out of the annual filing system). See the *Making tax easier* discussion document, paragraph 7.10. • Gives certainty to taxpayers, as large numbers would not be required to file. • Taxpayers who have been sent tax bills for small amounts of under-deducted PAYE would no longer be required to pay these amounts. • Addresses the problem of cherry picking (filing only in the years in which one is due a refund) to an extent. • Will increase Crown revenue to a moderate extent, but moreso than Option 3.	• Public consultation took place via the *Making tax easier* discussion document and online forum. • Feedback was generally against this proposal. Submitters felt that it was too arbitrary, and that taxpayers have a right to file a return and get any over-deductions refunded to them. • Feedback also argued that there is too much potential for over-deduction in the PAYE system, and as long as this is the case, this option should not be progressed.	• 528,000 taxpayers would no longer be able to file a tax return at the end of the income year. • Moderate increase in Crown revenue. • Efficiency gains to Inland Revenue (due to lowered contacts).	• Potential pressure from taxpayers for refunds could make this difficult to administer in a consistent way. • Difficulty in assessing what makes a major over-deduction. • Potential for employers to consistently under-deduct PAYE, leading to large-scale under-payment of PAYE and income tax. • May push some taxpayers out of the PAYE system and into receiving cash payments which are not subject to withholding tax payments. • System updates required.
2. Set a *de minimis* amount for refunds, below which refunds would not be paid out (e.g. $50).	• Very difficult to set an acceptable level, as any amount of refunded PAYE may be valuable to taxpayers, especially those on low incomes. • Fairness and equity – any amount of over-deducted PAYE should be refunded to its rightful owner.	• Simple to administer. • Recognises the cost and difficulty of processing large volumes of small-value refunds. • Counteracts the cost of processing these small refunds.	• This option was suggested by several submitters in response to the consultation on Option 1 (above) in *Making tax easier*.	• 327,000 taxpayers would no longer be able to file (see the *Making tax easier* discussion document, paragraph 7.6). • Results in some Crown savings.	• Some potential for employers to under-deduct PAYE to the extent of the de minimis. • Increased contacts, as individuals try to confirm the amount of their return. • System updates required.
3. Require taxpayers who self-select to file to be squared up across the previous four years.	• Removes the ability for taxpayers to file only in the years that they are due a refund (i.e. cherry pick), but arguably this is a fairer outcome. • Does not have the same degree of administrative	• This option is the best at addressing the problem of cherry picking refunds. • Would result in presently unpaid terminal tax being paid or offset against refunds. • Requires taxpayers to	• This option was developed in light of the responses received in the *Making tax easier* consultation. • Retains the ability for taxpayers to file a return if they wish to, something that came across in submissions	• No taxpayers would be prevented from filing, but those that are not required by law to file, would need to file for the previous four years. • Results in some Crown savings (approx. $27 million	• Communicating the change to taxpayers, particularly that the rule would be phased in over several years. • Minimising administrative pressure would depend on the uptake of electronic services being successful.

Option	Negatives	Positives	Consultation	Net impact	Implementation issues
INDIVIDUALS					
Options for reducing the number of taxpayers required to file an income tax return					
	savings as Option 1 may have. • Initially, the amount of refunds being released may increase, as taxpayers would be required to square up in years that they may not have otherwise.	choose either accuracy of tax paid, or administrative efficiency. • Results in Crown revenue savings of $66 million over ten years.	as being important to taxpayers.	per year).	• Potential operational pressure of ensuring that all taxpayers who self-select also do so for the previous four years. • Potential for taxpayers to try to "game" the system by attempting to bring themselves within the requirements to file. • System updates required. • There may be confusion from a customer perspective about what their final tax position actually is.
4. Retain the status quo, regarding the filing requirements of individuals.	• Allows taxpayers flexibility to file only in the years where they are due a refund (cherry pick). • Large numbers of taxpayers who do not have to file are doing so anyway, which has resulted in large numbers of taxpayers being brought back into the system unnecessarily. • This increase in taxpayers filing causes pressure on the system.	• Taxpayers understand the current system.	• Public consultation via the *Making tax easier* discussion document and online forum. • The feedback received was mostly concerned with the ability for taxpayers to file and get back any potential over-deductions, which is something this option provides.	• No taxpayers would be precluded from filing. • Taxpayers would still be able to cherry pick refunds. • No revenue savings for the Crown and no efficiency gains to Inland Revenue.	• Large pressures on the system and resources, which have been caused by significant increases in recent years of taxpayers self-selecting to file (taxpayers who are not required to file but choose to anyway). This has largely been facilitated by personal tax summary intermediaries (PTSIs). See graphs on pages 2 and 3.
5. Remove the requirement for Working for Families tax credits recipients to file an income tax return.	• This group would not have to pay terminal tax in the years that they are under-deducted; however, they also would not be automatically refunded over-deductions. • If the customer wants an overpayment of PAYE refunded, they would now fall into the four-year square up criteria and have to elect into the system.	• Reduces the tax compliance obligations for this group by giving them a choice of whether to file or not. • This group would not have to pay terminal tax in the years that they are under-deducted; however, they also would not be automatically refunded any over-deductions. • Potential for some revenue savings to the Crown of approximately $10 million	• This option has not been the subject of public consultation. • This option takes into account the concerns raised about the other proposals relating to individual filing, such as the importance of being able to file a tax return and be refunded any potential over-deductions. • Officials have consulted with NZICA, which supports this proposal, as it	• Approximately 260,000 taxpayers would no longer be required to file a tax return. • Results in efficiency gains to Inland Revenue, and a reduction in compliance costs for taxpayers. • Results in some revenue savings for the Crown (approx. $10 million per year).	• Significant system changes required. • Minimising administrative pressure would depend on the uptake of electronic services being successful. • There is potential that people within this group of taxpayers may be over-deducted, and if they do not file, they would not be refunded. • However, since they are currently required to file,

Option	Negatives	Positives	Consultation	Net impact	Implementation issues
INDIVIDUALS					
Options for reducing the number of taxpayers required to file an income tax return					
		per year • The exact amount of revenue savings will differ according to whether large numbers in this group continue to file. • Gives this group equality with other taxpayers, as they now have the choice to file.	reduces tax compliance for this particular group.		they would be familiar with the process, and many of them may choose to continue to file. • Managing people through the change in process.
6. Retain the status quo whereby all Working for Families tax credit recipients are required to file a tax return.	• All Working for Families tax credit recipients would be sent tax returns, which would mean that they would be required to pay terminal tax in the years when they have PAYE under-deducted. • Filing a tax return is arguably unnecessary for the bulk of these people, as all that is needed to assess their entitlement is their income, not how much PAYE they have paid.	• All Working for Families tax credit recipients would be sent tax returns, which would mean that they would automatically get their refunds in years when they are due them.	• This option has not been the subject of public consultation.	• All Working for Families tax credit recipients would still be required to file. • No efficiency gains, compliance cost savings or Crown revenue savings.	• There are approximately 400,000 recipients of Working for Families tax credits. Sending these taxpayers assessments and tax returns adds to the administrative burden on Inland Revenue.
7. Amalgamate the two major income tax return forms (the Personal Tax Summary and the IR3).	• Having a short form personal tax summary is useful for people with uncomplicated tax affairs.	• Results in less confusion about which form taxpayers are required to file. • Results in less duplication of processes, as both forms require a degree of maintenance.	• This option has not been the subject of public consultation. • Officials have consulted with NZICA and some representatives from the PTSI industry. Both support this option as it would reduce confusion about which tax return form to use and reduce the amount of paper they deal with on behalf of their clients.	• This should result in significant efficiency savings for Inland Revenue (approx. $6 million per year once fully implemented) and tax agents, and also potentially taxpayers. • Less confusion for taxpayers regarding which form to file. • As the form will be primarily web-based, it may not suit all taxpayers. However, a paper version will be available in limited circumstances.	• Would only work in a predominantly electronic environment. • Any paper version of an amalgamated tax return would be long and unsuitable for sending out in large volumes. • There would need to be a paper version for taxpayers who cannot use the online version, but this would function as a back-up channel only. • Significant system changes required.
8. Retain the status quo of two different income tax return forms	• Taxpayers are often unsure of which of the two forms they should fill in, and contact Inland Revenue for	• Many taxpayers are familiar with the current process. • Having a short form personal tax summary is	• Same as above.	• No efficiency gains for Inland Revenue. • Taxpayers would continue to use either of the forms.	• The status quo is based on a paper delivery system and so adds considerably to the large volume of letters that

Option	Negatives	Positives	Consultation	Net impact	Implementation issues
INDIVIDUALS					
Options for reducing the number of taxpayers required to file an income tax return					
for individual taxpayers (the Personal Tax Summary and the IR3).	guidance, which uses up administrative resources on what should be a simple decision. • Having two forms results in duplication, as any updates to personal income tax administration need to be done twice (i.e. for both forms).	useful for people with uncomplicated tax affairs.			Inland Revenue sends out each year. • If Inland Revenue moves to an electronic environment, the current forms would need to be substantially redesigned, as they have been developed for paper.
9. Mandate the use of electronic services.	• Would not suit some taxpayers, which in turn may affect their ability to comply with their tax obligations.	• Would result in a high uptake of electronic services, which would give Inland Revenue administrative efficiencies. • Would allow Inland Revenue to focus resources on the electronic channel. • Would allow private-sector providers such as PTSIs to assist taxpayers with their filing obligations. • No need for a residual paper channel.	• Public consultation via the *Making tax easier* discussion document and online forum. • There were strong views on either side of this option. o Those who had used Inland Revenue's current online services and were familiar with them were in support of the option. o Those who had not used these services were not in support. Many pointed out that many taxpayers may not have access to the internet or a computer, particularly older generations. They argued that Inland Revenue should maintain a paper channel for these people. • The submissions from private-sector individuals and interest groups such as NZICA were overall in support of electronic services, but had reservations about making the use of them mandatory.	• All individual taxpayers would be required to file online. • May result in a decrease in voluntary compliance among those unable or unwilling to file online. • Would result in a high degree of administrative efficiency for Inland Revenue.	• This may push some people into simply not complying with their tax obligations if they cannot file online. • It may result in high demand on Inland Revenue's call centre if large numbers of taxpayers need support to use the online services. • It could pose issues regarding authenticating taxpayers and ensuring security online, such as keeping taxpayer details secret and secure.
10. Apply a digital	• Cost may be prohibitive for	• Would result in a high	• This option has not been the	• Taxpayers who file paper	• This may push some people

Option	Negatives	Positives	Consultation	Net impact	Implementation issues
INDIVIDUALS					
Options for reducing the number of taxpayers required to file an income tax return					
border and charge for the submission of paper returns.	some taxpayers, leading them to fail to comply with their filing obligations. • Difficult for taxpayers who do not have access to computers and therefore have no reasonable alternative to filing paper returns.	uptake of electronic services, which would give Inland Revenue administrative efficiencies. • Would allow Inland Revenue to focus resources on the electronic channel, instead of trying to spread resources across several channels. • May open up tax compliance services to the private sector.	subject of public consultation.	returns would need to pay a fee in order to submit their return in this manner. • Some private sector businesses may provide this as a service for a fee. • It would result in high uptake of electronic services, which in turn would result in efficiency savings for Inland Revenue. • May discourage voluntary compliance among taxpayers who cannot file online and are unwilling to pay to submit a paper return.	into not complying with their tax obligations if they find the cost prohibitive and they cannot file online. • Inland Revenue would need to be careful to manage the relationship with any private-sector providers to ensure quality and that appropriate safeguards are in place for dealing with taxpayer information. • It is unclear how or by whom the data would be validated before being submitted to Inland Revenue. • Managing the quality of services provided by the private sector.
11. Move to "e" via a phase-in approach.	• May not suit all taxpayers, particularly those who do not have access to computers or are unfamiliar with them.	• Allows time for Inland Revenue and taxpayers to adjust to the change. • Allows Inland Revenue time to support taxpayers through the change.	• This option has not been the specific subject of public consultation, but it has been developed in light of the submissions that have been received on Option 8. • Officials have consulted with NZICA and some representatives from the PTSI industry. NZICA supports this option, but acknowledge that the services must be fit for purpose. The PTSIs support this option, as it should reduce the amount of paper they deal with on behalf of their clients, which in turn would improve their business processes.	• Would potentially result in large numbers of taxpayers using online services. • If high uptake of online services, there would be significant administrative efficiencies for Inland Revenue. • May not be preferred by all taxpayers.	• It would need to be managed carefully to ensure that: o There is sufficient uptake and enrolment for Inland Revenue's e-services. o Appropriate consultation and testing is done so that it is optimised. o It is simple and easy to use. o IR internal systems are able to cope with the increase to an e-environment. o It is robust and secure. • Getting most taxpayers using the services would be crucial so that Inland Revenue is not thinly spread across a range of channels. This could be difficult without mandating the use of

Option	Negatives	Positives	Consultation	Net impact	Implementation issues
INDIVIDUALS					
Options for reducing the number of taxpayers required to file an income tax return					
					electronic services.
12. Retain the status quo whereby tax return filing is based on paper processes, with some tax filing services available online.	• The heavy reliance on paper is unsuitable in the modern world, it is cumbersome, and it slows Inland Revenue's ability to deliver policy changes. • Difficult for Inland Revenue to try to maintain multiple channels. • Resources are spread thinly, as there is no scope to focus on one channel.	• Suitable for taxpayers who do not have access to computers and the internet.	• This option has not been the specific subject of public consultation, but it has been considered, given some of the strong objections that were received as part of the public consultation on the move to electronic services. • The submissions that were against mandating the use of electronic services were mostly concerned that there would be no back-up channel available for taxpayers who cannot use e-services. As long as there is provision for these taxpayers, a move to focusing on electronic services is probably acceptable.	• Taxpayers would not be required to file online, but would be encouraged to do so. • No significant administrative efficiencies for Inland Revenue.	• Sending out the current levels of paper statements and returns could be very difficult to maintain. Also, given the increasing trend for taxpayers to self-select to file tax returns, this group is likely to get larger.

Option	Negatives	Positives	Consultation	Net impact	Implementation issues
BUSINESSES					
Options for reducing barriers to electronic filing for businesses					
13. Allow the Commissioner of Inland Revenue to authorise, and also revoke permission for, "classes of persons" to keep their records outside New Zealand.	• Small risk that storage offshore is not as secure or as accessible as storage within New Zealand. However, this can be mitigated by administrative criteria, e.g. an application for offshore storage is still required by the Commissioner of Inland Revenue, and administrative criteria must be met.	• Administratively more simple than requiring an individual person to make applications (as is currently the case). • People who use an approved data storage product and provider would not have any extra obligation than currently exists for business records.	• This issue was raised by the Software Developers Working Group (an industry group that meets with Inland Revenue officials on a regular basis), which is in favour of the proposed solution.	• This would allow software developers the ability to request an exemption from the requirement to store data within New Zealand on behalf of their clients, rather than requiring the individual business to make an application • Should result in administrative efficiencies for Inland Revenue and a reduction in compliance costs for businesses.	• Inland Revenue is developing administrative criteria for the extension of the exemption. • Overseas territorial issues need to be considered when drafting criteria, especially if the country holding the data does not have a double tax agreement with New Zealand.
14. Remove the requirement for taxpayers to retain hard (paper) copies of electronic returns.	• Risk that businesses would not store their electronic returns. However, this risk currently exists with the paper return system. • Integrity of person's electronic return may be questioned. This risk is addressed in the requirements under the Electronic Transactions Act 2002.	• More consistent with the policy intent of the Electronic Transactions Act 2002, which treats electronic copies in a similar way to paper. • Reduces compliance costs for businesses.	• This issue was raised by the Software Developers Working Group, which is in favour of the proposed solution.	• This would allow taxpayers to store their records electronically. • Should result in administrative efficiencies for Inland Revenue and a reduction in compliance costs for businesses.	• Inland Revenue would need confidence that the information is stored in a system that ensures the completeness of the return, the return is unaltered, and is in line with any record-keeping requirements in the Tax Administration Act 1994.

CONSULTATION

10. The options have been developed in accordance with the generic tax policy process (GTPP). The initial consultation for these changes took the form of a June 2010 Government discussion document called *Making tax easier*. The discussion document outlined the potential new direction for Inland Revenue's delivery of services. It called for submissions from the public and was also accompanied by an online forum.

11. As the range of options were developed, officials engaged in more consultation as appropriate. As the consultation differed according to the particular proposal, a summary of the approach taken and the outcomes of consultation are outlined in the section on regulatory analysis. This format was also chosen in order to clearly show the impact that consultation had on the policy development, and the large extent to which the preferred options have been developed with the feedback in mind.

CONCLUSIONS AND RECOMMENDATIONS

12. For the options relating to individuals, the recommendations are those that best address the concerns detailed in the submissions received. For the options relating to employers, the recommendations are based on those that make the most administrative sense, and there has been consultation on these recommendations with the Software Developers Working Group.

13. Below is a table outlining the preferred options, and the key reasons why they are preferred:

	Option	Key reasons
3	To require taxpayers who self-select to file to be squared up across the previous four income tax years	• Best takes into account the argument, raised in submissions, that taxpayers should be able to claim amounts of over-deducted PAYE. • Reduces the number of contacts that Inland Revenue needs to process by consolidating the income tax return process. • Results in revenue savings.
5	Remove the requirement for Working for Families tax credit recipients to file an income tax return.	• Reduces the compliance burden. • No sound policy reason to continue to require this group to file tax returns, given that the WFF tax credit process is now different to the income tax process. • Results in revenue savings.
7	Amalgamate the two major income tax return forms and replace them with one, consolidated, web-based form.	• Results in less confusion for taxpayers regarding which form they should file. • Supported by NZICA and some representatives from the personal tax intermediary industry. • Significant step towards using electronic services as the main form of service delivery.
11	Move to the use of electronic services as the primary mode of service delivery, using a phase-in approach.	• Takes into account the views raised in consultation, which were generally against mandating the use of electronic services. • Allows for taxpayers to be gradually moved across to electronic service with a minimum of disturbance.
13	Allow the Commissioner of Inland Revenue to authorise, and also revoke permission for, certain "classes of persons" to keep their records outside of New Zealand.	• Extends existing policy (i.e. taxpayers can currently apply for an exemption to the current requirement to store records in New Zealand). • Simpler in an administrative sense, compared with requiring individual persons/businesses to make applications for an exemption.
14	Remove the requirement for taxpayers who submit electronic returns or information to Inland Revenue to retain paper copies.	• Reduces compliance costs for businesses. • Consistent with the policy intent of the Electronic Transactions Act 2003, which treats electronic copies in a similar manner to that of paper.

IMPLEMENTATION

14. Implementation issues have been considered in the table under the regulatory impact analysis section of this statement. This is because the issues are many and varied, and are specific to each option.

15. For the implementation of these proposals, Inland Revenue has four major pressures:

- addressing increasing demands for services
- managing tight baseline funding
- working with a computer system that has been substantially added to and modified
- managing any move to a new platform.

16. The key goal is to manage these tensions while meeting Inland Revenue's current and future obligations. In particular, as a consequence of student loan and child support redesign project pressures, Inland Revenue is reassessing the impact of its capital position and capability requirements.

17. From the 2011/12 financial year, it is proposed Inland Revenue would take a strategic approach over a multi-year period to migrate taxpayers into the updated electronic environment. The initial work would include research to determine the mix of education, customer change management and awareness approaches that Inland Revenue would adopt. We would also work with third parties and customers to identify enhancements to our online services and products.

18. To mitigate the risk to the student loans and child support deliverables, we would propose that the application date for options 3, 5 and 7 be 1 April 2015 (the 2014/2015 income year). However, work would commence immediately on initial design work. As officials gain more understanding of the impacts of the other commitments, we would report back to Ministers on whether this application date can be brought forward.

MONITORING, EVALUATION AND REVIEW

19. In general, the monitoring, evaluation and review of these proposals would take place under the GTPP. The GTPP is a multi-stage policy process that has been used to design tax policy in New Zealand since 1995. The final step in the process is the implementation and review stage, which involves a post-implementation review of legislation, and the identification of remedial issues. Opportunities for external consultation are also built into this stage. In practice, this would mean that these proposals would be reviewed at a time after the policy has had some time to work. Any changes that are needed to give the legislation its intended effect would be added to the tax policy work programme, and proposals would go through the GTPP.

Regulatory Impact Statement

Tax treatment of profit distribution plans

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

The problem addressed in the Statement is that the current tax treatment of profit distribution plans (PDPs) is inconsistent with the tax treatment of other similar arrangements. The objective is to align the tax treatment of PDPs with the tax treatment of other similar arrangements. This means there would be no opportunity to stream imputation credits, and shareholders would pay tax at their correct marginal tax rate on the distribution of bonus shares.

The analysis assumes that the existing tax treatment applied to similar arrangements should also apply to PDPs, and that PDPs are being used only by listed companies. There are no other key gaps, assumptions, dependencies, significant constraints, caveats or uncertainties concerning the analysis.

In June 2009, consultation on the tax treatment of PDPs was undertaken through a public issues paper. In May 2011, follow-up targeted consultation was undertaken on the draft legislative provisions for tax treatment of PDPs. As a result, alternative solutions for the tax treatment of PDPs were considered and are covered in this Regulatory Impact Statement. We have also consulted with the Treasury, who agree with our analysis.

None of the policy options considered impair private property rights, restrict market competition, or override fundamental common law principles. Submitters have responded that the proposed solution may reduce the incentives for businesses to innovate and invest since the status quo provides an effective way for a company to retain capital rather than pay out dividends. Submitters also responded that the proposed new tax treatment of PDPs would impose additional compliance costs on businesses and shareholders. However, the proposed new tax treatment of PDPs does not impose higher compliance costs than already incurred when a regular dividend is paid.

Dr Craig Latham
Group Manager, Policy
Inland Revenue

1 August 2011

STATUS QUO AND PROBLEM DEFINITION

1. The problem addressed by this Regulatory Impact Statement is that the current tax treatment of profit distribution plans (PDPs) is inconsistent with the tax treatment of other similar arrangements. The current tax treatment of PDPs provides opportunities to stream imputation credits away from shareholders who cannot use them, towards shareholders who can use them. Secondly, shareholders may not be taxed on dividends at their personal tax rates.

2. A PDP is a scheme offered by companies whereby the company advises all its shareholders that they will be issued with bonus shares on a particular date. The shareholders are asked if they would like to have the company repurchase those bonus shares immediately after the shareholder receives them. If the shareholder does not elect to have some or all of their bonus shares repurchased, the default option is for the shareholder to retain the bonus shares.

3. The current tax treatment is that the bonus issue of shares under a PDP are treated as a non-taxable bonus issue and are therefore not subject to tax. Furthermore, the subsequent sale of the bonus shares on the market will not be subject to tax if the shareholder holds the shares on capital account. However, if a shareholder elects for the company to repurchase their bonus shares, the cash that they receive is treated as a dividend and is therefore subject to tax. Imputation credits may be attached to the cash dividend by the company and used to credit the tax payable by the shareholder.

4. In other similar arrangements where shareholders are given the choice of receiving cash or bonus shares, such as a dividend reinvestment plan[1] and a bonus issue in lieu[2], the shareholder receives a taxable dividend whether they choose to receive the cash or shares.

5. Officials are aware of seven companies that have carried out PDPs in the past. In general these plans have been popular with publicly listed companies who have a large numbers of shareholders. However, we are aware of only one company that is currently carrying out PDPs.

6. PDPs are also popular because they are highly effective capital management tools. PDPs are successful at retaining capital because they benefit from lack of shareholder action. If the shareholder does not positively respond to the company and elect to have their bonus shares repurchased, the default position is for the shareholder to retain the bonus shares, thereby retaining capital in the company. If shareholders do not choose the cash option and as a result get bonus shares, they do not need to return these shares in their tax return.

7. The current tax treatment of PDPs provides an opportunity for imputation credits to be streamed. New Zealand resident companies can attach imputation credits to dividends paid to its shareholders, and shareholders can generally use the credits to reduce their tax payable in New Zealand. However, for some shareholders (such as foreign or tax exempt shareholders), imputation credits have little or no value as they can only be offset against taxable New

[1] A dividend reinvestment plan (DRP) is where a company provides all shareholders with a cash dividend, and then gives them the option of reinvesting their cash dividends in shares of the company. This can be advantageous for the company, allowing it to maintain a dividend payment policy, while providing an opportunity to increase cash retentions. DRPs are also convenient for shareholders as they are a method for shareholders to reinvest their cash dividends in a company at a lower cost and effort than purchasing shares on the market. If the shareholder does not make an election, the default option is to receive a cash dividend.

[2] A "bonus issue in lieu" is a tax concept. It is a bonus issue of shares made under an arrangement where a company gives its shareholders a choice whether to receive a bonus issue or money or money's worth. Under a bonus issue in lieu arrangement, regardless of whether the shareholder chooses to receive bonus shares or money, they are subject to tax.

Zealand income. This creates an incentive to direct the credits to those shareholders who are best able to use them (a practice known as imputation credit "streaming"). Tax rules generally prevent imputation credit streaming.

8. Imputation credit streaming can take place under a PDP when shareholders self-select whether to redeem their bonus shares for a cash dividend, depending on whether or not they can utilise imputation credits that would be attached to a cash dividend. Those shareholders who are unable to utilise imputation credits, for example foreign or tax exempt shareholders, may elect to receive bonus shares that are non-taxable. As the bonus shares are non-taxable, imputation credits will not be attached, preserving the credits for shareholders who can best use them. This defeats the current policy settings for the imputation system.

9. The current tax treatment also raises issues related to equity. Under a PDP:

- shareholders on personal tax rates higher than the company rate may not pay tax at their marginal tax rate on the distribution of the shares from the company; and
- shareholders who are receiving social assistance may receive entitlements that they would not receive if the bonus shares were taxable.

10. The current tax treatment of PDPs was the subject of a specific Inland Revenue product ruling in 2005. This ruling was made subject to certain conditions, including that the company making the bonus issue has sufficient credits in its imputation credit account to have fully imputed a cash dividend equal to the bonus issue not redeemed. On 31 March 2009, that product ruling expired.

11. On 16 April 2010, the Minister of Finance and the Minister of Revenue announced that the Government would clarify the law to ensure that bonus issues of shares distributed under PDPs are taxed in the same way as shares issued under other dividend reinvestment plans.

12. If the current tax treatment is retained, the tax treatment of PDPs will remain inconsistent with other similar arrangements. In addition, no action in this area may encourage imputation credit streaming.

13. We estimate that retaining the status quo rather than adopting the recommended option would result in a fiscal loss of approximately $0.76m per annum.

OBJECTIVE

14. The objective is to align the tax treatment of bonus shares provided under a PDP with the tax treatment of other similar arrangements. This is satisfied if the following two conditions are met:

1. **PDPs are not able to be used to stream imputation credits**
   There are tax rules that prevent imputation credits from being directed to shareholders who can best use them (streaming).

2. **Equity**
   Under current policy settings, a taxpayer's total annual income should be taxed at their personal tax rates under the progressive tax rate structure. In addition, all the income of taxpayers should be taken into account for social assistance purposes.

15. Alongside this objective, we have also taken into account compliance and administration costs. As far as possible, the compliance costs faced by taxpayers should be minimised.

REGULATORY IMPACT ANALYSIS

16. A number of options have been considered for the tax treatment of PDPs:

- **Option 1 (our recommended option):** treat the bonus shares issued under a PDP as a taxable dividend. Shareholders would be taxed when they receive their bonus shares. If shareholders are required to file a tax return, they must include the dividend income in their return.

- **Option 2:** treat the bonus shares issued under a PDP like a taxable dividend, and also give shareholders who are already required to file a tax return the **option** to include the bonus shares as a dividend in their return.

- **Option 3:** require the company to debit its imputation credit account (ICA) when issuing bonus shares, and also pay a levy as compensation for shareholders that may be on the top marginal tax rate and who, as a result of this proposal, do not return the income and pay tax at their personal tax rate. The ICA would be debited at the maximum imputation ratio (ordinarily 28%) on the value of the bonus shares that are retained by recipient shareholders. The additional levy could be up to 5%.

- **Option 4:** require the company to debit its ICA at the maximum imputation ratio (ordinarily 28%) with respect to the bonus shares that are retained by recipient shareholders, without requiring payment of an additional levy.

- **Option 5:** retain the status quo. Shareholders who retain their bonus shares issued under a PDP are not taxed, while shareholders who redeem their bonus shares are treated as receiving a taxable dividend.

17. Option one was the option originally proposed by officials in the 2009 issues paper. In May 2011 legislation was drafted based on this option and sent out for targeted consultation. Options two, three and four arose from consultation with interested parties.

18. Officials' analysis of the options is summarised in the following table:

Options	Costs	Benefits	Conclusion
One: treat bonus shares issued under a PDP as a taxable dividend.	- Higher compliance costs than the status quo, borne by shareholders and the company. - May discourage capital raising when compared to the status quo, but not when compared to substitutable arrangements.	- Limits imputation credit streaming opportunities. - Equitable as it ensures shareholders are taxed at their personal tax rates. - Ensures substitutable arrangements are treated the same. - Fiscally positive.	Recommended option **Net impact:** positive. Improvement on the status quo (equitable outcome, equivalent treatment with substitutes, and prevents streaming opportunities). However, does increase compliance costs.

Options	Costs	Benefits	Conclusion
Two: treat bonus shares as a taxable dividend and give shareholders an option to include bonus shares in their tax return.	- Does not treat substitutable arrangements the same. - Income may not be counted for social assistance purposes which may mean that taxpayers receive benefits that they would not receive if the payment was taxable.	- Limits imputation credit streaming opportunities.	Not recommended **Net impact:** marginally positive. Improvement on the status quo (prevents streaming). However, results in inequitable outcome, and does not result in equivalent treatment with substitutes.
Three: require company to debit ICA and pay an additional levy.	- Does not treat substitutable arrangements the same. - Low rate shareholders are effectively taxed at higher rates. - Income is not counted for social assistance purposes which may mean that taxpayers receive benefits that they would not receive if the payment was taxable. - Administratively complex because it is likely to require the creation of a new revenue item for Inland Revenue systems, and new forms/guides for the company.	- Limits imputation credit streaming opportunities. - Low compliance costs for shareholders. - Addresses fiscal concerns with shareholders not paying their personal tax rates on income.	Not recommended **Net impact:** negative. High administrative costs, inequitable outcome, and does not result in equivalent treatment with substitutes. However, does reduce compliance costs for shareholders, and prevents streaming.
Four: require company to debit ICA.	- Does not treat substitutable arrangements the same. - Low rate shareholders are effectively taxed at a higher rate, and higher rate shareholders are taxed at a lower rate. - Income is not counted for social assistance purposes which may mean that taxpayers receive benefits that they would not receive if the payment was taxable. - Fiscally negative: estimated at $7m revenue loss per annum. Costs borne by the Government.	- Limits imputation credit streaming opportunities. - Low compliance costs for shareholders. - A cheap and effective way of raising capital, and because tax treatment is concessionary, companies may be encouraged to use PDPs in order to raise capital.	Not recommended **Net impact:** negative. Inequitable outcome, fiscally negative, and does not result in equivalent treatment with substitutes. However, does reduce compliance costs for shareholders, and prevents streaming.
Five: retain status quo.	- There are imputation credit streaming opportunities. - Shareholders in similar arrangements are subject to more tax. - Bonus issues are not counted for social assistance purposes which may mean that taxpayers receive benefits that they would not receive if the payment was taxable. - Estimated revenue loss of $0.76m per annum when compared to the recommended option	- Low compliance costs for the company and its shareholders - A cheap and effective way of raising capital.	Not recommended **Net impact:** negative. Maintains status quo (streaming opportunities, and inequitable outcome)

19. Option one is the recommended option. This option treats substitutable arrangements the same for tax purposes, and as such, it meets the key objective. As such, it prevents opportunities for imputation credit streaming, and it ensures that shareholders are taxed at their personal tax rates on distributions from the company. It addresses the concerns regarding social assistance because a shareholder must include the bonus shares issued under a PDP in their tax return. Option one (the recommended option) results in more revenue being raised when compared to the status quo.

20. Officials note that option one imposes higher compliance costs on shareholders and the company when compared to the status quo. However, these costs are no higher than if a cash dividend was paid. Therefore, we do not anticipate that this option would impose significant costs beyond those already being incurred in the normal course of business. This is because publicly listed companies generally already have mechanisms in place for withholding resident withholding tax (RWT) or non-resident withholding tax (NRWT) on dividends[3]. If RWT is correctly deducted, a resident shareholder will not be required to file a tax return, simply because they receive a dividend under a PDP. A resident shareholder will only have to put the dividend in their tax return if they are already filing a tax return because, for example, they have income that has not had tax deducted at source (such as rents). For these shareholders, due to the rate of RWT on dividends, it is unlikely that the shareholders would face a tax liability as a result of the dividend. As such, we do not expect this to result in cash-flow problems for shareholders.

21. Although options two, three and four prevent opportunities for imputation credit streaming, they do not result in consistent treatment with substitutes and therefore do not tax shareholders at their personal tax rates. Therefore, these options are not recommended. They also raise concerns with social assistance entitlement, administrative simplicity and fiscal constraints.

22. Option five does not meet any of the objectives, and it also raises equity concerns. Therefore, this option is not recommended.

23. The economic, fiscal, compliance and social implications of the options are outlined in the table above. None of the options have environmental or cultural impacts.

CONSULTATION

24. Officials have consulted interested parties in two formal rounds of consultation.

25. The first round of consultation was open to the public where officials released an issues paper in June 2009. The issues paper proposed to amend the definition of "bonus issue in lieu" to include shares issued under a PDP, so that they would be subject to tax. Six submissions were received in response to this issues paper.

26. The feedback received from the first round of consultation was generally negative. All six submitters opposed the change that was proposed. The key reasons were:

- The form and substance of dividend reinvestment plans (DRPs) and PDPs differ and the tax treatment should be determined by the form rather than the substance of the transaction.

[3] NRWT is a final tax for non-resident shareholders.

- PDPs result in a high rate of retention of reserves. This outcome is good for New Zealand companies and the economy. Taxing the bonus issue of shares under PDPs would result in PDPs no longer being a viable mechanism to retain cash reserves.

- The tax consequences of PDPs would become too complicated to explain to shareholders, particularly as a result of the inconsistency in the resident withholding tax (RWT) rate on dividends (33%) compared with the company tax rate and the maximum imputation ratio (generally 28%).

- Relatively little weight should be placed on the concern that investors with marginal tax rates above the company rate benefit from a tax advantage. These taxpayers are equally able to reduce their tax liability by investing in a trust, portfolio investment entity or company and the medium-term Government policy is to move towards alignment.

- The proposal to tax PDPs like a bonus issue in lieu could lead to double taxation.

- Any potential fiscal cost would only be minimal, and the fiscally positive aspects of PDPs (such as additional tax revenue generated from the business operations) were not factored in.

- It would be more appropriate to include PDPs in a wider review of imputation.

27. After the first round of consultation, the Capital Markets Development Taskforce (the Taskforce) reported, stating that it:

> *...considers it important that the tax system treats substitutable transactions neutrally. If PDPs are substitutable for ordinary dividend payments with optional reinvestment, the tax treatment should ideally be identical in both cases. The same goes for other close substitutes. Otherwise, there is a danger that investment decisions will be biased towards companies that offer PDPs, and that there could be significant loss of tax revenue from normal dividend taxation.*
>
> *At the same time, the Taskforce considers it desirable that the tax system does not impede the supply of capital. A decision on the tax treatment of PDPs should, therefore, take into account the fact that PDPs are an effective way for companies to raise capital.*
>
> ***Recommendation:*** *We recommend that changes to the tax treatment of PDPs should be made as part of a broader review of tax settings and take into account any adverse impacts on capital-raising costs.*

28. Officials considered the Taskforce's report and agreed with their concerns around substitutability. Following this report, officials consulted on a solution that provided for a more consistent tax treatment across close substitutes.

29. Consequently we proposed treating bonus shares issued under PDPs like a taxable dividend. In May 2011, we began our second round of consultation by seeking comments on draft legislation, which would have treated bonus shares issued under a PDP in the same way as a taxable dividend. The draft legislation was sent to the six parties that had responded to the earlier round of consultation, as well as one other party who officials considered would be interested in the issue.

30. Several submitters provided feedback about the wording of the draft legislative provisions. This feedback would be taken into account in any drafting.

31. Some submitters also commented on policy matters. One submitter expressly supported the proposed change, and considered that shares issued under a PDP were the same as a taxable dividend for all practical purposes. Other submitters expressed concerns with the proposed tax treatment. The concerns that differed from the first round of consultation were:

- A PDP is not a dividend because it does not involve a transfer of value.
- There are other related inconsistencies in the tax acts that should be addressed, such as the RWT rules.
- Additional consultation was needed.

32. In addition to these two formal consultation rounds, the Minister of Revenue has on a number of occasions announced the progression of work on PDPs, and officials have been involved in a number of discussions with interested parties. Options two, three and four arose out of those discussions. These three options, along with option five, would allow PDPs to continue to be viable and cost-effective capital raising tools.

33. The key argument made by submitters has been that the proposed change would increase compliance costs for companies and shareholders to the extent that PDPs would no longer be a viable mechanism to achieve retention of cash reserves.

34. We acknowledge that after the change in the tax treatment there may be higher compliance costs for shareholders and for the company. However, as already noted, we do not anticipate that these costs would be significant.

35. It should be noted that the compliance costs of the recommended option are no greater than those currently faced by companies that pay dividends. Companies paying dividends are already required to report this in their tax returns. Under current law, many shareholders can already choose to not file a tax return even when they receive taxable dividends. This will be the case, for example, where the only other income they are receiving is employment income, or interest or dividends that have had tax correctly deducted at source. Shareholders will generally be required to recognise dividend income in their tax return only if they are required to file for some other reason (for example, if they have income which has not had tax deducted at source, such as rents).

CONCLUSIONS AND RECOMMENDATIONS

36. Option one is the recommended option and involves treating the bonus shares issued under a PDP in the same way as a taxable dividend. This would ensure that substitutable transactions are treated the same way for tax purposes, opportunities for imputation credit streaming are minimised, and dividends are effectively taxed at the shareholders' personal tax rates.

37. Although many of the other options prevent opportunities for imputation credit streaming, they do not treat substitutable arrangements the same. They also raise other concerns, such as equity and fiscal concerns.

IMPLEMENTATION

38. It is proposed that the necessary legislative changes be included in the tax bill that is due to be introduced in September 2011, with application from a prospective application date after date of enactment. There would be no need to implement transitional rules.

39. If option one (the recommended option) is adopted, the new rules would be administered by Inland Revenue through existing channels. Companies would be required to recognise bonus shares issued under a PDP in their tax returns as a dividend paid out. Shareholders who currently file tax returns would be required to include the bonus shares issued under a PDP as dividend income in their tax returns.

MONITORING, EVALUATION AND REVIEW

40. Inland Revenue will monitor the outcomes pursuant to the Generic Tax Policy Process (GTPP) to confirm that they match the policy objectives. The GTPP is a multi-stage policy process that has been used to design tax policy in New Zealand since 1995. The final step in the process is the implementation and review stage, which involves a post-implementation review of the legislation and the identification of remedial issues. Opportunities for external consultation are also built into this stage.

Regulatory Impact Statement

Making KiwiSaver more cost-effective

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue and the Treasury.

It provides an analysis of options for changes to KiwiSaver, to boost national savings. These are scheduled to be announced as part of Budget 2011.

The Government has signalled its desire to focus Budget 2011 on measures which will boost national savings as this will help to address economic imbalances and reduce New Zealand's indebtedness, either by enabling current debt to be paid down or by reducing the need for borrowing in the future.

As the quickest way for the Government to improve national saving and reduce economic imbalances would be to improve its own saving position,[1] the identification and development of options quickly narrowed to those most likely to reduce Government spending without undermining the primary purpose of KiwiSaver.

A key assumption is that any changes should be directed towards altering the balance of contributions made by each of the contributing parties (the member, their employer and the Crown) away from public funding and towards private saving. Any Crown incentives to save through KiwiSaver should be directed appropriately. This paper also analyses options for increasing the numbers enrolled in KiwiSaver, and/or increasing the amount of members' contributions, again with the aim of boosting national savings, and encouraging private savings behaviour that is focused on the long term return and specifically individual retirement.

The impacts of each option cannot be easily modelled using historical data, given the relative newness of the KiwiSaver savings model, nor is international comparison always appropriate, given many of KiwiSaver's unique features and New Zealand's TTE model of taxation[2]. Our analysis of the options is therefore dependent on behavioural assumptions, for which there is minimal empirical evidence, about individuals' and employers' responses to changes in savings incentives and other regulatory requirements. In modelling the effects on the Net International Investment Position (NIIP), the assumption has been made that additional national savings reduces the current account deficit rather than increases overall domestic investment. To the extent that these changes instead boost domestic investment, the impact on the NIIP will be smaller. These assumptions are consistent throughout, so we have greater confidence in the relativity between the various results than in their absolute levels.

---

[1] *Saving in New Zealand – Issues and Options* (The Treasury, September 2010).

[2] Taxes are often classified according to whether income is taxed (T), taxed at a concessional rate (t) or exempt (E) at three different stages: first when income is first earned, secondly when investment returns are earned (if income is saved before it is spent), and thirdly when income is spent. New Zealand's TTE approach means that contributions to retirement funds are made out of taxed income (T), tax is paid on investment income arising from the contributions (T) and withdrawals from retirement funds are exempt (E). Many other countries have special retirement saving vehicles that are taxed on an EET basis; so money placed in these vehicles is not taxed when first earned, nor as it compounds, but it is when it is withdrawn from the fund.

We have reconciled, as far as possible, each option for change with the primary purpose for which KiwiSaver was designed, which was to provide an easy-access, work-based low-risk product, which would enable individuals and households who might not be saving enough for their retirement to do so. KiwiSaver was not explicitly designed as an instrument to boost national savings and so, although it can make a positive contribution, its effectiveness towards this objective is likely to be more limited.

We have also recognised that KiwiSaver is less than five years old. Since its launch in July 2007, there have been several significant changes to contribution requirements, which have mostly affected employees and their employers, as well as new providers entering into the KiwiSaver market. The KiwiSaver industry has not experienced any period of stability in which to establish its core products, and this uncertainty and unpredictability is not helpful to either the industry or savers. Any changes made at this point in time should therefore be sustainable and, where possible, use pre-existing features of KiwiSaver rather than introduce new features.

Our analysis draws on matters identified by other interested agencies, including the Retirement Commissioner and the Government Actuary. As the need for Budget secrecy has limited opportunities for formal public consultation in the usual manner under the Generic Tax Policy Process, we have also drawn on the considerations of the Savings Working Group[3], which was commissioned by the Minister of Finance in August 2010 to provide a point of reference for the Government in developing its medium-term savings strategies.

The proposals do not impair private property rights, restrict market competition, reduce the incentives on businesses to innovate and invest, or override fundamental common law principles.

The proposal to increase the compulsory employer contribution rate at the same time as increasing the minimum employee contribution rate will lead to some additional costs on businesses that employ staff, by increasing labour costs; in the short term this may reduce firm profitability. The additional cost for employers is likely eventually to be reflected in wage settlements for all employees, although this impact should be limited as the economy and nominal wage growth are expected to strengthen from the end of 2011.

Steve Mack
Principal Advisor, Tax Strategy
The Treasury
6 April 2011

Dr Craig Latham
Group Manager, Policy
Inland Revenue
6 April 2011

3 The SWG comprised seven independent experts in fields such as taxation law, economics and accounting from the private sector and academia, assisted by policy officials from the Treasury and Inland Revenue. It was established in August 2010, and provided its final report to the Government on 31 January 2011.

INTRODUCTION

1. This RIS summarises officials' analysis of various changes to KiwiSaver that have been considered in order to deliver two objectives:

- to help return the Crown to surplus sooner by reducing the fiscal costs of KiwiSaver; and
- to continue to encourage increased levels of private household savings, and a long-term savings habit and asset accumulation, in order to increase well-being and financial independence in retirement.

2. Analysis of each of the key options for change is summarised in the table at paragraph 16.

STATUS QUO AND PROBLEM DEFINITION

Economic Growth and Saving Levels

3. The Government is concerned that, in recent years, New Zealand's economic growth performance has been poor by developed country standards, and our relative position in the OECD is well below average. In addition, as the Savings Working Group (SWG) noted, New Zealand's low rate of saving has created a dependency on foreign capital to fulfill domestic investment demand. This has created a large and persistent gap between New Zealand's investment and saving levels, as reflected in the current account deficit over several decades. The SWG agreed with the analysis set out in the Treasury's discussion document[4] that this presents two serious economic problems: firstly it makes the New Zealand economy too vulnerable to market shocks; secondly, it has an adverse impact on economic performance, especially growth[5].

4. In addition, the Government has signalled its desire to move quickly to reduce Government debt and return to fiscal surplus. Lifting the level of national savings would help to address economic imbalances, reduce New Zealand's indebtedness and thus possibly contribute to improved economic growth. The Government has indicated that the focus of Budget 2011 will be on national savings and investment. As noted by the SWG, returning towards fiscal surplus, as well as encouraging private individuals to save more, is an important component of improving the national savings position.

KiwiSaver

5. The objective of KiwiSaver, as set out in the KiwiSaver Act 2006, is "*to encourage a long-term savings habit and asset accumulation by individuals who are not in a position to enjoy standards of living in retirement similar to those in pre-retirement*". It was not explicitly designed as an instrument to boost national savings per se, but instead to increase individuals' well-being and financial independence in retirement, as a complement to New Zealand Superannuation for those who wish to have more than a basic standard of living in retirement.

---

[4] The Treasury, "*Saving in New Zealand*", op. cit.

[5] "*Saving New Zealand: Reducing Vulnerabilities and Barriers to Growth and Prosperity*", Savings Working Group Final Report to the Minister of Finance, January 2011, Section 2.

6. KiwiSaver was designed with features intended to encourage long-term savings, by making it easy and attractive to join, providing relatively limited opportunities to access savings once enrolled, and providing individual savers with opportunities to exercise as much or as little choice over their savings as they wish to or are able to. Although membership is available to all eligible New Zealand residents, many of the key features of KiwiSaver are those of a work-based superannuation scheme, such as the automatic enrolment of employees, deductions at source and (compulsory) employer contributions.

7. The numbers enrolling in KiwiSaver have consistently outstripped initial forecasts, and the present membership is double that forecast in 2007. The latest *KiwiSaver Evaluation* report[6] concluded that KiwiSaver's features are working as intended, particularly in attracting people into a savings product. It also concluded that KiwiSaver has generated some level of new savings, over and above what would have been saved in the absence of KiwiSaver.

8. KiwiSaver therefore has a potentially significant role to play in increasing national savings, both through the savings contributions made by members, and in promoting awareness about savings and inculcating a savings habit among a large majority of the population. However, the cost to the Government is significant and this restricts the benefits to national savings; a recent Colmar Brunton survey indicates that the percentage of contributions that were "new" savings (as opposed to diverted from other forms of saving) at approximately 29%[7]. This is partly because some of the private funds going into KiwiSaver accounts are being diverted from other savings rather than being additional saving, and partly because the Government's contribution means that individuals do not have to save as much themselves to achieve the same eventual outcomes.

OBJECTIVES

9. One of the Government's key goals for 2011 is to build the foundations for a stronger economy. The Government has therefore outlined several objectives, including building savings and investment in New Zealand. The Prime Minister has signalled the intention to focus Budget 2011 on measures which will boost national saving, by encouraging additional saving from private individuals and through Government efficiency savings. Further information on these objectives was provided in the Prime Minister's *Statement to Parliament* on 8 February 2011[8]:

> *Building Savings and Investment: In order to reduce our dependence on foreign lenders, New Zealand needs to build up the pool of Kiwi-owned savings and investment, held by both the Government and everyday New Zealanders. That will be the focus of this year's Budget...The Government will also consider ways in which we can encourage New Zealanders to increase their private savings and investments. Last year we asked the Savings Working Group to consider policy options to increase national savings, and it presented its report last week. The Government will consider this report very carefully. We expect to announce resulting policy decisions in the 2011 Budget.*

---

6 *KiwiSaver Evaluation Annual report, July 2009 – June 2010* prepared by Evaluation Services, Inland Revenue for Inland Revenue, Ministry of Economic Development, Housing New Zealand Corporation, September 2010

7 Colmar Brunton *KiwiSaver Evaluation: Survey of Individuals, Final report*, 21 July 2010, section 2.3.1. KiwiSaver members were asked what they would have done with their contributions if they had not put them into KiwiSaver. The estimate has been weighted by income to reflect the fact that higher income individuals who had higher rates of substitution contribute a larger proportion of funds to KiwiSaver accounts.

8 For the full text of the *Statement to Parliament*, see www.beehive.govt.nz speech/statement-parliament-1.

10. The objectives for any changes to KiwiSaver are:

- to help return the Crown to surplus sooner by reducing the fiscal costs of KiwiSaver[9], and
- to continue to encourage increased levels of private household savings, and a long-term savings habit and asset accumulation, in order to increase well-being and financial independence in retirement.

11. Each of the options for change that could meet one or more of these objectives was assessed against a matrix of criteria:

- impact on national savings, which was measured as the effect on the Net International Investment Position (NIIP) over ten years
- fiscal costs/fiscal savings
- economic impacts, such as the likely effect on labour costs and hence employer costs and profitability
- social welfare and distributional impacts on those on the lowest income
- alignment with the broader KiwiSaver framework and objective.

12. In making this assessment, the strongest weight was given to measures which reduced fiscal costs, in light of earlier advice from the Treasury that reducing the deficit sooner is the most important contributor to national saving. Additional weight was also given to options that did not threaten other aspects of the economic well-being, such as employment, or the social welfare of those on the lowest income. Further analysis of each option, including variations and dependencies between the options, is discussed below.

13. On a practical level, attention was also quickly directed towards options for change that could be developed in the immediate and short term, given the tight time-frames for delivery in Budget 2011. Certain options were therefore not taken forward, or further consideration within a longer time-frame was recommended, as the necessary consultation and implementation work could not be delivered within the timescale of this Budget.

REGULATORY IMPACT ANALYSIS

14. Each of the key options for change that were analysed are summarised in the table below. Paragraph options in larger, bold text are recommended as part of the Budget 2011 savings and investment package:

---

[9] Fiscal costs include both revenue foregone (ESCT exemption) and through Crown contributions to individual KiwiSaver accounts (MTC and kick-start).

Objective	Description		Summary assessment of impact on: National savings Impact on NIIP over ten years (% points)		Summary assessment of impact on: Fiscal savings (costs) over 4 years ($million)		Comments	See RIA para-graph
Reducing the fiscal cost of KiwiSaver	**Lowering the maximum member tax credits (MTC) to $521.43**		0.4–0.9%	The individual effect of lowering the maximum MTC	1,600	The individual effect of lowering the maximum MTC	• Will make KiwiSaver less attractive, but may encourage private contribution to raise final accumulations to replace government contributions • May mean fewer savings directed from other forms of savings if these become relatively more attractive. • Main impact on those contributing >$521.43/year • In conjunction with other changes, consistent with KiwiSaver objectives.	Para 24-29
	Lowering the rate of matching payment (to 50c per $1 contribution)		0.3–0.7%.	The individual effect of lowering the matching rate	1,300	The individual effect of lowering the matching rate	• Level of private contribution required to maximise Government contribution unchanged at $1042.86. • No change to employer costs. • Lower as well as higher level contributors affected. • In conjunction with other changes, consistent with KiwiSaver objectives.	Para 24-29
			0.5–1%.	Combined effect of these two options[10]	2,000	Combined effect of these two options		
	Removing the employer superannuation contribution tax (ESCT) exemption		0.6–0.7%		700		• Higher rate taxpayers lose more than lower rate tax payers compared to present setting. • Marginal increase of cost to employers. • In conjunction with other changes, consistent with KiwiSaver objectives.	Para 35-39
	Reducing or removing the kick-start payment		Not modelled separately		Not modelled separately		• Cost of kick-start expected to decline anyway. • Same absolute impact across income levels. • No change to employer costs. • Inconsistent with KiwiSaver objectives.	Para 30-34
Increased household savings	Increasing compulsory employer contribution rate up to 4% (matching employees' contributions)	With existing subsidies	0.9–1.2%		(240)		• Increase in employer costs likely to lead to reduced business profitability in short term, and lower wages over the longer term. • Encourage savings and increased private contributions. • Consistent with KiwiSaver objectives.	Para 55 - 59
		With reduced subsidies[11]	2.2–2.6%		2550			

10 Note that the options of lowering the maximum MTC and lowering the rate of the MTC matching payment are not additive when considered together.

11 Maximum MTC of $521.43, and matching rate of 50%. Removal of ESCT exemption

Objective	Description		Summary assessment of impact on		Comments	See RIA para-graph
			National savings Impact on NIP over ten years (% points)	Fiscal savings (costs) over 4 years ($million)		
Encouraging increased private household savings	**Increase minimum compulsory employer contribution to 3%**	Existing Subsidies	0.35-0.5%	-	• Increase in employer costs likely to lead to reduced business profitability in short term, and lower wages over the longer term. • Makes membership more attractive • Consistent with KiwiSaver objectives	Para 55 - 59
		Reduced Subsidies	1.5-2%	2700		
	Increased default contribution rate for employees to 4%	Existing subsidies	0.1%	(30)	• No change to employer costs. • Consistent with KiwiSaver objectives. Encourages individuals who can afford to do so to contribute at higher rates	Para 53 - 54
		Reduced subsidies	1.2–1.8%	2650		
	Introducing an intermediate 3% employee contribution rate		Not modelled separately	Not modelled separately	• Provide greater flexibility for KiwiSaver members to choose most appropriate contribution rate • Increases complexity. Inertia means take up likely to be low	Para 62
	KiwiSaver membership compulsory	Existing subsidies	0–0.7%	(2700)	• "Portfolio" costs of mandating savings in funds. • Timing of savings may not suit individual's present circumstances. • Significant increase in employer costs. • Inconsistent with KiwiSaver objectives of "encouragement."	Para 40 - 47
		Reduced subsidies	2.2%	900		
	One-off enrolment exercise (4% default)	Existing subsidies	0.1–0.5%	(1500)	• Increase in employer costs. • Consistent with KiwiSaver objectives.	Para 48-52
		Reduced subsidies	1.80–2.1%	1900		
	Increasing minimum employee contribution rate to 3%	Existing subsidies	0.1–0.2%	(115)	• Increases contributions and final accumulations for individual members • A small number may stop contributing, thereby missing out on employer and government contribution. • Consistent with KiwiSaver objectives.	Para 60 - 63
		Reduced subsidies	1.4–1.9%	2600		
	Lowering minimum employee contribution rate (considered in conjunction with compulsion)[12]		Not modelled separately	Not modelled separately	• Misapprehension about appropriate level of retirement savings. • May encourage participation. • Inconsistent with KiwiSaver objectives.	Para 64

[12] This also assumes a 10% fall in new and current membership.

15. As noted previously, the Government commissioned the independent Savings Working Group (SWG) to review medium-term savings strategies; their remit included a review of KiwiSaver's contribution to this strategy. Treasury and Inland Revenue officials provided support to the SWG. Other policy reports were received by Ministers regarding KiwiSaver's role in the overall savings package.

16. A large number of potential changes to KiwiSaver have been discussed in the public arena over the last five months because of the SWG review, such as the KiwiSaver default provider arrangements, management of funds, consumer financial literacy, and provider fee structures. Some potential options for change were considered by the SWG and are discussed in their interim and final report. Some of their recommendations are within the remit of other Government departments; for example, the Ministry of Economic Development[13] recently issued a discussion document regarding periodic reporting.

17. This RIS does not replicate all of the discussions about potential options for changes to KiwiSaver that have been considered. Instead, it summarises officials' advice on the development of a preferred package of feasible changes, assessed against the criteria outlined in paragraph 11, to deliver the Government's objectives for Budget 2011.

18. The options considered in more detail in developing this preferred package were:

Key objective: Reduce the fiscal costs of KiwiSaver

- Changing KiwiSaver incentives and entitlement rules: member tax credits (MTCs), initial Crown contribution ("kick-start"), and employer superannuation contribution tax (ESCT) exemption.

Secondary objective: Encourage increased levels of private household saving

- Increasing membership of KiwiSaver, including some form of compulsion
- Increasing contributions from existing members
- Increasing contributions from employers.

19. In exploring the options under each objective, the directional effect on the other objective had to be considered. For example, an increase in KiwiSaver membership would, in the short term, increase the amount of "kick-start" payments made and, in the longer term, increase the numbers claiming MTC. An increase in members' contribution levels could also lead to increased MTC payments; so although both changes might increase private savings, they would move against the objective of reducing the fiscal costs of KiwiSaver.

20. For most options, there were a number of potential variations. Some options were inter-dependent, while others were considered as complementary but independent. Many of the options considered had several sub-variations; for example, varying contribution rates per contributor, or re-structuring incentives such as the kick-start and member tax credit amounts and entitlement/payment mechanisms. The main variations that were explored are discussed under each option below.

[13] MED Discussion Paper, *Periodic Reporting Regulations for Retail KiwiSaver Schemes*, released 01/12/2010.

KiwiSaver options explored

Reducing fiscal costs by changing KiwiSaver subsidies: General

21. One of the biggest impacts the Government can have on national savings is by returning to a budget surplus as quickly as is reasonably possible. An effective way to achieve this is by cutting low-value fiscal spending. Under the current KiwiSaver settings, there are opportunities to achieve lower fiscal costs while having minimum impact on encouraging household saving. In order to reduce the fiscal costs of KiwiSaver, the various subsidies must either be reduced or removed, whether for all members or through more direct targeting of subsidies to particular member groups.

22. Government contributions to KiwiSaver through direct subsidies (kick-start and MTCs) and forgone tax (ESCT exemption) total over $1 billion per annum; this is estimated at about 40% of total contributions in 2009/10. The current settings mean that Government contributions will make up a significant proportion of individual KiwiSaver balances at retirement. Empirical evidence suggests that this expenditure is delivering poor value in terms of leveraging additional savings. Some of the savings going into KiwiSaver accounts are being diverted from other forms of saving rather than additional saving. Also those individuals saving towards a target level of income in retirement may reduce their own level of saving in response to Government contributions, since they can achieve the same final accumulations at less expense to themselves. Genuine additional private saving may therefore be as little as $29 for each $100 contributed by Government.

23. Although two thirds of members in the Colmar Brunton survey cited Government subsidies as one of the reasons why they joined KiwiSaver, other features such as auto-enrolment, ease of contribution (deductions from pay) and employer contributions were also important[14]. The ESCT exemption, being relatively hidden, did not feature in the survey responses.

Changing KiwiSaver subsidies: Member tax credits

24. The Government currently pays a member tax credit (MTC), up to a maximum of $1,042.86 a year, into the account of members aged over 18, which matches contributions made by the individual during the year. MTC payments for the year to 30 June 2010 totalled about $665 million.

25. Reducing the maximum annual MTC payment alone (i.e. without changing the matching rate) would provide immediate fiscal savings. It would also reduce the total accumulation in individual KiwiSaver accounts, compared to leaving the MTC maximum amount unchanged. However, other changes, such as increasing the matching rate or, notably, increased employer contributions, will work in the opposite direction to raise total accumulations.

26. The MTC is designed to encourage and reward the development of a regular pattern of savings once members have joined KiwiSaver. However, the current $1 to $1 matching rate is particularly generous by comparison with other savings options; it doubles the amount of contributions made (up to $1,042), effectively providing a minimum 100% return on these contributions.

---

[14] Colmar Brunton *KiwiSaver Evaluation*, op. cit, page 57.

27. MTCs are simple and relatively easy to administer because they are linked to the level of a member's contributions paid in a year rather than to the member's income. The cap ensures that lower contributors, who tend to be lower income earners, get a larger benefit proportionate to their contribution. The possibility of making a link between maximum entitlement, or matching rates, and a member's income (whether just active or active and passive income) was considered. However, the administrative reality is that any such link is not possible without prohibitively costly system changes, and even then would take several years to implement.

28. The SWG suggested increasing MTC payments for those on lower incomes by increasing the matching rate to $2 MTC for each $1 member contribution, in order to increase the amounts received by those on lower incomes making lower contributions. However, as well as increasing the fiscal cost of the MTC this could also have the effect of encouraging/enabling those on higher incomes to reduce their contributions, either by reducing their contribution rate or making fewer voluntary contributions (if self-employed) in order to maximise their MTC.

29. The converse matching position, for example 50c per $1 member contribution, should not lead to a reduction in contributions from those currently contributing to the maximum MTC level, since they would still need to contribute the same to maximise the Government contribution. A reduction in the matching rate spreads the impact more broadly than reducing the cap alone, which would deliver fiscal savings only in the case of KiwiSaver members contributing above the level of the cap. The cap would mean that the subsidy would remain broadly progressive, and still reflect a greater proportion of total KiwiSaver inputs for low income earners than for higher income earners.

Changing KiwiSaver incentives: Kick-start

30. The $1,000 kick-start payment from the Crown is a highly successful "recognition" feature for KiwiSaver; 92% of all respondents to the Colmar Brunton survey[15] (both KiwiSaver and non-KiwiSaver members) were aware of the kick-start. Payments for the last 12 months to February 2011 totalled $354.6m.

31. With a projected increase in KiwiSaver membership of approximately 300,000 members over the next four years, there would be fiscal savings to be made in removing or reducing the kick-start incentive. However, this could damage KiwiSaver's attractiveness to new members. There is a strong psychological boost attached with such an early initial increase in a member's funds and, on balance, the potential damage to public perception and to the initial attractiveness of KiwiSaver outweighs the diminishing value of fiscal savings made by reducing or removing the iconic kick-start payment.

32. The Savings Working Group recommended a gradual 'drip-feed' of kick-start payments, to be matched to members' contributions. However this would have minimal effect on costs, reduce the immediate psychological boost of a $1,000 incentive and would effectively make this payment a duplication of MTCs, which are intended to encourage regular contributions.

---

[15] ibid. page 3.

33. Removing or delaying payment of the kick-start to those under eighteen was also considered. The 2010 *KiwiSaver Evaluation*, conducted by Inland Revenue's Evaluation Service[16], identified that among those parents who had enrolled their children, the Government kick-start contribution was the most common reason provided; 83 percent said this was a factor in enrolling their children, while 34 percent said this was the most important factor in their decision. However, the value of accounts for most under eighteens is relatively low; a large numbers of children's accounts appear to hold nothing more than the $1,000 kick-start, indicating that this practice is doing little or nothing to raise private savings and encourage a savings habit via KiwiSaver.

34. There are therefore potentially some fiscal savings from delaying the payment of the kick-start for under-eighteens, for example, until their eighteenth birthday. However, such a change would add to the complexity of KiwiSaver, and yet the overall fiscal savings are likely to be minimal. Any KiwiSaver changes targeted at only this age group should form part of any wider consideration of how to boost savings levels for young people, and install good savings habits from a young age.

Changing KiwiSaver incentives: Employer superannuation contribution tax exemption

35. Employer contributions (currently up to 2% of employee remuneration) to employee KiwiSaver accounts and complying superannuation funds are presently exempt from ESCT. The exemption is estimated to cost the Government about $175 million a year in revenue forgone.

36. The Savings Working Group recommended that the existing exemption from ECST be removed; by its nature it is almost invisible to KiwiSaver members, and so is the least-value of the incentives in terms of raising levels of private saving. It is also the most regressive of the KiwiSaver subsidies, since those in higher tax bands get a proportionately greater benefit; 50 percent of the benefit goes to the top 15 percent of earners. Officials also recommend removing this exemption on similar grounds.

37. As part of removing the exemption, however, consideration should be given to how ESCT is computed on employers' contributions. The legislation currently gives two main methods to calculate ESCT. The default method allows employers to deduct ESCT at a flat rate of 33% from eligible superannuation contributions, while the "progressive scale" method allows lower ESCT rates to be applied to employers' superannuation contributions in relation to each individual's previous year's salary, wage and superannuation contribution levels.

38. Inland Revenue's administrative data is insufficient to identify which methods are used by employers. However, although it is recognised that the default method is simpler for employers to apply and so reduces compliance costs, it does mean that lower-income employees who are affected will be more heavily taxed than they would be the case compared to the "progressive scale" method and compared to the rate at which their salary or wages are taxed. This results in less money going into their superannuation accounts.

39. It is therefore proposed to require all employers to use the progressive scale system at the same time as removing the ESCT exemption. This should not be a particularly difficult change for employers using commercial payroll systems that already have this functionality.

---

[16] *KiwiSaver Evaluation Report* 2010, Inland Revenue Evaluation Services, for Inland Revenue, Ministry of Economic Development and Housing New Zealand Corporation, September 2010, page 12.

For ease, the timing of the change should be matched to the annual payroll cycle (1 April 2012). Employers preparing manual payrolls will need to include an additional calculation for ESCT when calculating KiwiSaver contribution amounts. Inland Revenue guidance, calculators and calculation tables will be available to assist with this.

Encourage increased levels of private household saving

Increasing membership: Compulsory versus voluntary

40. SWG and Government officials considered the impacts of KiwiSaver becoming a compulsory scheme. Variations included compulsion for employees only, with compulsory contributions deducted from pay; compulsion for all eligible adults; or compulsion for adults over a certain age or from a particular income level. This would also require changes to the current settings for "contribution holidays". The point of compulsion would otherwise be negated by the ability of members to choose not to contribute. Issues regarding market fees and investment strategy would need to be fully resolved in advance of any element of compulsion being introduced.

41. The present KiwiSaver model, although available to non-employees, is primarily marketed and designed as a work-based voluntary superannuation savings scheme. For a universal enrolment, as well as new enrolment mechanisms for those outside the employed workforce, new contribution models would need to be introduced to require and collect savings contributions from non-employed persons. Similar issues arose if compulsion was linked solely to age or income levels.

42. Compulsion for all employees, building on the existing KiwiSaver design, would therefore be more practical than a universal enrolment. It is estimated that KiwiSaver membership would increase by an estimated 730,000; the impact on national savings depends in part on other KiwiSaver settings, such as the contribution rate and Crown incentives, but would be expected to be positive.

43. However Inland Revenue and officials from the Treasury consider that these benefits KiwiSaver need to be weighed against the welfare costs for people at the lower end of the income distribution scale, who may be forced to reduce their spending on essential items in the present time in order to increase their income in retirement. The SWG considered the same point, and referred to this in their report as "timing costs".[17]

44. The SWG also noted that compulsion to save into KiwiSaver has a "portfolio cost", in that it forces some people to invest in superannuation when they would rather invest in something else, such as housing, an enterprise business, or in a savings scheme that provides earlier access to funds, such as for education purposes. The Retirement Commission also recommended against compulsion.[18]

45. Treasury modelling also indicates that, following compulsion, 30 percent of any new savings would be expected to come from 60 percent of new members, each earning less than $40,000. This suggests that the increase in national saving is unlikely to be justified by the negative impact on present welfare for such low earners, who are themselves unlikely to value the benefits in terms of increased consumption later over decreased consumption now.

---

[17] SWG: *Saving New Zealand*, op. cit. para 7.33.

[18] http://www.retirement.org.nz/retirement-income-research/policy-review/2010-review.

46. Linking compulsion for employees to wage levels or age were possible variations under this option that might have helped to alleviate some of the concerns over both "timing costs" and "portfolio costs" for savers. However, these variations would add to the complexity of KiwiSaver, and create additional compliance requirements for employers.

47. On balance, the modest increase in national savings that could be expected from introducing compulsion was outweighed by the harmful welfare impacts on some groups of people, and the increase in fiscal costs if the KiwiSaver subsidies were retained, even in a reduced form. Further, a move towards compulsion now was unlikely to be able to be readily reversed in future if it no longer aligned with the Government's longer term savings and investment plans.

Increasing membership: enrolment exercise (with option to opt out)

48. Some increase in KiwiSaver membership could nevertheless still be delivered through existing mechanisms, if the increase is targeted to attract the people most likely to continue to contribute. Employees are the prime market; behavioural analysis indicates that there is a strong "inertia" factor for contributions by this group, which is assisted by the automatic deduction of contributions from source.

49. Inland Revenue commissioned Colmar Brunton to undertake a survey to assess the outcomes of KiwiSaver for individuals. Colmar Brunton reported in July 2010[19]. Inter alia, the survey asked respondents why they had not become members of KiwiSaver: 28% had not got round to joining, while a further 13% wanted more information about KiwiSaver. This could indicate that, of the employed population who are not already members of KiwiSaver, over a third would not be averse to joining and so would be likely to remain a member if automatically enrolled by their employer.

50. Officials therefore considered a one-off enrolment for all employees who are not already members of KiwiSaver or a complying superannuation scheme. The exercise would provide employees the option to opt out before being enrolled in KiwiSaver by their employer. Such an exercise was estimated to deliver up to 330,000 new members. This differs from the SWG recommendation of a one-off exercise using the current auto-enrolment process, by avoiding the significant compliance and administration costs for employers to make deductions from wages, which are later refunded by Inland Revenue where employees subsequently opt out. Even so, there would be costs to employers, both in running the exercise and in increased employer contributions for new members.

51. Such an increase in KiwiSaver population would also significantly increase the fiscal costs, both in the short term through higher kick-start payments ($330 million in the first year) and ongoing through the MTC (around $100 million per year). Given the key objective to reduce fiscal costs, this was not regarded as the appropriate time to consider running such an exercise.

52. The SWG suggested that the immediate impact of the increased kick-start payments could by managed down by spreading payment over five years. However, this would have a limited effect on the overall fiscal cost and would have negative incentive impacts. The $1,000 kick-start is highly successful 'recognition' feature for KiwiSaver; 92% of all respondents to the Colmar Brunton survey[20] (both KiwiSaver and non-KiwiSaver members)

---

[19] Colmar Brunton *KiwiSaver Evaluation*, op. cit.

[20] ibid. page 3

were aware of kick-start, compared to only 58% who knew about member tax credits (MTCs). The spreading method would have to be applied to all new members, not just those enrolled as part of the exercise; it would therefore reduce the attractiveness of the kick-start payment in encouraging members to join in future.

Increasing contributions: increasing default contribution rate for auto-enrolled employees

53. The "default contribution rate" is the rate at which employees who are automatically enrolled into KiwiSaver by their employers will start contributing, unless they actively choose a rate. The default rate now stands at 2% of wages. However, of those joining before 1 April 2009, when the default employee contribution rate was 4%, 75 percent of members are still contributing at least 4%; that is, they did not take advantage of the introduction of the 2% minimum rate from 1 April 2009. Only 20 percent of members joining on or after 1 April 2009, when the default rate was set at 2%, have actively chosen a higher rate.

54. Thus, for many members, the default rate at which they start making KiwiSaver contributions governs the level of on-going contributions ("set and forget"). However, those employees who have chosen to move to a lower contribution rate have tended to be lower-income. This suggests that affordability does have some influence, since the cap on Government contributions means that incentives are already stronger for low income members to contribute at above-minimum levels; and that 4% may be too high for some members.

Increasing contributions: increasing compulsory employer contribution rate

55. Compulsory employer contributions both increase individual final accumulations and, especially if matched to employee contributions, are a strong way to encourage individuals to save towards retirement. With the exception of higher-paid executives where retirement contributions are a key part of a total remuneration package, many employees do not traditionally regard their employers' contributions as deductions from "their" wages, even though the additional cost to employers from making contributions is likely eventually to find its way through to lower wages (including for those not members of KiwiSaver).

56. At present, the minimum employer contribution is 2% of employee wages. The rate was originally set at 1% with the intention that this should increase by 1 percentage point each year until it reached 4%, but it was capped at 2% in 2008. Internationally, employers traditionally contribute at much higher levels; for example, the Australian scheme involves an employer contribution rate of 9%.

57. In contrast to employee contributions, where many employees are contributing above the 2% minimum rate, 90 percent of employer contributions are made at 2%. A requirement for employers to raise their minimum contribution would therefore make a fairly significant impact on total KiwiSaver accumulations.

58. Higher employer contributions would increase labour costs in the short term. A delayed or staged introduction of an increased minimum rate for employer contributions (either with or without an employee matching requirement) would better enable employers to prepare for and manage these changes alongside other business costs. In the longer term higher contributions are likely to be reflected in lower wage settlements, but this impact should be limited as the labour market and nominal wage growth are expected to strengthen from the end of 2011.

59. If the requirement were that employers should raise their own contributions only where employees contribute above the minimum rate, it would reinforce the incentive for employees to raise, or maintain, their own contribution rates. However, the well-documented power of inertia raises the risk that many employees would still take no action and leave contribution rates unchanged even though they could afford and would derive greater benefits from a higher rate. Where subsidies are reduced as set out above, such employees, who are most likely to be in the lower income bracket, would see reductions in both their employer contributions (because of removal of the ESCT exemption) and in the Government's MTC contribution. Making the increased employer contributions dependent on voluntary action by individual members may therefore mean that many lower-income members see no individual benefit.

Increasing contributions: increasing minimum employee contribution rate

60. Increasing the current minimum employee contribution rate would increase the amounts of employee savings. It would also move some way to address the risk that the current 2% minimum and default rate setting sends the wrong message regarding the appropriate level of savings that individuals should be making in order to provide an adequate retirement income.

61. This must be weighed against the "timing costs" for people at the lower end of the income distribution scale. A higher minimum contribution effectively increases the price of contributing to KiwiSaver. People who cannot afford to contribute a revised minimum would be forced onto contributions holidays or never join in the first place, thus missing out on Government and employer contributions. So a very sharp increase in the minimum contribution rate may not deliver very much by way of additional household savings.

62. Allowing an additional 3% employee contribution rate, between the existing 2% minimum and the next optional contribution rate of 4% could be a helpful option for some members. Matching employer contributions at higher rates would reinforce the incentive for employees to contribute more where they can, and help to ensure that there is little movement from employees the other way (that is, downwards to 3%). However, the risk of down-shifting may not actually be very high, given that employees on 4% already have the option to reduce their contribution rates, and the additional cost to employers may not therefore be justifiable. The additional costs to both Inland Revenue and employers of introducing this further option would be very modest, as would be the introduction of further contribution rates, for example 5%, 6% etc.

63. Nevertheless, from the point of view of the individual KiwiSaver member there is a strong interest in keeping the scheme as simple and clear as possible; and in serving the interests of those who take no action. The addition of further options which require active decision making on the part of members and which many are likely to ignore anyway, even though they could benefit from them, would work against that objective. Members who are keen to engage more fully can always make voluntary contributions to increase their final accumulations and (for those on lower incomes) Member Tax Credit receipts.

Increasing contributions: minor change options

64. Other more minor change options that were considered but not recommended for the Budget 2011 package are summarised below:

Option	Comment	Conclusion
Lowering minimum contribution rate to 1%	Considered alongside compulsion. Would reduce the amount employees would be required to save, but could overcome "timing" concerns in mandating savings.	Not recommended: potential negative effect on national savings. From a retirement savings perspective, this is an unreasonably low rate of savings for all but the lowest-income families (from whom NZ superannuation alone already provides a reasonable pre and post income match). May increase misperceptions about the appropriate rate of savings.
Auto-enrolment extended to employees under 18	Recommended by the SWG, along with extending compulsory employer contributions and MTCs in order to increase participation in KiwiSaver.	Not recommended; retirement savings not high priority for this age-group. Estimated amounts saved into KiwiSaver would be relatively low. Increased member tax credits would increase fiscal costs. Negative impact on short-term employer costs and consequently on youth employment outweighs potential savings increases.
Reducing non-contributory periods ("contribution holidays")	After the first year of membership contributions holidays may be taken for any reason, and they may be taken successively, effectively allowing employees not to contribute to KiwiSaver. They do not receive any employer contributions during this time.	Further work recommended. Ability to cease contributions is a useful "safety valve" for employees at difficult points in their life. Reducing holiday periods or imposing stricter criteria might lead to some increase in savings from existing members, although a few may simply choose not to join KiwiSaver at all.

CONSULTATION

65. Due to the need for Budget secrecy, and the short time-frames involved in developing a KiwiSaver-related savings package for Budget 2011, the ability to consult in the usual manner under the Generic Tax Policy Process has been constrained.

66. However, many of the issues noted in this paper have already been considered by the SWG which, in discussing New Zealand's medium-term savings strategies, was particularly asked to consider the role of KiwiSaver in improving national saving outcomes, including the operation and outcomes of KiwiSaver, and the fairness and effectiveness of current KiwiSaver subsidies. The SWG made several recommendations in this regard, which have been discussed above.

67. The SWG received considerable public feedback during the process; the submissions it received and its interim and final reports are available on the Treasury website. Officials have been able to view these submissions and listen to specific concerns raised by interested groups during the SWG process, albeit that there has been no active consultation by officials.

68. The Retirement Commissioner also released her triennial review of retirement income policy on 7 December 2010, which discussed KiwiSaver, costs, and the effectiveness of incentives, as well as making KiwiSaver compulsory.

69. Thus, some of the debate about KiwiSaver reforms, and in particular whether KiwiSaver should remain a voluntary scheme, have been in the public domain for some time, with the ability for the public to provide comment. This provides some alignment with the Generic Tax Policy Process.

70. Some implementation decisions, such as the staged increase in the compulsory employer contribution rates, and the possible one-off enrolment exercise for existing employees, have been deferred until after the Budget. This will enable detailed consultation to take place, and any specific technical issues to be identified and addressed at the detailed design stage.

CONCLUSIONS AND RECOMMENDATIONS

71. The KiwiSaver change package recommended for Budget 2011 mostly aims to reduce fiscal costs by transferring the costs of KiwiSaver from the public to the private sector, by reducing the Government subsidies. The proposed measures could also encourage higher private contributions. However, further public education and awareness about the continuing importance of individual saving, to ensure resources are over and above New Zealand Superannuation in retirement, are highly desirable. The promotion of educational resources, such as the Retirement Commission's *Sorted* website, is strongly recommended to encourage individuals to take an active interest in considering their own longer term needs and how best to provide for these.

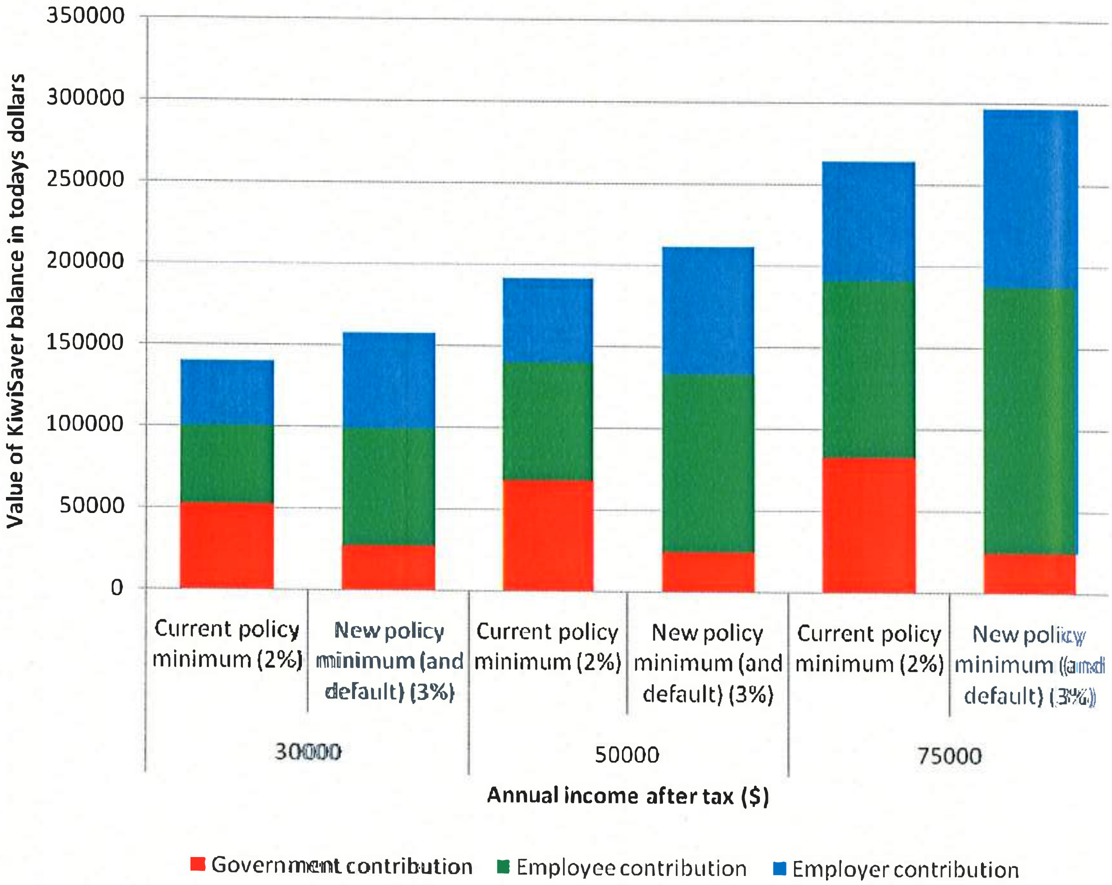
72. The table below shows a summary of recommendations and cumulative impacts:

The additional effect of each recommended change	Impact on NIIP (over 10 years)	Fiscal savings (costs) over 4 years ($million)	Comment
Halve matching rate (50c per $1) and maximum amount ($521.42) of member's tax credits	+0.5 – 1%	1,998	Large fiscal savings. Member still contributes $1042.86 to maximise MTC; encourages private savings
Additional effect of employer superannuation contribution tax (ESCT) exemption	+0.6 – 0.7%	678	Large fiscal savings. The ESCT represents the least-value, and most regressive, of all the subsidies.
Additional effect of increasing minimum contribution rate for employees to 3%	+0.2%	(60)	Should be affordable for most and deliver greater final accumulations than the present minimum
Additional effect of compulsory employer contributions to match employees (up to 3%)	+0.35 – 0.5%	-*	Increases absolute amount of contributions.
Total	**1.85 – 2.25%**	**2,616**	

* This does not include any additional cost to the crown as an employer from higher employer contributions

73. The figures below illustrate the impact of the proposed changes, as a package, on the KiwiSaver fund of an employee who opts in at 30 years old, for different contribution rates. Figure 1 shows that an employee who is contributing 2% under the current policy settings and contributes 3% after the policy change would have a significantly higher balance at retirement, despite the sizable decrease in Government contribution. Figure 2 shows that if an employee is contributing 4% under the current policy settings and continues contributing 4% after the policy change, he would have a slightly lower balance at retirement than under present settings.

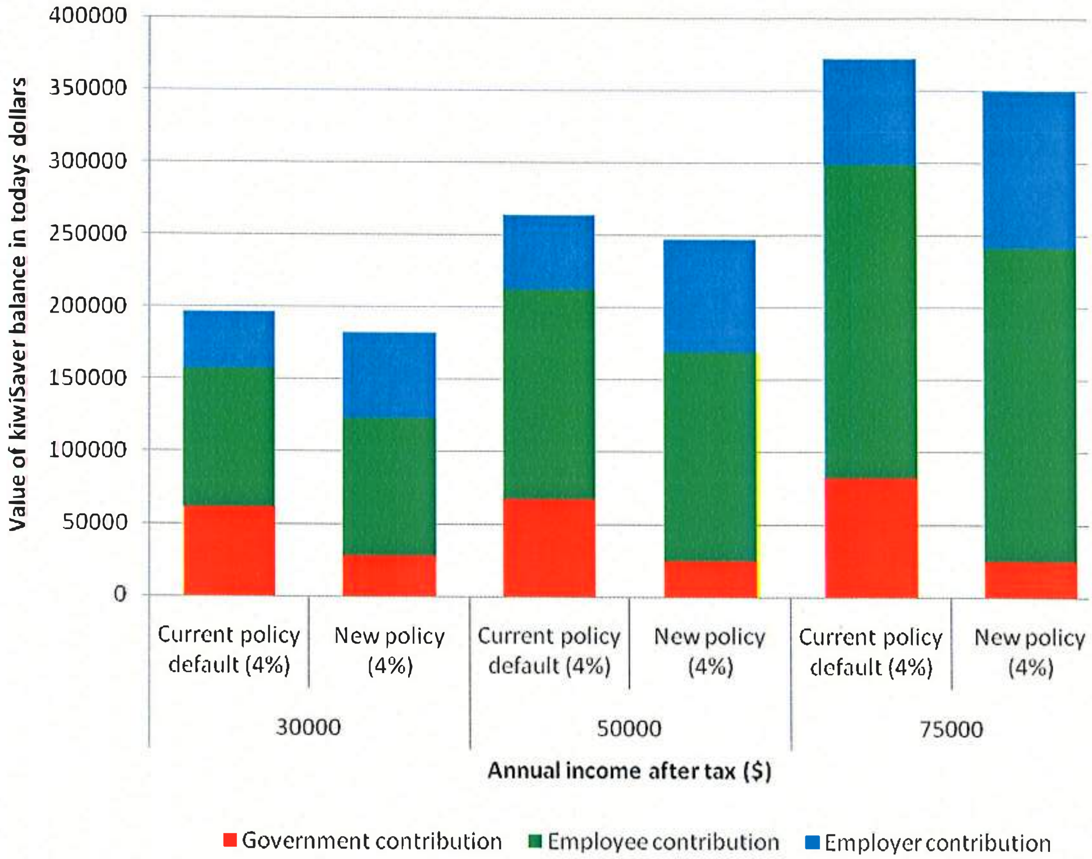
Figure 1. Forecast composition of a KiwiSaver fund at retirement for an employee who opts in at age 30* (comparing minimum employee contribution rates)



Note: Employee contribution rates in parentheses.

* Assumes real wage growth of 1.5% per annum, that funds earn a real return of 4% per annum and that PIE and ESCT thresholds are indexed to inflation

Figure 2. Forecast composition of a KiwiSaver fund at retirement for an employee who opts in at age 30* (comparing 4% contribution rates)



Note: Employee contribution rates in parentheses.

* Assumes real wage growth of 1.5% per annum, that funds earn a real return of 4% per annum and that PIE and ESCT thresholds are indexed to inflation

IMPLEMENTATION

74. Officials have recommended that the proposed changes to the ESCT and the Member Tax Credit should be included in Budget night legislation which will go through all the stages in the House in a single Parliamentary day. This is to allow sufficient time for implementation, both for employers and Inland Revenue.

75. The removal of both the ESCT exemption and the 33% flat-rate calculation method would come into effect on 1 April 2012. This is to tie in with the start of the tax year and so take advantage of the various updates to payroll systems and employer information leaflets that are already scheduled to be made at that date.

76. The proposed changes to reducing the MTC matching rate to 50c per $1 member contribution, and reducing the maximum annual MTC payment to $521.43 (half of the present level), would take place with effect from 1 July 2011, being the 2011/12 MTC claim year. Most MTC claims are made after the year-end, which gives providers and Inland Revenue over 12 months to prepare for the changes before the bulk of the 2011/12 payments are made. As the proposed changes do not directly affect the claims process, the compliance costs would be expected to be relatively minimal.

77. The proposed increase to 3% for the compulsory employer contribution rate and for the default and minimum employee contribution rates would come into effect on 1 April 2013. The delayed start of this change means that it can be included within a normal taxation bill, enabling interested parties to be consulted on design aspects.

78. The proposals for a one-off enrolment exercise would be discussed with employers, payroll providers and other interested parties. This would explore both the expected costs and benefits to each party, and possible design models for such an exercise.

MONITORING, EVALUATION AND REVIEW

79. Both Inland Revenue and the Government Actuary[21] currently receive and collate KiwiSaver membership and scheme data. Inland Revenue prepares regular monthly statistical reports and an annual evaluation report, which focuses largely on enrolment, contribution and incentive payments data. The Government Actuary's report is presented to the House of Representatives pursuant to section 194 of the KiwiSaver Act 2006, and reports on the Government Actuary's regulatory role in the management and operation of individual KiwiSaver schemes and funds, and the duties and obligations of trusts and managers in relation to those schemes. These annual reports will form the main basis for the collection and monitoring of the impacts of each KiwiSaver change over the next 12-24 months.

---

[21] The Government Actuary's functions will be moved to the Financial Markets Authority from 1 April 2011; his KiwiSaver review and reporting obligations will fall to the new Authority to discharge.

Regulatory Impact Statement

Tax minimum equity rules for foreign-owned banks

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

It provides an analysis of options for updating the tax minimum equity rules for foreign-owned banks, to reflect changes in the commercial and regulatory banking environment, and ensure that the appropriate amount of tax is paid in New Zealand.

The existing rules envisage regular review, taking into account changes in regulatory and market practice to ensure an appropriate allocation of equity and debt to New Zealand. Therefore, our analysis has been confined to a review of whether (because of changes in the regulatory and commercial environment) the tax minimum equity ratio for foreign-owned banks should be raised from its current percentage, rather than an overarching review of the use of a tax minimum equity ratio.

The analysis and consultation undertaken as part of our review has been subject to time constraints in order to meet Budget 2011 deadlines.

In keeping with the established process in this area, consultation has been undertaken with the New Zealand Bankers' Association, and with some other individual banks. A key concern raised during consultation was that any increase in the minimum equity percentage should be made on a principled basis, and not merely to raise revenue. If this is not the case, it would imply that the percentage could be increased any time that the Government needed money. This perception would have ramifications for the financing structures that banks would use over the longer term and, therefore, on the cost of capital. The consultation undertaken has informed both the setting of the appropriate ratio and the transitional approach.

We carried out our review in conjunction with the Treasury, and the Treasury supports our conclusions and recommendations. We also consulted the Reserve Bank of New Zealand throughout our review process. Their independent analysis of our modelling supports the conclusions we reach.

Any increase in the tax minimum equity ratio for foreign-owned banks would be likely to impose additional tax costs on foreign-owned banks. However, we believe that the increased tax costs are justified, as our analysis shows that the amount of tax currently being paid in New Zealand by foreign-owned banks does not fairly reflect the economic reality of their banking business in New Zealand. Moreover, these increased tax costs in New Zealand would be substantially offset by reduced tax costs overseas.

There are also likely to be transitional costs for banks in restructuring their balance sheets (for example, by converting existing tax debt into tax equity) to meet the proposed requirements. However, ongoing compliance costs are minimised, as banks already have systems in place for monitoring their tax equity position under the current rules.

Any increase in the tax minimum equity ratio for foreign-owned banks may reduce the incentives for those banks to invest in New Zealand. However, our analysis shows that our recommended option would not materially influence these incentives.

None of the policy options would impair private property rights, restrict market competition, or override fundamental common law principles.

Dr Craig Latham
Group Manager, Policy
Inland Revenue

28 March 2011

STATUS QUO AND PROBLEM DEFINITION

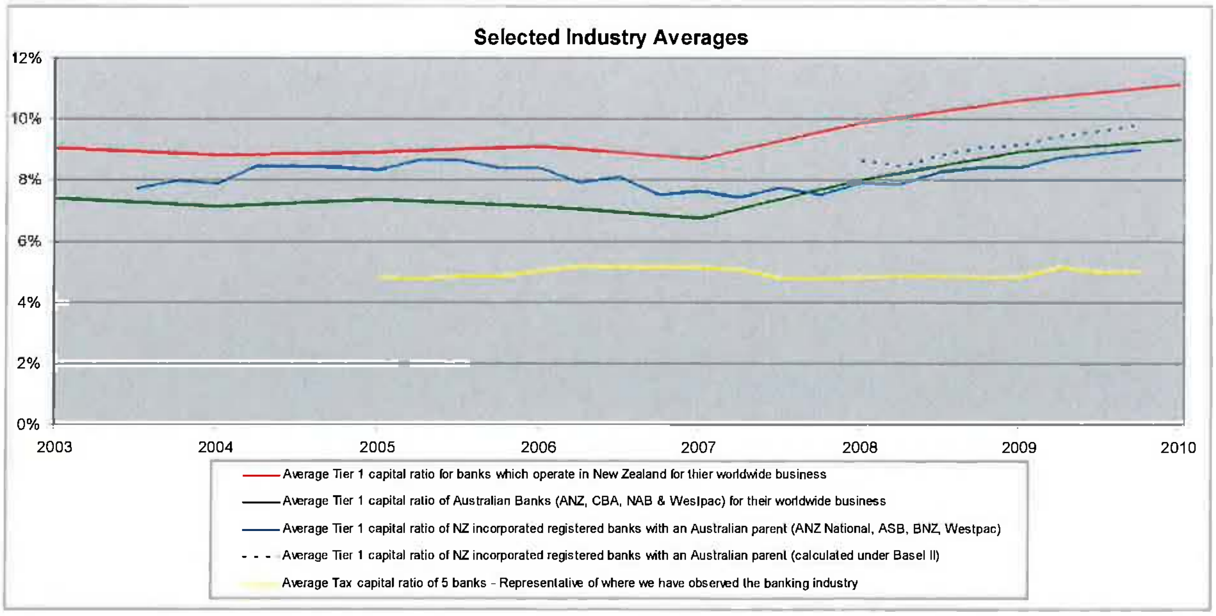
1. The problem addressed in this Regulatory Impact Statement (RIS) is the setting of the appropriate tax minimum equity ratio for foreign-owned banks. The setting of this ratio is important for ensuring that foreign-owned banks pay an appropriate amount of tax in New Zealand.

2. Currently, foreign-owned banks operating in New Zealand are subject to a special form of thin capitalisation rule. This rule was introduced in 2005 and requires the New Zealand banking group to hold equity equal to at least 4% of its New Zealand risk-weighted exposures (RWEs). The rule prevents banks from using structures that allow excessive interest deductions against the New Zealand tax base.

3. New Zealand incorporated banks are also subject to prudential regulatory requirements, which prescribe the minimum levels of capital they must hold, to protect against insolvency in the event of bad loans or other unexpected losses. This capital is split into "tiers", with Tier 1 capital consisting of the capital that is closest in nature to ordinary share capital. The minimum Tier 1 capital ratio is currently also 4% of RWEs. Tax equity and Tier 1 capital are generally defined in the same way, with similar instruments (such as common equity) being included in both. However, there are a number of important technical differences, which must be borne in mind when comparing the tax and regulatory amounts of equity.

4. The prudential requirements are based on the "Basel" frameworks, which are applied in many countries. The Basel Committee on Banking Supervision has recently recommended an increase in the minimum Tier 1 capital ratio to 6%, as part of a number of changes proposed under the Basel III framework. The Reserve Bank of New Zealand (RBNZ) will be consulting with the banks regarding the implementation of Basel III in New Zealand. The New Zealand Bankers' Association (NZBA) expects an increase from 4% to 6% to occur, and that this will happen sometime between January 2013 and January 2015.

5. As illustrated in the following graph, in recent times (post-financial crisis of 2008), the banks operating in New Zealand have been maintaining higher Tier 1 capital levels than they were pre-financial crisis.



6. This increase is partly explained by the anticipation of higher prudential regulatory ratios, but officials understand that there has also been a fundamental reassessment by markets of the amount of capital that financial institutions must hold.

7. However, as also illustrated on the above graph, the average tax equity ratio has remained close to the prescribed minimum of 4% of RWEs. The primary reason why the average tax equity ratio has remained relatively stable, while average Tier 1 capital ratios have been increasing, is the use of holding company structures in New Zealand. Holding company structures are ignored for New Zealand regulatory purposes but are included for tax purposes. This allows the operating bank (the prudentially regulated entity) to be equity funded by the holding company, while the holding company is partially funded by debt. This enables the holding company to take interest deductions on a portion of the "capital" and thereby pay less tax in New Zealand.

OBJECTIVES

8. The desired Government outcomes are to ensure that:

- the amount of tax paid in New Zealand by foreign-owned banks reflects the economic reality of their banking business in New Zealand, and
- there is continued stability in the banking sector in New Zealand.

REGULATORY IMPACT ANALYSIS

9. The existing rules envisaged regular review, taking into account changes in regulatory and market practice to ensure an appropriate allocation of equity and debt to New Zealand. Therefore, the options considered do not involve an overarching review of the use of a tax minimum equity ratio to prevent excessive interest deductions against the New Zealand tax base. Instead, the review focuses on whether, because of changes in the regulatory and commercial environment, the tax minimum equity ratio for banks should be raised from its current level of 4% and, if so, to what level. Consequently, the options considered in this RIS are different tax minimum equity percentages and transitional approaches.

New threshold options

10. The following table outlines a range of tax minimum equity percentages that could be chosen. For each of these thresholds, the table shows the additional capital that would be required in aggregate by foreign-owned banks, the aggregate reduction in interest deduction, and the estimated increased tax revenue per annum resulting from the increased equity. All of these figures assume that the banks would hold a 0.5 percentage point buffer over the threshold.

New Threshold	Actual % Equity Held	Additional Capital Required ($ million)	Reduction in Interest Deduction ($ million)	Increased Tax per annum ($ million
4.5%	5.0%	34	2	0
5.0%	5.5%	556	28	8
5.5%	6.0%	1,391	70	19
6.0%	6.5%	2,225	111	31
6.5%	7.0%	3,060	153	43
7.0%	7.5%	3,894	195	55
8.0%	8.5%	5,781	289	81

11. In setting the percentage in 2005, worldwide Tier 1 capital ratios were taken as a starting point. At the time, worldwide Tier 1 ratios were, on average, 7% to 8% for the main banks. This was then discounted to take account of surplus capital held by the parent banks, non-bank business equity, and the use of hybrid instruments (equity-like debt instruments). This took the rate to less than 6%.

12. However, other factors were also taken into account, which further lowered the appropriate percentage. These factors included the potential for disruption to the banking industry if further capital was required to support the New Zealand business, robustness over the business cycle and across different banks in different commercial situations, and the fit with the broader trans-Tasman relationship and the economic and revenue impacts.

13. It was also felt that the use of an external statutory benchmark would avoid the perception of arbitrariness that could attach to a percentage that had no such linkage. As such, it reduced the potential uncertainty for the banks as to the future tax consequences of their long-term financing decisions.

14. In the end, it was decided that on balance a ratio of 4% was appropriate, the same as the regulatory minimum.

15. The considerations taken into account in setting the percentage in 2005 remain relevant today. For comparisons with the tax minimum equity ratio, the relevant regulatory equity concept is Tier 1 capital held by the consolidated Australian banks. Tier 1 capital levels currently average over 8.5%, and have been growing over the last 24 months. Tier 1 capital levels for the New Zealand incorporated banks average over 9%. However, some instruments that would not be included in equity for tax purposes are included in the regulatory capital, so these figures are not directly comparable to the tax minimum equity percentage. To the extent to which such instruments give rise to tax deductions, they are already excluded from equity for purposes of the minimum equity calculation in New Zealand. Accordingly, the above

figures would need to be adjusted downward for comparative purposes. Overall, the increase in capital has raised capital ratios by 1 to 1½ percentage points from 2005 levels.

16. The regulatory requirements are likely to change in the near future, following a process of consultation between the RBNZ and the banking industry. As noted above, the NZBA expects that the minimum Tier 1 capital ratio will be increased from its current level of 4% to 6%, an increase of 2 percentage points. This increase has been anticipated and banks are already preparing for it, holding more than the current regulatory minimum even though the financial crisis has eased.

17. Based on these increases, applying the policy parameters underlying the 2005 decisions would imply an increase in the minimum equity percentage of between 1 and 2 percentage points. Given the advantages of basing the tax percentage on the regulatory percentage, our preferred option is an increase in the tax minimum equity percentage to 6%.

18. Setting the tax minimum equity percentage for foreign-owned banks above the regulatory minimum has been considered, but is not recommended by officials, particularly because of the increased likelihood that banks' regulatory capital would be insufficient to meet the tax requirement at these higher levels. As well as potentially creating practical problems for banks in obtaining additional tax capital, a higher tax minimum equity percentage may have an appearance of arbitrariness. This could suggest to foreign-owned banks that the percentage may again be increased at any time in the future as a revenue raising measure, which could be destabilising to the banking industry in New Zealand.

19. The wider economic impact of increasing the tax minimum equity percentage must also be considered. We have carried out modelling of the effect of increasing the tax minimum equity ratio on banks' cost of capital or the cost of borrowing in New Zealand. Our modelling shows that a rise in the threshold to 6% would have only a minimal impact, requiring a rise in lending interest rates of less than 2 basis points in order to maintain shareholder returns. The primary reason that the impact on lending costs in New Zealand would not be significant is because the increased tax in New Zealand would be substantially offset by reduced tax in Australia.

Transitional options

20. As Ministers wished to announce any increase in the tax minimum equity percentage as part of their Budget 2011 package, options considered included application from either:

- 1 July 2011
- 1 April 2012, or
- at the same time as the anticipated changes under Basel III.

21. Regarding transitional approaches, officials considered both a one-off rise and a staggered rise to the chosen new threshold. A staggered approach would involve increasing the tax minimum equity percentage incrementally over a specified timeframe until it reached the desired level. A myriad of permutations would be possible due to the number of variables involved (including the desired eventual new threshold, and the length of time over which the staggering would occur). Staggering would mean that the aggregate additional capital required by foreign-owned banks would increase incrementally.

22. The following table provides an example of the use of a staggered rise to a new threshold. It illustrates the effects of a staggered rise of the tax minimum equity threshold

from 4% to 6% from 1 July 2011 to 31 March 2013. The threshold is increased in six-monthly increments of 0.5 percentage points over the period. For each quarter, the table shows the aggregate additional capital required, the reduction in interest deduction, and the estimated increase in tax. The increased tax is then aggregated for fiscal years.

Quarter Ended	New Threshold	Actual % Equity Held	Additional Capital Required ($ million)	Reduction in Interest Deduction ($ million)	Increased Tax ($ million)	Annual Tax Increase Year ended 30 June ($ million)	
30-Sep-2011	4.5%	5.0%	34	0	0		
31-Dec-2011	4.5%	5.0%	34	0	0		
31-Mar-2012	5.0%	5.5%	556	7	2		
30-Jun-2012	5.0%	5.5%	556	7	2	30-Jun-2012	4
30-Sep-2012	5.5%	6.0%	1,391	17	5		
31-Dec-2012	5.5%	6.0%	1,391	17	5		
31-Mar-2013	6.0%	6.5%	2,225	28	8		
All subsequent quarters	6.0%	6.5%	2,225	28	8	30-Jun-2013	25
						All subsequent years	31

23. As mentioned above, there are myriad permutations of using a staggered approach to raising the tax minimum equity percentage. The above table is but one example. However, it allows for some general observations to be made. Use of the staggered approach means that the annual increase in tax paid rises gradually over the transitional period. Therefore, the longer the transitional period, the longer before the annual estimated increase in Crown revenue reaches its maximum.

24. The use of a staggered approach makes more sense the nearer in time the application date of the new tax minimum equity requirements is. The further away in time the application date is, the more sense it makes to just have a one-off increase in the tax minimum equity percentage, as banks would have more time to convert debt into equity.

25. When considering what the application date should be, officials were mindful that the banks would need sufficient time to make the necessary adjustments to their balance sheets. This may involve the conversion of existing tax debt into tax capital. For some banks, this debt is long-term third party debt.

26. When officials decided on a threshold of 6% as their preferred option, the decision as to the implementation approach became easier. The higher the new threshold, the more time banks would need to make the necessary adjustments, which would influence our choice of preferred implementation approach. A later application date and/or use of a staggered

approach would be more appropriate the greater the rise in the threshold. At the relatively small rise to 6%, particularly with a later application date, we considered that staggering was unnecessary.

27. For a new threshold of 6%, our preferred option would be an application date of 1 April 2012 without staggering. This approach (which would give banks until 30 June 2012 to bring in any additional capital required) would allow banks a reasonable amount of time to make the required adjustments, and would also allow for the legislation to go through the full Parliamentary process, including the Select Committee stage.

28. This approach would be expected to raise approximately $8 million of additional tax revenue in the 2011/12 fiscal year and $31 million in each subsequent fiscal year, as per the following table:

	$ millions increase / (decrease)				
Vote Revenue **Minister of Revenue**	2010/11	2011/12	2012/13	2013/14	2014/15
Crown Revenue and Receipts: Tax Revenue	-	8.000	31.000	31.000	31.000

29. For a new threshold of 6%, we also considered an application date of 1 July 2011 without staggering. This approach would be expected to raise approximately $31 million of additional tax revenue in the 2011/12 fiscal year, and the same in each subsequent fiscal year, as per the following table:

	$ millions increase / (decrease)				
Vote Revenue **Minister of Revenue**	2010/11	2011/12	2012/13	2013/14	2014/15
Crown Revenue and Receipts: Tax Revenue	-	31.000	31.000	31.000	31.000

30. Although this approach would raise more revenue in the 2011/12 fiscal year, officials do not recommend this approach, because of the short notice it would give the banks, and the potential problems some banks may face in quickly making the necessary adjustments to their balance sheets. Also counting against this approach is the fact that it would not allow for the legislation to go through the full Parliamentary process.

31. We also considered an application date coinciding with the expected implementation of Basel III in New Zealand. Such an approach would mean that it would take longer before tax revenue increased. We do not recommend this approach, as we consider that the tax minimum equity rules have a different purpose to the regulatory rules and, therefore, an explicit linkage in application date is not appropriate. Officials' view is that the tax minimum equity ratio is already too low at present, given the level of Tier 1 capital currently being held by banks.

CONSULTATION

Banking industry consultation

32. In late October 2010, officials wrote to the affected banks, advising them that the Government intended to explore some issues with the minimum equity rules for banks—in particular, whether the current 4% threshold for minimum equity was still the appropriate percentage. We indicated in our letter that we wanted to get their input into any possible changes, and that we would be in contact with them to see if they wanted to meet to discuss the issues.

33. In November 2010, Inland Revenue and Treasury officials released an issues paper on banking minimum equity, for the purposes of consultation between the banking industry and tax policy officials.

34. In early December 2010, officials again wrote to affected banks. Officials set out, in more detail, the issues with the existing bank minimum equity rules, and asked the banks for their feedback on the following questions:

- Do you agree that the gap between actual capital and tax capital was widened?
- Do you consider a 20% discount to take account of surplus capital, hybrids and other non-banking business to be a useful rule of thumb?
- What would you consider the impact of increasing the minimum equity ratio to the range of 7% to 8% would be in terms of capital and tax paid at the New Zealand entity and banking group level? Would there be any other impacts?
- If the rules were to be changed, what would your expectations be regarding transitional arrangements?
- Are there any other issues which you believe should be taken into account?

35. Further correspondence was exchanged and meetings were held between officials and the NZBA, and some other individual banks, between late November 2010 and late February 2011.

36. As a result of this consultation, the NZBA raised a number of issues, including the impact on the cost of capital and the perceived stability of the New Zealand taxing environment as banks make long-term financial commitments to New Zealand.

37. The NZBA's key concern was that any increase in the minimum equity percentage should be made on a principled basis, and not merely to raise revenue. If this is not the case, it would imply that the percentage could be increased any time that the Government needed money. This perception would have ramifications for the financing structures that banks would use over the longer term and, therefore, on the cost of capital. Accordingly, the NZBA suggested that the tax minimum equity requirement be linked explicitly with the minimum regulatory requirement.

38. The banks have also expressed concerns about the level at which the tax minimum equity percentage is set. The strong message is that any increase above 6% would be problematic for banks.

39. Another key concern expressed by banks was about the timing of the changes to the tax minimum equity requirements. They emphasised that it will take time for banks to put extra tax capital into their New Zealand balance sheets. This is because it may involve converting

some of their existing tax debt (which for some banks is long-term third party debt) into tax capital. Banks have also suggested that the tax changes should coincide with the changes under Basel III.

40. Feedback received through consultation has helped officials in arriving at their preferred option. Officials' preferred option is for the change not to apply until the quarter beginning 1 April 2012, which would give banks until 30 June 2012 to bring in any additional capital required.

Intra-governmental consultation

41. Inland Revenue officials have carried out their review of the tax minimum equity ratio for foreign-owned banks in New Zealand in conjunction with Treasury officials. The Treasury concurs with our conclusions and recommendations.

42. Officials have maintained close consultation with the RBNZ throughout the review process.

43. RBNZ officials have emphasised their position that the regulatory regime in New Zealand is not designed to provide protection for the New Zealand tax base.

44. RBNZ officials were also consulted about the potential impact on the banking sector of raising the tax minimum equity percentage. RBNZ officials concur with Inland Revenue modelling, which shows that an increase in the percentage to 6% is likely to have only a minimal impact on banks' cost of capital or the cost of borrowing in New Zealand.

CONCLUSIONS AND RECOMMENDATIONS

45. Officials recommend increasing the tax minimum equity percentage for foreign-owned banks from 4% to 6% from 1 April 2012.

46. Officials do not recommend raising the tax minimum equity percentage any more than the increase in the regulatory minimum, particularly because of the increased likelihood that banks' regulatory capital would be insufficient to meet the tax requirement at these higher levels.

47. This option allows banks sufficient time to organise the extra capital required, which was a major concern raised by banks during consultation.

IMPLEMENTATION

48. The proposed option, which requires legislative change, would be included in the August 2011 Bill. This would allow the legislation to go through the whole Parliamentary process, including the Select Committee stage. The change would apply for the quarter beginning 1 April 2012, which would give banks until 30 June 2012 to bring in any additional capital required.

49. We expect any additional administrative costs to be minimal, as the proposal involves only a change to the existing tax minimum equity percentage for a small group of taxpayers. Monitoring of the level of tax paid and banks' compliance with the rules already occurs.

50. Banks are expected to incur initial compliance costs in restructuring their balance sheets (for example, by converting existing tax debt into tax equity) to meet the proposed requirements.

51. Ongoing compliance costs are minimised, as banks already have systems in place for monitoring their tax equity position under the current rules.

MONITORING, EVALUATION AND REVIEW

52. In general, Inland Revenue's monitoring, evaluation and review of new legislation takes place under the Generic Tax Policy Process (GTPP). The GTPP is a multi-stage tax policy process that has been used to design tax policy in New Zealand since 1995. The final stage in the GTPP is the implementation and review stage, which involves post-implementation review of the legislation, and the identification of any remedial issues. Opportunities for external consultation are also built into this stage. In practice, any changes identified as necessary for the new legislation to have its intended effect would generally be added to the Tax Policy Work Programme, and proposals would go through the GTPP.

53. We would continue to monitor the tax equity ratio maintained by banks and the amount of tax paid in New Zealand. If it became apparent that the amount of tax being paid in New Zealand by foreign-owned banks no longer fairly reflected the economic reality of their banking business in New Zealand, we may revisit the tax minimum equity rules for foreign-owned banks, and any proposals for change would again go through the GTPP.

Regulatory Impact Statement

Non-resident film renters' tax

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

The question in this Statement is whether the non-resident film renters' tax rules in the Income Tax Act 2007 are necessary and, if not, whether the rules should be replaced by non-resident withholding tax (NRWT).

The non-resident film renters' tax was introduced in 1928 because of the difficulties in accurately determining the net profit derived by non-residents from renting out films in New Zealand. However, there is no longer a sound policy rationale for retaining the non-resident film renters' tax rules.

Public consultation was undertaken as part of the Government discussion document, *New Zealand's International Tax Review: a direction for change*, released in December 2006 and three submissions were received on the proposal. Recently, officials have been in contact with the submitters about the proposed change and they raised no additional points to their submissions.

Other than set out in this Disclosure Statement and the broader Regulatory Impact Statement, no significant gaps, assumptions, dependencies, constraints, caveats or uncertainties have been identified.

In preparing this Statement, we have consulted with the Treasury, which agrees with our analysis.

The proposed change may impose some compliance costs for New Zealand customers who make payments to non-resident film renters for renting and exhibiting film purposes in New Zealand. New Zealand customers would need to withhold tax for the non-resident film renters and some may potentially need to re-negotiate existing contracts and re-configure systems for the deduction of NRWT. But, overall and also in the long term, the change would simplify the New Zealand income tax rules applying to non-residents and reduce compliance costs on non-resident companies by removing their filing responsibility in New Zealand. The change does not affect the local film production industry.

The proposed change does not impair private property rights, reduce market competition, provide disincentives to innovate and invest or override common law principles.

Dr Craig Latham
Group Manager, Policy
Inland Revenue

2 June 2011

STATUS QUO AND PROBLEM DEFINITION

1. At present, 10 percent of the gross receipts derived by non-residents from renting out films in New Zealand are deemed to be assessable income under section CV 17 of the Income Tax Act 2007. Under section DW 3, a non-resident film renter is not allowed a deduction in relation to this income. The rate of tax that is applied is the rate of tax applicable to the non-resident. Because the non-resident is invariably a company, this means that non-resident film renters are generally subject to an effective tax rate of 2.8 percent on their gross receipts (i.e. 28 percent of 10 percent).

2. Income subject to this rule is not included in the income of the non-resident film renter under any other provision in the Act. Importantly, this income is excluded from the definition of non-resident passive income and is therefore not subject to non-resident withholding tax (NRWT).[1]

3. The rule for taxing non-resident film renters has existed in various forms since 1928. The rule was originally enacted because of the difficulties in accurately determining the net profit derived by non-residents from renting out films in New Zealand. Given NRWT is now well-established and could apply to such income, there is no longer a sound policy rationale for having separate tax rules for non-resident film renters.

4. This Statement considers whether the Income Tax Act should be amended to remove the separate tax rules for non-resident film renters.

OBJECTIVES

5. The main objective is to review whether the existing non-resident film renters' tax rules are necessary and, if not, whether the rules should be replaced by NRWT.

REGULATORY IMPACT ANALYSIS

6. The options that we have identified are to retain the status quo or to repeal the provisions relating to non-resident film renters' tax so that NRWT applies to amounts derived by non-resident film renters.

7. The non-resident film renters' tax is an historical anachronism. It appears that the non-resident film renters' tax was not replaced in 1964 when NRWT was introduced because of the 1948 double tax agreement (DTA) between United States and New Zealand. That DTA prevented New Zealand taxing the income of United States film renters except to the extent allowed under the existing non-resident film renters' tax. The 1982 DTA between New Zealand and the United States (replacing the 1948 DTA) and the current DTA (in force from November 2010) contains no similar restriction on New Zealand's ability to tax income derived from New Zealand by the United States-resident film renters.

8. The preferred option is to repeal the existing provisions relating to non-resident film renters' tax so that NRWT could apply. This would rationalise and simplify the New Zealand income tax rules applying to non-residents and provide consistency with other tax treatments.

---

[1] NRWT is a broad set of withholding taxes on interest, dividends and royalties derived from New Zealand by non-residents.

Also, this approach is in line with how other countries, such as Australia, tax amounts derived by non-resident film renters.

9. Practically all amounts subject to the non-resident film renters' tax would come within the royalty definitions in the Income Tax Act 2007 and in New Zealand's DTAs. Hence, such amounts would be subject to NRWT if non-resident film renters' tax is repealed.[2]

10. Under this option, NRWT at variable rates would apply in accordance with DTAs between New Zealand and other countries, which limit the amount of NRWT that New Zealand can charge on royalties. The DTA royalty rate is generally 10 percent. However, the rate under the United States and Australia DTAs is five percent, which would apply to many non-resident film renters. The NRWT rate of 15 percent applies if there is no applicable DTA.

11. This option will result in the following estimated increase in tax revenues, with a corresponding impact on the operating balance:

	$ millions increase / (decrease)				
Vote Revenue Minister of Revenue	2010/11	2011/12	2012/13	2013/14	2014/15 &outyears
Crown Revenue and Receipts: Tax Revenue	–	–	5.000	5.000	5.000

12. No social, environmental or cultural costs are expected to arise under this option. Also, no significant behavioural changes by non-resident film renters are expected to arise. NRWT on film rental payments derived from New Zealand by non-residents would generally be creditable in the home country of the non-resident film renter.

13. There will be some compliance costs for New Zealand customers who make payments to non-resident film renters for renting or exhibiting film purposes in New Zealand. New Zealand customers will have to withhold tax for the non-resident film renters from the 2012–13 income year and may potentially re-negotiate existing contracts and re-configure systems for the deduction of NRWT. Because it involves making deductions from gross payments at a flat rate, NRWT is a relatively simple tax to comply with. Some non-resident film renters may also face increased compliance costs to re-negotiate existing contracts but this will be partially offset by the removal of filing responsibility in New Zealand.

14. The proposed change will not affect the local film production industry.

CONSULTATION

15. Inland Revenue has consulted on the proposal as part of the government discussion document, *New Zealand's International Tax Review: a direction for change*, released in December 2006 and three submissions were received. The submitters raised a general

[2] Note that certain types of receipts, which are currently subject to non-resident film renters' tax, would not be subject to NRWT (being outside the royalty definition). These are receipts from the sale or hire of film containers or other film accessories. However, the value of film containers or other accessories relative to the copyright in the film itself would be immaterial. The transfer pricing rules would prevent non-arm's length values being attributed to such accessories if film rental payments were subject to NRWT.

concern about an increased cost of film rental to New Zealand customers. These costs may include the increased tax burden on New Zealanders because of the existing contract conditions (for example, gross-up clauses) and the increased compliance costs on New Zealand customers to withhold tax for the non-resident film renters. Recently, officials have been in contact with the submitters about the proposed change and they raised no additional points to their submissions.

16. Officials have reviewed the submitters' concerns but consider the policy arguments for replacing the non-resident film renters' tax with NRWT are stronger. The change would simplify the New Zealand income tax rules applying to non-residents and, in particular, the burden of the increased tax will not necessarily be borne by New Zealanders because NRWT would generally be creditable in the home country of the non-resident film renter.

17. Inland Revenue has also consulted with the Treasury.

CONCLUSIONS AND RECOMMENDATIONS

18. The recommended option is to replace the non-resident film renters' tax with NRWT so that NRWT applies to amounts derived by non-residents from renting out films in New Zealand.

IMPLEMENTATION

19. The necessary legislative change will be included in the scheduled September 2011 tax bill, with application to payments made on or after the date of enactment.

20. A small number of non-resident film renters would have a reduced compliance burden as a result of the removal of filing responsibility in New Zealand. Some New Zealand customers, who make payments to non-resident film renters for renting and exhibiting film purposes in New Zealand, would have to deduct and return NRWT from payments made to non-resident film renters. Some may need to register with Inland Revenue for NRWT. Because it involves making deductions from gross payments at a flat rate, NRWT is a relatively simple tax to comply with.

21. Inland Revenue intends to identify these New Zealand customers and target them with communications advising them of their new obligations, and what they need to do.

MONITORING, EVALUATION AND REVIEW

22. The new tax treatment of the non-resident film renters would be part of any monitoring, evaluation and review of NRWT. If any specific concerns are raised, officials would determine whether there are substantive grounds for review under the Generic Tax Policy Process. The Income Tax Act 2007 is also subject to regular review by officials.

Regulatory Impact Statement

Extending eligibility for the in-work tax credit to unpaid shareholder-employees in certain circumstances

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

The question in this Statement is whether unpaid shareholder-employees can be eligible for the in-work tax credit where they work the required number of hours per week. Currently, the in-work tax credit is only available to a shareholder-employee who works full-time and where they derive wages, salary or a shareholder salary. It is not available if they only derive dividends or other distributions from the company.

The Statement provides an analysis of the options for extending eligibility to unpaid shareholder-employees.

As the change concerns people who are currently ineligible, there is little information to indicate the number of people affected. Estimates have been made based on current administrative data and information gathered through consultation. The number affected is expected to be very low and also likely to vary between years due to economic conditions affecting business profitability.

Other than set out in this Disclosure Statement and the broader Regulatory Impact Statement, no significant gaps, assumptions, dependencies, constraints, caveats or uncertainties have been identified.

In preparing this Statement, we have consulted with the Treasury and the Ministry of Social Development, which agreed with our analysis. We have also discussed the issue and potential options with representatives of the New Zealand Institute of Chartered Accountants. The consultation informed the problem definition, development of options and analysis summarised in this Statement.

The proposed change will not impose any significant new compliance costs on shareholder-employees seeking to apply for the in-work tax credit. The proposed change also does not impair private property rights, reduce market competition, provide disincentives to innovate and invest or override common law principles.

Dr Craig Latham
Group Manager, Policy
Inland Revenue

19 July 2011

STATUS QUO AND PROBLEM DEFINITION

1. Where a person meets certain criteria they will be eligible for the in-work tax credit. The criteria include being a New Zealand resident, caring for a dependent child, not receiving an income-tested benefit or student allowance, working the minimum required number of hours a week and deriving income from that work activity.

2. Section MD 9 of the Income Tax Act 2007 requires the full time worker to be receiving specified income from the work activity. This specified income is defined to include wages and salary, shareholder salary and income from a business carried on for profit, as well as weekly ACC and parental leave payments in certain circumstances.

3. This requirement is not clearly stated on the application form leading to some applicants being unaware of the requirement for income to be derived from the work activity. Additional costs can be incurred by the department and applications in correcting applications.

4. Where all the criteria are met the person can apply for the in-work tax credit, which provides up to $60 a week where the family has up to three children, and an extra $15 a week for each additional child. The total amount, along with any family tax credit or parental tax credit, is abated against family scheme income. Family scheme income is defined in the Income Tax Act 2007 to include wages and salary, shareholder salary and business income. It also includes income attributed to people from trusts or companies in specific circumstances.

5. These criteria are intended to encourage people to move off income-tested benefits into work. It also encourages people to remain in work.

6. When a business makes a loss in a tax year, it may decide not to make a payment to the business owner relating to the owner's work activity. If the business owner is a sole trader, partner, shareholder of a look-through company, or beneficiary of a trading trust, they may still be eligible for the in-work tax credit as the gross income of the business can be treated as the person's income from a business. However, this treatment does not apply where the business is conducted via a company. A shareholder-employee will only qualify as receiving income from a work activity if they are paid wages or salary, or a shareholder salary. The gross income of the company is not treated as the person's income from a business for the purposes of the test in section MD 9.

7. In a number of situations, companies have elected to make no payment to the shareholder-employee due to the overall net loss of the company in that year. As a result, an unpaid shareholder-employee is not eligible for the in-work tax credit, even though they normally work the required number of hours per week. The number affected is estimated to be very low.

8. The current situation creates an inequity between working business owners based on the type of structure their business operates in.

9. An alternative could be for a shareholder-employee to receive a nominal payment, meaning they would meet the criterion of receiving income from a work activity. However, as this is an artificial construct it is likely to receive additional scrutiny from Inland Revenue with associated costs for the department and applicant. It would be preferable to address the problem directly.

10. The key cause of this situation is the inability for an unpaid shareholder-employee to meet the current legislative definition of income from a work activity. While the definition is sufficient for business owners in other entities, it does not cover shareholder-employees in standard companies. A non-legislative solution of the payment of a nominal salary is artificial and could result in greater scrutiny being applied to it with increased uncertainty and compliance costs for applicants.

OBJECTIVES

11. The main objective is to ensure that the in-work tax credit operates as intended by encouraging people to move into and remain in work. It aims to support people with dependent children based on their level of work activity and their level of income. The question is whether the legislation setting out the eligibility criteria achieves the policy objectives.

12. In making changes to the eligibility rules, consideration should be given to government priorities to improve the integrity of the tax credits. Fiscal costs are also a consideration.

REGULATORY IMPACT ANALYSIS

13. The options that we have identified are to:

> Option A: provide further guidance to applicants and Inland Revenue staff about the requirements for income to be derived from work and the approach taken on nominal salary payments in light of the recent broadening of the definition of income. This would only clear some confusion on the current rules and would not extend eligibility to unpaid shareholder-employees.
>
> Option B: change the definition of "full-time earner deriving income from a work activity" to include major shareholder-employees of close companies that produce gross income, provided the person meets all other requirements. This would extend eligibility to unpaid shareholder-employees who meet all other requirements.

14. As noted, Option A does not address the inequity that has been identified, although it may reduce the uncertainty and compliance costs for some applicants.

15. The preferred option is Option B to amend the Income Tax Act 2007 to extend eligibility to major shareholder-employees of a close company, where the close company produces gross income and all other requirements are met. This addresses the inequity.

16. The preferred Option B will result in an estimated increase in expenditure on the in-work tax credit of approximately $0.650 million per year. The 2011-12 appropriation for the in-work tax credit is approximately $567 million. The estimated cost of the preferred option can be met within the existing appropriation.

17. Shareholder-employees affected by the proposed change will be required to confirm that they meet all the eligibility requirements when applying for the in-work tax credit. No social, environmental or cultural costs are expected to arise.

CONSULTATION

18. Officials discussed the status quo and problem definition with representatives from the New Zealand Institute of Chartered Accountants, who provided information to inform the analysis. Indicative options were also discussed and the representatives did not support the

option to issue further guidance only. Feedback from the consultation was factored into the analysis and informed the development of the preferred option.

19. Inland Revenue has also consulted with the Treasury and the Ministry of Social Development, which agreed with our analysis.

CONCLUSIONS AND RECOMMENDATIONS

20. The recommended option is to amend the Income Tax Act 2007 to change the definition of "full-time earner deriving income from a work activity" to include major shareholder-employees of close companies that produce gross income, provided the person meets all other requirements. This would ensure comparable treatment between major shareholder-employees and other working business owners.

IMPLEMENTATION

21. The definition of family scheme income has been broadened from 1 April 2011 to improve its integrity. The broadened definition of family scheme income will reduce the risks associated with potential behavioural changes. In particular, section MB 4 attributes the net undistributed income of a close company to the major shareholders in proportion to their shareholding. Furthermore, section MB 7 attributes the income earned by a trust that is not paid out as beneficiary income to the settlors of the trust. This broadened definition of family scheme income ensures that Working for Family tax credits, including the in-work tax credit, are well targeted.

22. The necessary legislative change will be included in the tax bill scheduled to be introduced in September 2011, with effect from the 2012-13 tax year.

23. As the proposed option refers to existing definitions of major shareholders and close companies, it can be implemented within existing processes for changes to Working for Families. Administrative costs will be met within the Inland Revenue's existing baselines. No significant risks have been identified.

MONITORING, EVALUATION AND REVIEW

24. The proposed change to eligibility will be monitored as part of business as usual processes on the take-up and expenditure of the in-work tax credit.

Regulatory Impact Statement

Liquidators and receivers changing GST accounting basis

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

The question in this Statement is whether liquidators and receivers should be able to change from the payments to the invoice basis when accounting for GST. The main objective is to ensure that liquidators and receivers are not able to engage in tax driven behaviour to generate GST refunds to the detriment of the Government's tax base.

Other than set out in this Disclosure Statement and the broader Regulatory Impact Statement, no significant gaps, assumptions, dependencies, constraints, caveats or uncertainties have been identified. Officials have consulted with the relevant industry body, INSOL, and the Treasury. Given the technical nature of the issue and its small stakeholder group, wider public consultation has not been undertaken.

In preparing this Statement, we have consulted with the Treasury, which agrees with our analysis.

The proposed change will not impose any compliance costs on liquidators or receivers.

The proposed change does not impair private property rights, reduce market competition, provide disincentives to innovate and invest or override common law principles.

Dr Craig Latham
Group Manager, Policy
Inland Revenue

20 July 2011

STATUS QUO AND PROBLEM DEFINITION

1. The question in this Statement is whether liquidators and receivers should be able to change from the payments to the invoice basis when accounting for GST.

2. If a registered person meets certain conditions, for example, the total value of taxable supplies for a 12 month period has not, or is not likely to exceed $2,000,000, the registered person may account for GST on a payments basis. The Goods and Services Tax Act 1985 allows registered persons who are accounting for GST on a payments basis to change to the invoice basis by applying to the Commissioner. There are currently no restrictions on registered persons making this accounting basis change.

3. The large majority of registered persons choose to account for GST on a payments basis because it suits their business needs.

4. It is normal practice for liquidators and receivers to switch the GST accounting basis of registered persons they are acting for from the payments basis to the invoice basis. Changing from the payments to the invoice basis often results in refunds being made to the liquidator or receiver despite in many cases there being no realistic prospect that the debt, to which the input credit relates, will ever be paid. Even though output tax is also recognised on an invoice basis when the accounting basis is switched, Inland Revenue's statistics show that liquidators and receivers consistently receive net refunds when they make the switch.

5. For example, in the period 1 January 2009 to 30 July 2010 there were 627 companies where the liquidators requested a change from the payments basis to the invoice basis – the amount of GST claimed by these liquidators on switching accounting basis was approximately $4.5 million, whereas the output tax returned was approximately $550,000.

6. Although companies not in liquidation or receivership can similarly change their GST accounting basis, this is not considered an equivalent problem because such persons who stay in business eventually come into a net paying position.

7. Officials also note that it is not the policy intent of the GST legislation that refunds obtained by changing GST accounting bases be used to fund the liquidation or receivership of private companies.

8. The problem, therefore, is liquidators or receivers engaging in tax driven behaviour in order to generate GST refunds, which is at the detriment of the Government's tax base.

9. This Statement considers whether the Goods and Services Tax Act 1985 should be amended to preclude liquidators and receivers switching from the payments basis to the invoice basis when accounting for GST.

OBJECTIVES

10. The main objective is to ensure that liquidators and receivers are not able to engage in tax driven behaviour to generate GST refunds to the detriment of the Government's tax base.

REGULATORY IMPACT ANALYSIS

11. The options that we have identified include retaining the status quo or amending the Goods and Services Tax Act 1985 to preclude liquidators and receivers switching from the payments basis to the invoice basis when accounting for GST.

12. The preferred option is to amend the Goods and Services Tax Act 1985 to preclude liquidators and receivers switching from the payments basis to the invoice basis when accounting for GST in order to generate GST refunds. The amendment should also apply to voluntary administrators.

13. Officials considered other options including making the change of accounting basis subject to Commissioner discretion and amending the incapacitated persons provisions in section 58 of the GST Act 1985. These options were disregarded because a discretion would be arbitrary in nature and the incapacitated persons provisions have a might wider ambit than liquidators and receivers.

14. The impacts of the preferred option are:

	Impacts		**Comment**	**Net Impact**
	Costs	***Benefits***		
Liquidators/ Receivers	$2.5 million less tax refunded.	Marginally reduced compliance costs as no longer making a change in accounting basis.	Approximately 400 companies going into liquidation each year could be affected by this proposal.	Negative
Government	None.	$2.5 million per annum.	GST no longer inappropriately used to fund liquidation or receivership of private companies.	Positive

CONSULTATION

15. Officials have discussed the amendment with representatives from INSOL (a group representing insolvency practitioners). The group considered the GST refunds were used to investigate companies, which could result in higher returns to creditors and therefore supported the status quo. It is not the policy intent of the legislation that GST refunds obtained by changing GST accounting bases be used to fund the liquidation or receivership of private companies.

16. Inland Revenue has also consulted with the Treasury who agree with our recommendation.

CONCLUSIONS AND RECOMMENDATIONS

17. The recommended option is to amend the Goods and Services Tax Act 1985 to preclude liquidators and receivers switching from the payments basis to the invoice basis when accounting for GST.

IMPLEMENTATION

18. The necessary legislative change will be included in the tax bill scheduled to be introduced in September 2011, with application to payments made on or after the date of

enactment. There is no need for transitional provisions. No implementation risks have been identified. Implementation can be managed within existing systems.

MONITORING, EVALUATION AND REVIEW

19. There are no plans to monitor, evaluate and review the GST treatment of liquidators and receivers following this amendment. If any specific concerns are raised, officials will determine whether there are substantive grounds for review under the Generic Tax Policy Process. Also, the Goods and Service Tax Act 1985 is subject to regular review by officials.

Regulatory Impact Statement

GST and late payment fees

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

It addresses an issue with the GST treatment of late payment fees by taxpayers and a potential significant fiscal risk if GST is not payable on the fees.

Late payment fees are fixed fees charged by businesses to their customers on late payment of accounts. The fees are different from penalty and default interest payments which are specifically GST-exempt in the same way as other financial transactions.

Inconsistency between interpretation and practice has created a lack of clarity around the application of the GST rules to late payment fees. The current interpretation of the law raises boundary issues that would result in different GST treatments for comparable fees, such as prompt payment discounts, depending on how the fees are structured. There should not be a difference in GST treatments between two similar types of charges when GST is intended to be imposed on the consideration for any transaction. The current interpretation creates a significant fiscal risk to the GST base. It means that taxpayers, most of whom have charged GST on late fees to their customers, may be entitled to a refund of the output tax that they have returned to Inland Revenue.

We recommend that a legislative amendment be made to clarify that late payment fees are subject to GST and this be made retrospective. However, we recommend a savings provision that would preserve the position that a small minority of taxpayers may have taken in relation to this matter before the effective date of the proposed legislative amendment.

A general limitation of our analysis was the time constraint in developing the options. A prompt change was considered necessary as maintaining the status quo raises a potentially significant fiscal risk. We consulted with the Treasury, which agrees with our analysis. Full consultation has not been undertaken with the public so as not to signal a potential base maintenance change that could result in a behavioural change by taxpayers. We do, however, intend to inform a small number of taxpayers, who may be affected by the amendment, of the proposed legislative change closer to the date of bill introduction.

The proposed amendment does not impair private property rights, reduce market competition, provide disincentives to innovate and invest or override common law principles. As noted, a retrospective amendment in this area would remove the ability of taxpayers to seek GST refunds. However, the savings provision would maintain the existing treatment for all affected taxpayers.

Dr Craig Latham
Group Manager, Policy
Inland Revenue
20 July 2011

STATUS QUO AND PROBLEM DEFINITION

1. This statement considers options to address a recent issue relating to GST and late payment fees. Late payment fees are fixed fees charged by businesses to their customers in respect of the late payment of accounts – for example, a telephone company may charge their customers a set fee for the cost of administration if they do not pay their monthly telephone bill on time. These fees are common across a range of sectors and charging GST on these fees is a common practice among many businesses. The fees are different from penalty or default interest payments which are specifically GST-exempt under the Goods and Services Tax Act 1985 ("the GST Act") in the same way as financial transactions.

2. Under the GST Act, GST is only charged on a taxable supply. The term "supply" being very broadly defined in keeping with the policy of GST having the broadest base that is practically possible. However, under the current interpretation of the law, no GST should be imposed late payment types of fees as there is a lack of connection between the fee charged and the underlying supply of goods and services, even though they may represent the cost of administering the late payment. This is inconsistent with both the policy of a broad-based tax and with Inland Revenue's public statement to date which has been that while penalty interest is clearly not subject to GST, late payment fees are subject to GST.[1]

3. The current interpretation of the law raises boundary issues that would result in different GST treatments for comparable fees depending on how the fees are structured. There should not be a difference in GST treatments between two types of charges when GST is intended to be imposed on the consideration for any transaction. In this respect, late payment fees should be treated in the same manner as prompt payment discounts.

4. Inconsistency between interpretation and practice has created a lack of clarity around the application of the GST rules to late payment fees. If this is maintained, there will be an ongoing fiscal cost of around $3.3 million per year. This would be the result of taxpayers who currently charge GST on late fees no longer charging it. Moreover, the same group of taxpayers may be entitled to a refund of the output tax that they have already returned to Inland Revenue. This is estimated to amount to a one-off revenue loss of approximately $13.8 million.

OBJECTIVES

5. The main objective is to clarify the current law around GST and late payment fees. A clarification to the law would also ensure that there is no potential ongoing fiscal risk resulting from the inconsistency between interpretation and practice. A further objective is to ensure that this need to remove the fiscal risk is balanced with the need to treat fairly those who have taken an interpretation that is justifiable under the current law.

REGULATORY IMPACT ANALYSIS

6. The options we have identified are to maintain the status quo or to make a legislative amendment which would clarify that late payment fees are subject to GST. For base

[1] See *GST Treatment of Interest Charged on Overdue Accounts* – TIB Volume Two No. 5 December (1990).

maintenance reasons and to remove the fiscal risk resulting from the current interpretation of the rules, our preferred option is a legislative amendment.

Legislative amendment

7. Our preferred option is that the application date of an amendment is aligned with the last year in which taxpayers can possibly argue for a refund of overpaid GST. Under the GST rules, the Commissioner must refund overpaid GST if he is satisfied that the amount of the refund represents an excess over the amount properly payable and the four-year time-bar in the Tax Administration Act 1994 has not expired. However, this time-bar is extended to eight years if the GST overpaid is the result of a clear mistake or simple oversight. Under this option, the effective date would be the date that is 8 years before the date of bill introduction, say from September 2003, with application for taxable periods ending on or after that date.

8. This option would also include a savings provision that would effectively preserve the positions that taxpayers may have taken in relation to this matter, say prior to the introduction of legislative amendment.

9. We recognise that a savings provision may give rise to concerns about the potential disparity between taxpayers who have applied the current law and have not charged GST on late fees, and those who, based on their understanding of the rules have charged GST. However, on balance, we believe that this concern is outweighed by both the need to treat fairly those who have taken an interpretation that is justifiable under the current law, and the need to remove the fiscal risks outlined.

Other legislative options considered

10. Another option considered was a prospective legislative amendment – that is, an application date that would make GST chargeable on all late payment fees from the date of bill introduction. This option would prevent taxpayers from either adopting or continuing to rely on the recent interpretation of the current law from this date. Practically speaking, it means that taxpayers who had previously relied on the interpretation would not have to account for the GST that they did not charge during the periods before the introduction of the legislative change. Equally however, it would mean that taxpayers who had charged GST on late fees before the introduction of the amendment may be entitled to a refund of the output tax that they have returned to Inland Revenue. As noted above, the fiscal cost of this would be about $13.8 million.

11. We also considered a retrospective amendment without a savings provision. This option would make it clear that GST has always been chargeable on these types of fees. In practice, it would prevent taxpayers who have already charged GST on their late payment fees from claiming refunds. A retrospective application date, however, would mean that taxpayers, who had relied on an interpretation that is justifiable under current law and not charged GST on their late payment fees, would now be accountable for the outstanding output tax from the effective date of the retrospective amendment.

12. The preferred option, therefore, represents a compromise between these alternative options. The inclusion of a savings provision allays concerns about enacting retrospective

legislation while, at the same time, ensuring that the interpretation of the current law and any proposed amendments to the rules around GST and late payment fees do not pose an ongoing risk to the GST base.

Status quo

13. Maintaining the status quo is unsustainable. It results in uncertainty, creates boundary issues, and poses a significant fiscal risk to the GST base.

14. No social, environmental or cultural costs are expected to arise under any of these options.

CONSULTATION

15. We consulted with the Treasury, which agrees with our analysis. Full consultation has not been undertaken with the public so as not to signal a potential base maintenance change that could result in a behavioural change by taxpayers. We do, however, intend to inform a small number of taxpayers, who may be affected by the amendment, of the proposed legislative change closer to the date of bill introduction.

CONCLUSIONS AND RECOMMENDATIONS

16. The recommended option is a legislative amendment to the Goods and Services Tax Act 1985 that would clarify that late payment fees imposed by business on their customers are subject to GST.

IMPLEMENTATION

17. The necessary legislative change would be included in the tax bill scheduled to be introduced in September 2011, with an application date that is 8 years before the date of bill introduction, and application for taxable periods ending on or after that date. A savings provision would also apply to preserve the positions that taxpayers took before the date of bill introduction.

18. No implementation risks have been identified. The proposed changes can be done within existing administrative functions. Any legislative change in this area will be communicated. Specifically, Inland Revenue will prepare a Tax Information Bulletin item to communicate the effect of the proposed changes to taxpayers.

MONITORING, EVALUATION AND REVIEW

19. In general, the monitoring, evaluation and review of these proposals would take place under the Generic Tax Policy Process (GTPP). The GTPP is a multi stage policy process that has been used to design tax policy in New Zealand since 1995. The final step in the process is the implementation and review stage, which involves post-implementation review of legislation, and the identification of remedial issues. Opportunities for external consultation are also built into this stage. In practice, this would mean that these proposals would be reviewed at a time after it has had some time to work. Any changes that are needed to give the legislation its intended effect would be added to the Tax Policy Work Programme, and proposals would go through the GTPP.