Taxation (Annual Rates for 2015–16, Research and Development, and Remedial Matters) Bill

Number 7-1

Regulatory Impact Statements (RIS)

Regulatory Impact Statement

Review of child support scheme reform

AGENCY DISCLOSURE STATEMENT

This Regulatory Impact Statement has been prepared by Inland Revenue.

The statement provides an analysis of options to change the child support scheme reforms, enacted in 2013 but not yet in force, in order to recognise the increased priority of reducing child support debt and to reduce the administrative cost of implementing the reforms.

The statement reviews the child support reforms as enacted and considers whether alternative options could continue to provide the benefits the reforms seek but at a lower implementation cost. Another key consideration in the analysis is whether the reforms, and components of the reforms, reduce child support debt.

The decision to introduce the child support reforms was accompanied by a Regulatory Impact Statement (RIS) *Child support scheme reform* of 26 July 2011. The earlier RIS contains background information and analysis that is useful to the options considered in this RIS, particularly the status quo.

There was consultation with a range of Government agencies and significant public consultation on child support issues over a long period of time culminating in the Child Support Amendment Act 2013. However, there has been limited consultation on the subsequent options in this statement given the timing constraints on decision-making and the sensitivity of the decisions being considered.

Some assumptions have been made on the number of people who may be affected by aspects of the reforms yet to come into force and the likely impact on compliance behaviour, based on existing administrative data. These assumptions impact on the analysis on the likely benefits from various options and the impact of different options on the debt book.

There are no other significant constraints, caveats and uncertainties concerning the regulatory analysis undertaken.

None of the policy options would restrict market competition, reduce the incentives for businesses to innovate and invest, unduly impair private property rights or override fundamental common law principles. Some options would reduce costs on some businesses that employ parents who pay child support, although these costs were not thought to be significant and already form part of the existing PAYE processes.

Chris Gillion
Manager, Policy and Strategy
Inland Revenue
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STATUS QUO AND PROBLEM DEFINITION

Background

1. As at 31 March 2014, the New Zealand child support scheme was providing financial support for around 203,500 children. There were 134,800 receiving carers and 136,000 liable parents with current liabilities. However, there are another 43,800 liable parents who have no current liability but owe arrears. Of the liable parents, 125,000 are in debt. In the 2013/14 tax year there were around 41,000 new child support applications and around 24,000 receiving carers left the child support scheme.

2. The scheme was established by the Child Support Act 1991, which revised the rules relating to child maintenance when agreement between parents proved difficult or when the receiving parent was a beneficiary. The Child Support Act 1991 sets out the requirements for applying for child support, the means of determining liability, and processes for payments and objections.

3. The child support scheme is administered by Inland Revenue, which is responsible for both assessing contributions and collecting payments. The child support scheme is voluntary for parents unless the caregiver is receiving a sole-parent benefit or Unsupported Child Benefit. The majority of people in the child support scheme are beneficiaries.

Reasons for the review of the 1991 scheme

4. Although the current child support scheme provides a relatively straightforward way of calculating child support liability for the majority of parents, there are some major concerns that seem to be affecting an increasing number of parents (and therefore children).

5. The primary assumption under the current scheme is that the paying parent is the sole income earner and that the receiving carer is the main care provider. The formula assessment is therefore focused on the paying parent and their ability to pay. However, today when parents live apart, there is an increased emphasis on shared parental responsibility and both parents remaining actively involved in their children's lives. Work participation rates of both parents, particularly in part-time work, has also increased since the scheme was introduced, resulting in the principal carer of the children now being more likely to be in paid work or seeking paid work.

6. Escalating levels of accumulated child support debt, relating in particular to child support penalties, is increasingly becoming an issue. Child support debt now exceeds $3 billion, with 75% of the amount being penalties.

7. The scheme is now, in many cases, out of date and out of line with social expectations. This undermines some parents' incentives to meet their child support obligations and therefore detrimental to the wellbeing of their children.

Original policy problems

8. The child support scheme was reformed in 2013 to address the main policy problems identified at the time. These included:

- whether the current child support system accurately reflects the expenditure for raising children in varying family circumstances in New Zealand;
- whether greater levels of shared care and other regular care should be taken into account when calculating child support;
- whether both parents' income should be taken into account when calculating the child support to be paid;
- whether incentives to make payments can be improved by changing the child support penalty rules and write-off provisions.

9. The main change of the 2013 reforms has been to shift the focus of the child support formula assessment from assessing the liability of the paying parent, to focusing on the level of support that is required from each parent for each qualifying child. In doing so, it considers a greater range of shared care, the income of all parents of the child (including legal step-parents), and the average cost of raising the child (taking into account other children of the parents). At the same time, changes were made to the general administrative processes and rules around payments and debts to improve incentives to make timely payments.

10. More information on the background and the reasons for reviewing the 1991 scheme can be found in the earlier Regulatory Impact Statement (RIS) *Child support scheme reform* prepared by Inland Revenue for the original reforms, dated 26 July 2011 and released November 2011 (see http://taxpolicy.ird.govt.nz/publications/type/ris). The RIS also considered the problems with the 1991 scheme, the consultation undertaken and analysis of the options for addressing the problems.

Child Support Amendment Act 2013

11. Following consultation on a range of options, the child support scheme was amended by the Child Support Amendment Act 2013 (Amendment Act). However, the reforms are yet to come into effect.

12. The Amendment Act comes into effect from different dates. The application, formula assessment and notification process is due to come into effect from 1 April 2015 (first phase of changes). These changes specifically address the first three bullet points of the original policy problems. The changes to the payment process, penalties and debt come into effect from 1 April 2016, along with other policy changes (second phase of changes)[1]. These changes specifically address the last bullet point of the original policy problems.

[1] Changes to liabilities for prisoner and long-term hospital patients came into effect on 1 April 2014. These were small changes that required no system changes to implement. There are also transitional provisions that came into effect from date of Royal assent.

13. The specific reform changes are to be implemented in two phases and are set out in the box below.

First Phase

The first phase includes the new formula, the new assessment, the reassessment process and the issuing of notices.
It concerns changes that come into effect from 1 April 2015.

The new formula includes:

- the estimated average cost of raising children in New Zealand, which will be annually updated;
- a lower level of minimum shared care, being 28% of nights (down from 40%);
- the child support income of both parents, not just the liable parent;
- recognising where there may be more than two parents (such as legally recognised step-parents);
- recognising where a parent has qualifying children in multiple relationships.

The formula will continue to determine a child support income amount.

The child support income includes:

- a living allowance based on equivalent levels of welfare benefits, but will no longer provide an allowance for a new spouse;
- a dependent child allowance. Children from a new relationship, who are not legally dependent on the parent, will no longer be included in dependent child allowances;
- a multiple relationship allowance to recognise the cost of child support paid for children in other relationships;
- a new simplified process for measuring taxable income if the person only has calendar year income that is withheld at source, for example, wages.

There is an updated process for parents who wish to estimate their taxable income for the year, which will also apply to receiving carers who are parents.

A new assessment and reassessment process is established to collect the new information required for the formula. It also sets out that receiving carers will require care levels of 35% of nights to qualify to receive payments.

There will be greater Commissioner discretion to recognise significant daytime care for shared care purposes, and to rely on parenting orders when establishing care levels.

Notices that are issued will contain additional information reflecting the changes to the formula.

Second Phase

The second phase of the reforms includes the changes to the payment, penalties and debt write-off rules. It also includes other policy changes. The changes in the second phase come into effect from 1 April 2016, or are not required until after the end of the child support year beginning April 2015.

The second phase includes:

2.1 a new definition of "adjusted net income", which includes income adjustments to taxable income, such as income in trusts and companies;

2.2 a penalty for receiving carers who are parents and who underestimate their income for the year;

2.3 reducing the maximum age of a qualifying child from under 19 to under 18, unless they are 18 and still in full-time secondary education – aligning with Working for Families age limit;

2.4 compulsory deduction of child support from employment income, unless there are grounds for an exception such as privacy or cultural reasons;

2.5 a two stage late payment penalty with an immediate 2% late penalty, with the remainder of the current 10% penalty only being charged if the debt remains unpaid after seven days;

2.6 a reduction in the ongoing monthly penalty rate from 2% to 1% after a year;

2.7 the ability to offset current payments against past debts where the liable parent and receiving carer swap roles (that is, where the child moves to live with the other parent);

2.8 relaxing the circumstances in which penalties can be written-off, including when a liable parent enters into an instalment arrangement or is in serious hardship, when debt recovery is an inefficient use of Inland Revenue's resources or when only low levels of penalty debt are outstanding, and allowing Inland Revenue to write off assessed debt owed to the Crown on serious hardship grounds;

2.9 recognising re-establishment costs as a grounds for an administrative review;

2.10 the discretion to recognise other payments, such as payment of school fees, as qualifying as child support payments where they directly benefit the child.

14. Further detail on the 1991 scheme and the 2013 scheme and the consultation undertaken can be found on Inland Revenue's websites, including the Tax Policy website (see http://www.ird.govt.nz/childsupport/)

Impact of the reform

15. Analysis from 2011 determined the reforms to the child support formula would have financial implications for some parents.

Parents	Unaffected	Receive more / pay less	Receive less / pay more
Receiving parents	82,230 (60%)	24,505 (18%)	29,776 (22%)
Paying parents	57,823 (42%)	45,997 (34%)	32,691 (24%)

16. Overall, it was estimated that 70,502 parents would be better off under the changes (that is, they will receive more or pay less child support) and 62,467 worse off (that is, they will receive less or pay more).

17. For the majority of parents whose child support will be affected, the change in child support received and paid was estimated as likely to be between plus or minus $66 per month (plus or minus $800 per year). That was based on rates and data held at the time and assumptions were made where data was lacking such as the number of dependent children paying parents would have.

18. For a large percentage of receiving and paying parents (60 percent and 42 percent respectively), the changes to the formula would not result in any change in the amounts received or paid. A total of 140,053 parents would be unaffected. This is because many parents would continue to either receive a sole-parent benefit (and therefore not receive child support payments directly) or continue to pay the minimum contribution because their income level is below the minimum level for child support purposes. For those who would be affected, however, the reforms would represent a more transparent and equitable result in a greater number of different circumstances.

19. Parents who qualify for the wider recognition of share care would be most affected, with paying parents likely to pay less in such cases.

Problem Definition

Impact on child support debt

20. The Minister of Revenue has indicated that reducing child support debt is a priority for child support policy. Child support debt is over $3 billion and growing. 75% of the debt is related to the penalties and the vast majority is over a year old. The penalty rate is approximately 37% a year (in addition to a late penalty payment of 10%), meaning the size of the penalty debt can soon eclipse the size of the child support assessment debt. Liable parents faced with large debt amounts may be discouraged from making further payments, especially if they are on a low income. Of the penalty debt, 97% is impaired (not expected to be collected). A disproportionate amount of debt is owed by parents living overseas.

21. The Amendment Act goes some way to addressing the issue of child support debt by improving the fairness of the scheme (and therefore acceptance by paying parents). In particular, the changes to reduce the penalty rate and allow for debt write-offs will reduce debt from 2016 but are unlikely to be a full solution. Child support debt remains a problem.

Cost of implementation

22. The original 2011 cost estimate for the programme to implement the reforms was $30 million. As the legislation was developed and greater details on the specific changes were determined and finalised, a business case was prepared in 2012. The business case revised the estimated cost up to $120 million over the ten year period from 2011-12 to 2021-22 (costs in the latter half of the period cover ongoing depreciation, capital charges and ongoing additional staff costs to administer the modernised scheme). The increase reflected a greater appreciation of the complexity of the changes proposed by the new formula. One of the main assumptions in the business case was that the vast majority of the expenditure would be operating cost.

23. The legislation was amended during the Parliamentary process in response to both changes recommended by officials and matters raised by submitters. For example, the level of shared care at which a receiving carer would qualify for payment was increased to 35%, but 28% of care was kept as the lower threshold for the formula assessment of child support liability. This meant some work already underway had to be significantly altered, increasing the costs and time for delivery.

24. During 2013 Inland Revenue re-assessed the time and costs associated with the programme and the assumptions underlying the business case. It became clear that the work could not be implemented, to the level of quality and certainty required, by the original legislative deadline. More time was required. Also, the assumption that the majority of development costs would be operating and not capital expenditure was proving to be incorrect as the reform was implemented. Capital expenditure comes with associated depreciation costs and capital charges leading to a higher overall cost for the reforms. If the correct assumption had been made in the business case, the cost of the reforms would have been much higher than $120 million. In early 2014, the legislative deadlines were delayed a year to allow time to complete the first phase to the standards required. The revised estimate of the project, including costs from the delay and the higher ratio of capital expenditure, is now $210 million for the ten year period from 2011/12 to 2020/21. The majority of the higher cost is the depreciation and capital charge associated with the capital expenditure.

25. The higher estimated cost mean the implied benefit:cost ratio for implementing the reform has changed from when the Government originally made its decision. As a result, the Minister of Revenue requested a review of the reforms in light of the revised cost estimate. The Minister also requested a greater focus on reducing the child support debt book.

Assessment of Status Quo

26. The status quo option is to implement the reforms as set out in the Amendment Act. The status quo meets the original objectives and policy problems and is expected to deliver the original non-quantified benefits considered in the earlier RIS of improved fairness, a modern scheme, and greater incentives to make timely payments. Implementing the status quo will require a higher cost than anticipated – meaning a lower value for money return to the Government.

27. The estimated cost of implementing the whole reform is estimated at $210 million over the ten year period. While the benefits of the reform are generally intangible, it is questionable whether the Government would have agreed to implement all of the reform components at the revised total cost.

28. The overarching fiscal objective of the Government has been to restrain the growth in government spending, reduce deficits and return to surplus. The additional cost of implementing the status quo will impact on the Government's operating balance meaning less spending elsewhere (where the value for money proposition may be higher), greater debt or lower surplus.

29. As the reform is made up of a number of components, the value for money of individual components will vary. Most of the reform elements are expected to have a positive impact on timely payments and reducing the growth of new debt, especially the changes to penalty and debt write-off provisions. Other elements of the reform will have a small or no impact on debt. In terms of reducing debt further, other non-legislative options may have a greater impact than elements of the child support reforms, especially as non-legislative options generally on only require operating costs and no capital expenditure.

30. While the status quo addresses the original policy problem and will mostly meet the priority of reducing child support debt, it does so at a higher than expected cost, and therefore represents less value for money than originally anticipated. Consequently, the status quo is no longer supported.

OBJECTIVES

31. The objectives are to:

a) reduce child support debt (or at least slow the growth);

b) reduce the implementation cost of the reforms;

c) improve the fairness of the child support scheme so that it reflects social and legal changes which have occurred since its introduction in 1992;

d) promote the welfare of the children, in particular by recognising that children are disadvantaged when child support is not paid, or not paid on time.

32. High levels of debt can discourage paying parents from meeting their obligations leading to non-compliance and child support not being paid on time. A more responsive system with a better targeted payment and penalties system would encourage, or at least not discourage, parents to pay their child support, reduce debt and would help improve the well-being of their children. The cost of implementing changes to make the system more responsive should be commensurate with the likely and intended benefit.

33. Reducing the implementation cost would mean not delivering some of the changes that meet the other objectives. For example, not proceeding with the changes to the penalty rates would reduce the implementation costs but would not reduce child support debt, may be considered unfair and have a negative impact on compliance, ultimately resulting in disadvantage to the child of the parent.

Constraints

34. The Government has previously approved funding for $120 million and authorised the department to use a further $10 million of its capital reserves. There are significant constraints on additional funding over the next few years, particularly in the 2014/15 fiscal year. The Government is unlikely to authorise new funding to meet the $210 million cost of the status quo.

35. As legislation is already in place, any further changes to legislation should be enacted before the existing provisions come into force, to avoid the prospect of retrospective application. Legislative changes that impact on child support assessments are required to be in place by February for a 1 April year as notices are sent out to parents in advance. Changes to the Inland Revenue's FIRST system take time to be implemented and checked, with the minimum time dependent on the complexity and type of change.

36. Parliament is dissolved for the election period from Thursday 14 August 2014 until after the election on Saturday 20 September 2014. Parliament also tends to rise over January. The first phase of changes applies from 1 April 2015. Therefore, to avoid retrospective application, any legislation affecting the formula assessment on the first phase of the reforms would require urgency through at least some stages of Parliament. A higher threshold is required to be met for urgent legislation. This constrains the options that affect the first phase of the reforms.

37. These time constraints also impact on the ability to consult and gather information.

REGULATORY IMPACT ANALYSIS

38. Four major options have been considered to reduce the cost of implementing the child support reforms and slowing the growth of child support debt while continuing to address the objectives of the reform. These range from repealing the reforms and returning to the 1991 child support scheme to scaling back the scope of the child support reform package. These options are described below:

Option 1 –Defer the child support reforms until Inland Revenue's Transformation programme has been completed

39. Under this option the reforms would be further amended to either delay the commencement dates by several years or to repeal the legislation and re-introduce the reforms at a later date once the Inland Revenue Business Transformation programme is completed. The Business Transformation programme is looking to improve the processes supporting the administration of the tax system, including the technology and computer systems. Part of the implementation of the child support reform underway now will be in the department's legacy FIRST system, which is expected to be replaced as part of the Transformation programme.

Option 2 – Repeal the child support reforms and return to the 1991 scheme on child support

40. Under this option, the reforms would be repealed entirely, with no expectation of re-introducing the reforms at a later date. Some small improvements may continue to be made to the scheme through the usual remedial programme or through the Budget process, as funds and resources allow.

Option 3 – Implement the first phase of the reforms and repeal the second phase of the reforms

41. Under this option, the second phase of the reforms in the Amendment Act would be repealed, but the first phase will remain and be implemented. This would mean most of the change to the formula assessment and associated processes would continue but the penalty, debt write-off and payment changes would no longer proceed.

Option 4 – Implement the first phase and part of the second phase of the reforms

42. This option is the closest to the status quo. Under this option, parts of the reforms would be repealed. All of the first phase will remain and be implemented and some parts of the second phase that meet the objective of debt reduction would also be implemented. This would mean most of the change to the formula assessment and associated processes would continue as well as the penalty, and debt write-off provisions but the changes to payment options, the wider definition of income and the underestimation penalty would no longer proceed.

Impact analysis of the options

43. The impacts of options one to four and the status quo option, and whether they meet the objectives in paragraph 31, are summarised in Table 1.

44. In 2011 it was determined that 60% of receiving carers and 42% of paying parents would be unaffected by the reforms in the amount of child support they are liable to pay or expect to receive. It is expected that a similar proportion of the current and future child support parents would be unaffected by the options on whether to delay, stop or proceed with the first phase of the reforms. For liable parents this is because they are on a low income and therefore are required to only pay the minimum amount of child support, whether under the old or new formula. For receiving carers who are on a welfare benefit, any child support paid is retained by the Crown to offset the cost of the benefit payments and is not passed on. The options considered in the RIS around the first phase would impact only on the remaining 40% of receiving carers and 58% of paying parents.

45. Option 1, to defer the reforms, would likewise defer the expected impact of the reforms mentioned earlier. Option 2, to repeal the reforms, would undo the expected impact on families discussed above. That is, those expecting to be better off would no longer be, and those expected to be worse off would presumably continue to receive their current levels of support. This would depend on whether the repeal alters the compliance behaviour of paying parents. It is possible that the repeal could result in some paying parents ceasing to be compliant due to perceptions of unfairness, leading to receiving carers being worse off.

46. The status quo, options 3 and 4 would continue to implement the first phase of the reforms including the change to shared care and the formula calculation. The expected impact on families from the 2011 RIS would continue to apply.

47. Option 4 and the status quo are the options that propose to proceed with changes to debt and penalties in the second phase. Options 1, 2 and 3 would defer or repeal the second phase, and therefore the debt and penalty provisions. Around 125,000 paying parents are in debt, about 70% of paying parents. The total debt just exceeds $3 billion, an average of $24,250 per person. Around 75% of the debt is the penalty component. Of the penalty debt, about 4% relates to the late payment penalty, with the rest relates to the 2% monthly penalty rate. However, the average debt is not a good indicator of the spread of the impact of the changes. Nearly half of the 125,000 paying parents have a debt where the penalties are greater than the value of the assessment debt; 44% or 55,000 people. The older the debt, the higher the proportion of penalties. This smaller group will receive the greatest impact from the penalty write-off and penalty rate reductions proposed under the status quo and option 4. For example, a $1,000 missed payment after 2 years grows to $1,768 under the current rules. Under the proposed changes in the second phase, the same debt after 2 years would be $1,571, a reduction of $197 or nearly 20% of the original missed payment.

48. For some debtors the issue is the inability to make payments over and above current liabilities. Around 67% of domestic debtors have low incomes, around 63,500 people. Penalty debt write-offs will have a particularly positive impact on this group.

49. To the extent that the debt and penalty changes improve the timeliness of payments, and the payment of assessment debt by paying parents, there would be a corresponding impact on the receiving carers and their children. However, receiving carers do not receive penalty payments (75% of all debt), and receiving carers who are beneficiaries do not receive assessment debt as this is retained by the Crown. Around 25% of domestic assessed debt and around 50% of the international assessed debt is owed to receiving carers, the rest is owned to the Crown. The number of receiving carers expected to be impacted by the penalty and debt write-off changes is therefore expected to be much less than 70% of the total carers.

Table 1: Summary of the impacts of the options and the status quo.

Option	*Meets objectives*	*Impacts*				*Recommendation and net impact*
		Economic/ Revenue impact	*Administrative implications*	*Compliance implications*	*Risks*	
Status Quo *Implement the whole reform – phases 1 & 2*	A, C & D	The revenue cost of the reforms is estimated at $115 million over the 10-year forecast period (2011/12 to 2020/21).	The cost of implementing the reforms is approx. $210 million over the 10-year forecast period (2011/12 to 2020/21). This includes one-off set up costs and ongoing costs of administering the reforms. There will be additional costs of migrating the reforms to the new "transformed" environment.	Compliance costs would increase for businesses and individuals due to the additional compliance requirements imposed under the reforms. For further details see comment "compliance impact" below.	There is a small risk to the timing of delivery of the whole reform if unexpected issues arise during implementation.	Not recommended. This option fails as it does not reduce the implementation costs of the reforms.
One *Defer implementation of the whole reform until Transformation project completed*	B A, C & D are delayed for up to 10 years	The revenue implications of this option are unknown but are expected to be favourable on a net present basis, as the revenue cost of the reforms will not be incurred in the deferral period.	The cost of deferring the reforms has not been quantified but is expected to be favourable on a net present value basis compared with the status quo. There would be a cost of approx. $2 million of undoing changes to date to the FIRST system to return to the 1991 scheme. Less staff would be required to administer child support during the deferral period requiring redundancies at a cost of approx. $5m A full assessment of the administrative implications of reintroducing the child support reforms in the "transformed" environment would need to be undertaken as part of the transformation project.	Compliance costs would decrease for businesses and individuals during the deferral period. Compliance behaviour may decrease as the 1991child support scheme is perceived as unfair, increasing debt and impacting child outcomes. A full assessment of the compliance implications of reintroducing the child support reforms in the "transformed" environment will need to be undertaken, as part of the transformation project.	Benefits of the reforms will be delayed up to 10 years until the new "transformed" environment is delivered. Debt may escalate to unmanageable levels under old penalty rules. Urgent legislation is required to defer the reform.	Not recommended. This option reduces the cost of implementation but does not address the problem of escalating child support debt or achieve the majority of objectives in the short-term.

Option	*Meets objectives*	*Impacts*				*Recommendation and net impact*
		Economic/ Revenue impact	***Administrative implications***	***Compliance implications***	***Risks***	
Two *Repeal the whole reform*	B	There will be revenue savings of $115 million over the 10-year forecast period (2011/12 to 2020/21).	This option has the highest administrative savings, as spending on the implementation would cease at the time of decision. The amount is not quantified as it is dependent on a number of variables. There would be a cost of approx. $2 million of undoing changes to date to the FIRST system to return to the 1991 scheme. Less staff would be required to administer child support requiring redundancies at a cost of approx. $5m	Compliance costs would decrease for businesses and individuals. Compliance behaviour may decrease as the 1991child support scheme is perceived as unfair, increasing debt and impacting child outcomes.	Debt may escalate to unmanageable levels under old penalty rules. Urgent legislation is required to repeal the reform.	Not recommended. This option would not achieve any of the objectives besides reducing costs. It may worsen compliance behaviour, making child outcomes worse.
Three *Implement the first phase of the reforms and repeal the second phase*	B & C A (partially)	There will be a revenue cost of $42.5 million over the 10-year forecast period. This cost is based on the new child support formula recognising shared care at 28% (original proposal).	The cost of implementing phase 1 of the reforms is estimated at $145 million over the forecast period. There will be an additional cost of migrating the reforms to the new "transformed" environment.	Compliance costs would increase for some parents from the removal of payment options.	Debt may escalate to unmanageable levels under old penalty rules.	Not recommended. While this option addresses the problem definition it does so by preferring cost savings over debt reduction.
Four *Implement the first phase and part of the second phase of the reforms*	A, B, C D (partially)	The revenue cost of the reforms is estimated at $115 million over the 10-year forecast period (2011/12 to 2020/21) – same as status quo.	The cost of implementing phase 1 and part of phase 2 of the reforms is estimated at $163 million. There will be an additional cost of migrating the reforms to the new "transformed" environment.	Compliance costs would increase for some parents from removal of payment options.		Recommended. This option addresses the problem definition and achieves the best balance between the objectives while minimising the impact on families.

Administrative impacts

50. The status quo of implementing the whole reforms have a higher level of ongoing administrative costs than the 1991 scheme, mostly as a result of the new, more detailed, formula assessment in the first phase of the reform. It is expected that the new formula will result in additional contacts from parents to discuss the assessment and update details. Likewise, customer calls are expected to be longer. Other aspects, such as the change in qualifying age and compulsory wage deductions, will also increase administrative costs. At the same time, some of the changes in the first and second phase are expected to reduce the level of administration through the automation of manual processes or ability to rely on existing information and call recording. The overall result for the status quo is an increase in administrative costs. This is mainly through costs associated with an increase in staff numbers.

51. Options 1 and 2 reduce the administrative costs compared to status quo as a repeal or significant delay in the new formula assessment would be expected to reduce the need for the additional staff in the near future. The positions have been filled so there would be some additional costs associated with a redundancy process. There would be some relatively small costs associated with rolling the systems back to the 1991 scheme and communicating the changes to parents. Overall Options 1 and 2 are expected to have administrative savings.

52. Option 1 seeks to defer the changes until a new business process and computer system is in place. It is intended that the new system will mean that implementation costs of changes are reduced, and the ongoing administrative costs are reduced. As a new technological solution has not yet been chosen it is not possible to determine the extent of any future administrative savings for delaying the child support reforms.

53. Options 3 and 4 retain the new formula assessment, and therefore the additional staff and associated administrative costs.

Compliance impacts

54. The status quo of implementing the whole reforms have a higher level of compliance costs than the 1991 scheme, mostly as a result of the new, more detailed, formula assessment in the first phase of the reform. The formula assessment will now require additional information from the receiving carers, so most of the compliance costs fall on this group. Other aspects of the reforms may reduce compliance costs through providing a wider range of options for liable parents to make payments, such as qualifying payments or debt offsetting. However, the reforms will also introduce compulsory wage deductions for liable parents who have employment income. This will increase the compliance costs for employers who will be required to administer deduction notices.

55. Options 1 and 2 would reduce the compliance costs for receiving carers by removing or significantly delaying the requirement for them to provide additional information or set up compulsory wage deductions.

56. Options 3 and 4 retain the new formula assessment and therefore the additional compliance on receiving carers. They also will repeal some of the payment options proposed for liable parents. This could result in a small increase in compliance costs to make payments.

Option 3 will reduce the compliance costs for employers by removing the requirement for compulsory wage deductions and not replacing it with an alternative. Option 4 includes a voluntary wage deduction process, which will have compliance costs on employers if their staff request to have child support deducted from their wages. This option has lower compliance costs than the status quo, as the status quo includes a compulsory wage deduction process. A voluntary process is expected to impact on a smaller number of employers.

Social, environmental or cultural impacts

57. There are no environmental or cultural impacts associated with any of the options considered above. There are social impacts from the options as they will potentially impact on the levels of financial support available to families with children, the timeliness of payments, and the level of debt. Some families have made financial decisions or shared care decisions on the basis of the reforms being implemented.

Other risks

58. There is a risk around the timing of options 1 and 2. These will seek to repeal or change the parts of the Child Support Amendment Act that come into effect from 1 April 2015. Inland Revenue will need to amend various systems to roll back to the 1991 scheme in time for notices of assessment in February 2014. Ideally legislative change would need to be enacted 8 months to a year before the change is required to allow time to amend and test systems. However, Parliament will be dissolved between August and October 2014 and usually rises over January. Implementing these options would likely require urgent legislation and for Inland Revenue to begin system changes before the legislation has been enacted. There is a risk that either the legislation will not be enacted in time, making it retrospective, or that Inland Revenue would be unable to change systems in time, leading to incorrect assessments.

59. The current penalty rules impose a 2% a month compounding rate on defaults. This means that overall debt quickly escalates. Nearly half of all liable parents in debt have penalties higher than the assessment debt. The reforms will reduce the penalty rate to 1% after a year in default. Options 1, 2 and 3 will delay or repeal this change, meaning debt will continue to climb. Experience indicates that compliance levels fall as debt accumulates and ages, especially when penalty debt begins to exceed the core assessment. This is a risk that debt becomes unmanageable, impacting on perceptions of the scheme and ultimately the welfare of the children.

Further analysis relating to Option 4 - *completing the first phase and part of the second phase*

60. In option 4 some, but not all, of the second phase would be implemented. This option would incorporate those aspects that have the greatest impact on debt, or which can be delivered at low cost in comparison to the other benefits expected to arise. Components that have limited benefits and significant costs or have a small impact on debt would not proceed.

61. A similar impact analysis is required on the different components of the second phase of the reforms to determine if they should form part of Option 4. The analysis is contained in the following table.

Option	*Meets objectives*	*Impacts*			*Recommendation and net impact*
		Advantages	*Disadvantages*	*Risks/Size*	
2.1 Keep wider income definition	A & C	A fairer income measure. Reduces need for an administrative review.	Higher compliance costs and administration costs High implementation cost.	Parents may not understand new definition Very limited numbers of parents actually impacted, less than 0.5% of possible parents	Not recommended. Very limited impact on outcomes does not justify cost.
2.4 Keep compulsory wage deductions with limited exemptions	A & D	More liable parents making payments on time.	Higher compliance costs and administration costs Requires policies for exemptions (eg privacy).	Parents may assume wage deductions meet all liabilities when it doesn't. Impacts on large number of employers	Not recommended. Compulsion relatively expensive and creates own problems.
2.4 Introduce voluntary wage deductions	A, B & D	More liable parents making payments on time. Compliance behaviour improves. No need for exemptions.	Higher compliance costs and administration costs	Impacts on smaller number of employers than compulsory deductions.	Recommended. Parents can choose best method of payment
2.10 Keep qualifying payments	C & D	Flexibility in payments Payments directly benefit the child	High compliance and administrative costs Requires agreement of both parents.	Very few people expected to meet criteria, less than 0.2% of possible parents	Not Recommended. Very limited impact on outcomes does not justify cost.
2.7 Keep offsetting of debt	A & C	Reducing debt Fairer. May encourage compliance.	Higher administration cost Receiving carer may receive insufficient income	Impacts a limited number of parents, less than 1% of possible parents	Not recommended. Very limited impact on outcomes does not justify cost.

Option	*Meets objectives*	*Impacts*			*Recommendation and net impact*
		Advantages	***Disadvantages***	***Risks/Size***	
2.5 & 2.6 Keep penalty rate changes – ongoing and late payment	A, C & D	Reduces new debt. Fairer.	Significant implementation cost but lower administration cost	Impacts a large number of parents	Recommended. Will make a significant impact on new debt.
2.8 Keep debt and penalty write-off provisions	A, C & D	Reduces new debt. Fairer. Improves incentives to re-comply. Lower admin costs/ better use of resources.	Significant implementation cost	Impacts a large number of parents	Recommended. Will make a significant impact on legacy debt.
2.3 Keep reduction in qualifying age	A & C	Matches international law and age limits in other social policies. Fairer. Reduces debt	Higher administration costs to determine if in school.	Impacts a reasonable number of parents and children.	Recommended. On balance, is value for money.
2.9 Keep re-establishment ground for administrative review	C & D	Recognises additional costs incurred for child's benefit. Very small implementation cost.		Unknown impact but expected to be small	Recommended. On balance, is value for money.
2.2 Keep underestimation penalty for receiving carers	D	Encourages receiving carers to provide their best estimate of current income.	Carers may be penalised even when they have provided best estimate.	Limited evidence that a penalty would improve compliance behaviour. Small numbers of people affected.	Not recommended. Unclear impact on outcomes does not justify cost.

CONSULTATION

62. A significant level of public consultation was undertaken on the original options for potential child support reform. There had also been consultation with a range of Government agencies on child support issues over several years. Feedback from these agencies had, wherever possible, been incorporated into the formulation of the original policy options and subsequent legislation. There was a general recognition from these agencies that the various issues with the child support scheme need to be addressed.

63. There was less opportunity to consult on the options in this RIS given the timing constraints on decision-making and the sensitivity of the changes. Treasury, the State Services Commission and the Department of Internal Affairs (in regards to the Government Chief Information Officer) were consulted. Their feedback is incorporated in the options considered.

CONCLUSIONS AND RECOMMENDATIONS

64. Inland Revenue supports option 4 (implement phase and part of phase 2 of the reforms). Proceeding with the first phase would provide more equitable financial support for children in a variety of circumstances. It would also better reflect many of the social and legal changes that have occurred since the introduction of the current scheme in 1991, in particular the greater emphasis on separated parents sharing the care of and financial responsibility for their children.

65. Inland Revenue supports some aspects of the second phase continue as enacted but that other aspects not proceed; aspects that were designed to provide general improvements to the operation of the child support scheme, particularly in regards to payments.

66. The aspects we support proceeding include the changes to the imposition of penalties, and the writing-off of penalties and debt, and a new voluntary wage deduction process to replace the proposed compulsory wage deduction process. These will encourage and facilitate parents to make timely child support payments for the benefit of their children, and to reduce debt. While these components have an implementation cost, the impact on debt across a significant number of child support parents justify the cost.

67. The associated cost of implementation is considered to exceed the expected benefits for the components we do not support proceeding. In most cases the benefits from these changes are now expected to impact on a much smaller group of parents than anticipated, and alternative existing process may exist to achieve the desired outcome, although at a higher compliance cost to those involved.

68. Overall, option 4 is recommended as it is close to the status quo in terms of the expected benefits to be delivered by the reforms, especially in relation to debt reduction, but at a significantly reduced implementation cost.

Summary of changes that are proceeding or not proceeding

First Phase

All aspects to proceed as enacted.

Second Phase

It is recommended that the following aspects continue:

- 2.3 reducing the maximum age of a qualifying child from under 19 to under 18, unless they are 18 and still in full-time secondary education – aligning with Working for Families age limit;
- 2.5 a two stage late payment penalty with an immediate 2% late penalty, with the remainder of the current 10% penalty only being charged if the debt remains unpaid after seven days;
- 2.6 a reduction in the ongoing monthly penalty rate from 2% to 1% after a year;
- 2.8 relaxing the circumstances in which penalties can be written-off, including when a liable parent enters into an instalment arrangement or is in serious hardship, when debt recovery is an inefficient use of Inland Revenue's resources or when only low levels of penalty debt are outstanding, and allowing Inland Revenue to write off assessed debt owed to the Crown on serious hardship grounds;
- 2.9 recognising re-establishment costs as a grounds for an administrative review;

It is recommended that a new voluntary wage deduction be introduced.

It is recommended that the following aspects no longer proceed:

- 2.1 a new definition of "adjusted net income", which includes income adjustments to taxable income, such as income in trusts and companies;
- 2.2 a penalty for receiving carers who are parents and who underestimate their income for the year;
- 2.4 compulsory deduction of child support from employment income, unless there are grounds for an exception such as privacy or cultural reasons;
- 2.7 the ability to offset current payments against past debts where the liable parent and receiving carer swap roles (that is, where the child moves to live with the other parent);
- 2.10 the discretion to recognise other payments, such as payment of school fees, as qualifying as child support payments where they directly benefit the child.

69. The total implementation cost of the recommended option is estimated at $163 million over the ten year period.

70. The components that do not proceed could be reconsidered in the future if the implementation costs can be reduced as part of, or following, the Business Transformation programme.

IMPLEMENTATION

71. Changes to the child support reform programme would require amendments to the Child Support Amendment Act 2013 and to any consequential provisions in other legislation. These amendments would be required before 1 April 2016, when the second phase comes into effect, and ideally before January 2016 as notices of assessments and communication with child support parents are usually issued in February each year.

72. The legislative amendments could be introduced as a stand-alone bill or may form part of a taxation omnibus bill. The next taxation bill is expected to be introduced after the 2014 election is concluded.

73. The scope of the child support reform implementation programme will be amended in accordance with Cabinet decisions and legislation. The programme will re-plan delivery of the remaining aspects of the reform accordingly, including any new performance indicators required. The child support reform implementation programme was subject to an independent review to determine why it was unable to deliver to the original timeframes. The recommendations of the review have been accepted and are being incorporated into the programme management to ensure the implementation of the revised reforms can be delivered on time.

74. Once implemented, Inland Revenue will enforce the new legislation as part of its usual business operations.

75. There is a risk that child support families will be confused about what the revised reforms mean for them. Communications will be prepared for child support families and key stakeholders to ensure they understand the changes. Inland Revenue websites will be updated, and an article included in a *Tax Information Bulletin*.

MONITORING, EVALUATION AND REVIEW

76. A programme governance group will oversee the implementation of the changes to ensure the legislative changes are delivered correctly. The changes, once implemented, will be monitored by senior managers to ensure they achieve the objectives. Any issues will be raised through Inland Revenue's internal processes. Complaints and correspondence will also be analysed to identify any issues with the new legislation or the implementation.

77. In accordance with the Generic Tax Policy Process (GTTP), the legislation will be reviewed and remedial changes may be included on a future tax policy work programme, subject to resources and priority.

78. In general, Inland Revenue's monitoring, evaluation and review of new legislation takes place under the GTPP: 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 contemplates the implementation and review stage, which can involve 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.

Regulatory Impact Statement

Black hole tax treatment of research and development expenditure

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

It provides an analysis of options to address the problems with the current "black hole" tax treatment of certain research and development (R&D) expenditure.

Generally, business taxpayers will try to reduce their income tax liability by claiming deductions for business expenditure, wherever possible, against their assessable income. "Black hole" expenditure is business expenditure that is not immediately deductible for tax purposes, and also does not form part of the cost of a depreciable asset for tax purposes and, therefore, cannot be deducted over time as depreciation.

Black hole tax treatment of expenditure can produce economic distortions. A taxpayer may choose to invest in an area where they can deduct or depreciate their expenditure instead of investing in an area where they cannot. If investing in the area that receives black hole tax treatment would have been the most efficient choice in the absence of taxation, the taxpayer's investment decision has been distorted by tax settings.

The preferred option would reduce these distortions, by allowing capitalised R&D expenditure to be either depreciated or deducted, depending on the particular circumstances.

Initial proposals to provide tax deductibility for capitalised R&D expenditure were consulted on via the release of a Government discussion document on 7 November 2013.

The discussion document proposed making capitalised development expenditure that creates an intangible asset with a reasonably certain useful life part of the depreciable costs of the asset. Submitters generally accepted that this was the appropriate way to treat this expenditure.

The discussion document also proposed allowing a deduction for capitalised R&D expenditure towards an unsuccessful intangible asset with a reasonably certain useful life when the asset is written off for accounting purposes. This proposal would have meant capitalised R&D expenditure towards intangible assets with uncertain useful lives would have remained non-deductible. A number of submitters were concerned that this would leave a significant category of capitalised R&D expenditure still never being deductible for tax purposes, and that this was not the appropriate treatment of expenditure on intangible assets with indefinite but finite useful lives. After consideration of this feedback, the proposals were altered to also make these costs deductible when the asset is written off for accounting purposes.

The Treasury and the Ministry of Business, Innovation and Employment were involved in the policy development of the options discussed in this RIS, and they agree with the conclusions and recommendations made.

There is some uncertainty around the estimated fiscal costs of the options, as significant assumptions were made in developing fiscal cost estimates, due to lack of source data and limited relevant additional information provided by submitters. There are no other significant constraints, caveats or uncertainties concerning the analysis undertaken.

The preferred option and the other alternative policy options will impose some additional compliance costs on businesses that wish to avail themselves of the proposed increased allowance of tax deductions for R&D expenditure. However, businesses would only incur these additional compliance costs in cases where they consider that the benefit to them of the increased allowance of deductions outweighs the costs.

None of the policy options would impair private property rights, restrict market competition, reduce the incentives for businesses to innovate and invest, or override fundamental common law principles.

Mike Nutsford
Policy Manager, Policy and Strategy
Inland Revenue

27 March 2014

STATUS QUO AND PROBLEM DEFINITION

Current tax rules

1. "Black hole" expenditure is business expenditure that is not immediately deductible for tax purposes, and also does not form part of the cost of a depreciable asset for tax purposes and, therefore, cannot be deducted over time as depreciation.

2. Under current tax rules, a person is allowed an immediate deduction for expenditure they incur on research or development up until an intangible asset is recognised for accounting purposes. Further development expenditure is capitalised.

3. Capitalised development expenditure can only be depreciated (that is, deducted over the life of an asset) for tax purposes once there is "depreciable property" under the Income Tax Act 2007 (ITA). Expenditure on intangible property may only be depreciated if the intangible property is listed in schedule 14 of the ITA, which lists items of "depreciable intangible property". For an item of property to be listed in schedule 14, it must be intangible and have a finite useful life that can be estimated with a reasonable degree of certainty on the date of its creation or acquisition.

4. In the event that a research and development (R&D) project does not create a depreciable asset for tax purposes, the development expenditure that has been capitalised will be rendered non-deductible, either immediately or over a period of time. This includes capitalised development expenditure on assets that are completely unsuccessful, as well as intangible assets that are useful but are not listed in schedule 14.

5. Moreover, even if the project does create an asset that is listed in schedule 14, capitalised development expenditure incurred in creating the asset may still be rendered non-deductible, either immediately or over a period of time. As explained in paragraphs 6 and 7 below, this may occur because, although the expenditure has given rise to an asset that is depreciable for tax purposes, the depreciable costs of the asset have been interpreted to exclude development expenditure.

6. An interpretation statement issued by Inland Revenue takes the view that the depreciable patent costs (for a taxpayer who has lodged a patent application with a complete specification or had a patent for an invention granted) are limited to the administrative and legal fees incurred in the patent process.[1] According to Inland Revenue's view of the law, capitalised development expenditure relating to the invention that is the subject of the patent (or patent application) is potentially neither deductible nor depreciable for tax purposes.

7. Although the interpretation statement is confined to patents, it is likely that the depreciable costs of plant variety rights would be interpreted in the same way, given that they are both types of intellectual property rights obtained by registration following an R&D process.

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[1] Interpretation statement "Income tax treatment of New Zealand patents", *Tax Information Bulletin* Vol 18, No 7 (August 2006), p 51.

The problem

8. Black hole tax treatment of expenditure can produce economic distortions. A taxpayer may choose to invest in an area where they can deduct or depreciate their expenditure instead of investing in an area where they cannot. If investing in the area that receives black hole tax treatment would have been the most efficient choice in the absence of taxation, the taxpayer's investment decision has been distorted by tax settings.

9. The scale of the problem cannot be quantified with any degree of precision, as we do not have direct information on what projects would have been undertaken in the absence of taxation. The vast majority of R&D expenditure is already immediately tax deductible. However, there is still room for improvement.

OBJECTIVES

10. The objectives against which the options are to be assessed are to:

(a) ensure economic efficiency by ensuring that, as far as possible, investment decisions are not distorted by tax considerations;

(b) provide certainty about the tax treatment of particular expenditures;

(c) minimise compliance costs for taxpayers; and

(d) ensure the coherency, consistency and integrity of the overall tax system.

11. Objective (a) is the key objective in this analysis because the aim of the review is to reduce the cases where tax rules may be discouraging R&D investments that would be undertaken in the absence of taxation. We recognise that there are likely to be trade-offs between these tax policy objectives. For example, the preferred option minimises economic distortions but will involve some compliance costs to ensure the integrity of the tax system.

12. It is also necessary to consider the Government's Business Growth Agenda (BGA), which emphasises the importance of building innovation to help grow New Zealand's economy. "Encouraging business innovation" is one of the seven key initiatives of the Building Innovation work stream, which recognises that enabling R&D is a key element in the innovation process.

REGULATORY IMPACT ANALYSIS

13. Several options have been considered for addressing the problem and achieving the stated objectives. These options are set out below.

Option one

14. Option one is to retain the status quo. Under the status quo, capitalised development expenditure will continue to be neither deductible nor depreciable for tax purposes.

Option two

15. Option two is to allow failed capitalised development expenditure, which the taxpayer intended would lead to an item of "depreciable intangible property", to be depreciated over the estimated useful life of the asset the development expenditure was intended to create.

Option three

16. Option three is to allow an immediate deduction for failed capitalised development expenditure, which the taxpayer intended would lead to an item of "depreciable intangible property", upon the intangible asset being written off for accounting purposes.

Option four (preferred option)

17. Option four is to allow a one-off tax deduction for capitalised development expenditure upon the intangible asset to which it relates being written off for accounting purposes, for taxpayers who have developed intangible assets that are not depreciable for tax purposes. This would apply irrespective of whether the asset was useful for a period or a completely unsuccessful investment.

Option five

18. Option five is to allow capitalised development expenditure that creates an intangible asset with an uncertain useful life to be depreciated over a given period of time. This would apply irrespective of whether the asset was useful for a period or a completely unsuccessful investment.

Option six

19. Option six is to:

- allow capitalised development expenditure that creates a useful intangible asset with an uncertain useful life to be depreciated over a given period of time; and
- allow an immediate deduction for capitalised development expenditure that gives rise to a completely unsuccessful intangible asset upon the asset being written off for accounting purposes.

Further proposals

20. Additionally, each of options two to six, would allow capitalised development expenditure that creates an intangible asset with a useful life that can be estimated with a reasonable degree of certainty at the time of its creation to be depreciated over that life.

21. As an integrity measure, each of options two to six would also involve the introduction of appropriate claw-back rules (outlined below).

22. In the event that an intangible asset that has been written off for accounting purposes becomes useful, it is proposed that any capitalised development expenditure previously allowed as a tax deduction would be clawed back as income. The clawed-back amount would then be able to be depreciated over the estimated useful life of the asset, if the asset is depreciable.

23. In the event that an intangible asset that has been written off for accounting purposes is sold, it is proposed that any capitalised development expenditure previously allowed as a tax deduction (or the sale proceeds, if this amount is lower) would be clawed back as income.

Impacts of options

24. The table below summarises the impacts of each of the options.

Table 1: Impacts of the options

Option	Meets objectives?	Impacts					Net impact
		Economic impact	Fiscal impact	Administrative impacts	Compliance impacts	Risks	
One *Status quo*	No	Potential for capitalised R&D expenditure to receive black hole tax treatment and this could discourage investments in R&D that would have been undertaken in the absence of taxation.	No impact.	No impact.	No impact.	None.	Does not address the problem or achieve any of the stated objectives, as it may lead to a sub-optimal level of investment in R&D.
Two	No	Would reduce the tax distortion against some R&D investments, but there would still be distortions as not all capitalised R&D expenditure would be covered. Economically neutral between successful and unsuccessful projects.	Fiscal cost is unquantified, but would likely be lower than option 3, as the deductions for failed capitalised development expenditure would be spread over time rather than taken immediately upon write off.	No systems implications for Inland Revenue, but there may be some minor one-off additional administrative costs, which would be met within existing baselines.	Some additional compliance costs, but taxpayers would only incur them where they consider the benefit of the increased allowance of deductions outweighs them. Depreciation of failed capitalised expenditure means higher compliance costs than options 3 and 4.	Potential perception that this option does not go far enough, as it would not provide tax deductibility for capitalised development expenditure on intangible assets with uncertain useful lives.	Does not fully address the problem, and fails to achieve any of the stated objectives. Specific concerns include: • Distortions and some uncertainty would remain. • Inconsistent with the usual treatment of failed capitalised expenditure. • Incoherence between treatment of expenditure on assets with reasonably certain useful lives and assets with finite but indefinite useful lives. • Increased compliance costs.

Three	C	Would reduce the tax distortion against some R&D investments, but there would still be distortions as not all capitalised R&D expenditure would be covered.	Under the preferred transitional approach, estimated aggregate fiscal costs of $5.3m over the period 2014/15 to 2017/18.	No systems implications for Inland Revenue, but there may be some minor one-off additional administrative costs, which would be met within existing baselines.	Some additional compliance costs, but taxpayers would only incur them where they consider the benefit of the increased allowance of deductions outweighs them. Immediate deduction for failed capitalised expenditure means lower compliance costs than options 2, 5 and 6.	Potential perception that this option does not go far enough, as it would not provide tax deductibility for capitalised development expenditure on intangible assets with uncertain useful lives.	Does not fully address the problem, and fails to achieve all of the stated objectives. Specific concerns include: • Distortions and some uncertainty would remain. • Incoherence between treatment of expenditure on assets with reasonably certain useful lives and assets with finite but indefinite useful lives.
Four *Preferred option*	A, B, C and D	More effective than options 2 and 3 in reducing the tax distortion against R&D investments. Greatest expected improvement in productivity and growth.	Under the preferred transitional approach, estimated aggregate fiscal costs of $13.1m over the period 2014/15 to 2017/18.	No systems implications for Inland Revenue, but there may be some minor one-off additional administrative costs, which would be met within existing baselines.	Some additional compliance costs, but taxpayers would only incur them where they consider the benefit of the increased allowance of deductions outweighs them. One-off tax deduction for capitalised expenditure on non-depreciable intangible assets means lower compliance costs than options 2, 5 and 6.	Would place additional pressure on the definition of R&D and Inland Revenue's ability to monitor the line between capitalised R&D expenditure and other capitalised expenditure.	Addresses the problem and achieves all of the stated objectives. Overall, greatest improvement upon the status quo as it would reduce the tax distortion against R&D investments, provide the most coherence and certainty, and minimise increases in compliance costs.

Five	B	More effective than options 2 and 3 in reducing the tax distortion against R&D investments. Could provide a tax-subsidy to investment in R&D-generated intangible assets with uncertain useful lives.	Fiscal cost is unquantified, but would likely be higher than options 2 and 3 due to the wider ambit of capitalised development expenditure that would be eligible for deductions, and lower than option 6 as the deductions for failed capitalised development expenditure on intangible assets with uncertain useful lives would be spread over time rather than taken immediately upon write off.	No systems implications for Inland Revenue, but there may be some minor one-off additional administrative costs, which would be met within existing baselines.	Some additional compliance costs, but taxpayers would only incur them where they consider the benefit of the increased allowance of deductions outweighs them. Depreciation of capitalised expenditure that creates an asset with an uncertain useful life means this option has the highest compliance costs.	Would likely create pressures for assets with longer (but certain) finite lives to be characterised as assets with finite but indefinite lives. Would place additional pressure on the definition of R&D and Inland Revenue's ability to monitor the line between capitalised R&D expenditure and other capitalised expenditure.	Does not fully address the problem, and fails to achieve all of the stated objectives. Specific concerns include: • Would potentially provide a tax-subsidy for certain investments. • Potential incoherence between tax treatments proposed for R&D-generated intangible assets with reasonably certain useful lives and those with uncertain useful lives. • Does not minimise compliance costs.
Six	B	More effective than options 2 and 3 in reducing the tax distortion against R&D investments. Could provide a tax-subsidy to investment in R&D-generated intangible assets with uncertain useful lives.	Fiscal cost is unquantified, but would likely be higher than options 2 and 3 due to the wider ambit of capitalised development expenditure that would be eligible for deductions, and higher than option 5 as the deductions for failed capitalised development expenditure on intangible assets with uncertain useful lives would be taken immediately upon write off rather than spread over time.	No systems implications for Inland Revenue, but there may be some minor one-off additional administrative costs, which would be met within existing baselines.	Some additional compliance costs, but taxpayers would only incur them where they consider the benefit of the increased allowance of deductions outweighs them. Depreciation of capitalised development expenditure that creates a useful intangible asset with an uncertain useful life means higher compliance costs than options 3 and 4.	Would likely create pressures for assets with longer (but certain) finite lives to be characterised as assets with finite but indefinite lives. Would place additional pressure on the definition of R&D and Inland Revenue's ability to monitor the line between capitalised R&D expenditure and other capitalised expenditure.	Does not fully address the problem, and fails to achieve all of the stated objectives. Specific concerns include: • Would potentially provide a tax-subsidy for certain investments. • Potential incoherence between tax treatments proposed for R&D-generated intangible assets with reasonably certain useful lives and those with uncertain useful lives. • Does not minimise compliance costs.

Fiscal costs

25. The fiscal cost estimates should be treated with some caution. Due to lack of source data and limited relevant additional information provided by submitters, significant assumptions were made in developing them, for example:

- the stock of capitalised R&D expenditure;
- the percentage of capitalised R&D expenditure that will be depreciated; and
- the R&D failure rate.

26. Inland Revenue has carried out sensitivity analysis around some of the assumptions and the fiscal costs do not vary materially.

Compliance costs

27. The proposed changes are taxpayer-friendly, but will impose some additional compliance costs on businesses that wish to avail themselves of the proposed increased allowance of tax deductions for R&D expenditure. These additional compliance costs are associated with:

- complying with a higher accounting standard than the new minimum requirements;[2]
- claiming a deduction for expenditure that previously would have been non-deductible; and
- application of the proposed claw-back rules for written off assets that become useful or are sold.

28. However, these additional compliance costs would only be imposed on those businesses that wish to avail themselves of the proposed increased allowance of tax deductions for R&D expenditure. Therefore, businesses would only incur these additional compliance costs in cases where they consider that the benefit to them of the increased allowance of deductions outweighs the costs. Furthermore, we consider that the proposed claw-back rules are important integrity measures which would not be expected to often require application.

Social, environmental or cultural impacts

29. There are no social, environmental or cultural impacts associated with any of the options considered above.

Net impact of all options

30. The preferred option (option four) addresses the problem by reducing the cases where tax rules could discourage R&D investments that would be undertaken in the absence of taxation. It also achieves all of the stated objectives.

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[2] We note that, when the Financial Reporting Act 2013 comes into effect on 1 April 2014, minimum financial reporting requirements will be reduced for many businesses. The current tax provisions that allow a tax deduction for R&D expenditure, and the proposal to allow a tax deduction for taxpayers who have developed intangible assets that are not depreciable for tax purposes, are linked to particular accounting standards.

31. Inland Revenue does not support options one, two, five and six because they do not fully address the problem and fail to achieve some or all of the stated objectives. We originally preferred option three (the discussion document's proposal) but after consideration of the feedback received, and further analysis of that option, it is no longer preferred.

CONSULTATION

32. Public consultation was carried out via the release of a consultation document, *Black hole R&D expenditure: a government discussion document*, on 7 November 2013.

33. The proposals in the discussion document were essentially option three in the above regulatory impact analysis.

34. Twelve submissions were received in relation to the discussion document. The submissions were generally supportive of the intent of the proposals to relieve black hole R&D expenditure. However, many submitters were concerned that the initial proposals would still leave a significant category of capitalised development expenditure never being deductible for tax purposes. These submitters argued that this was not the appropriate treatment of expenditure on intangible assets with indefinite but finite useful lives. These submitters wanted the scope of the proposals widened to provide tax deductibility for – both successful and unsuccessful – capitalised development expenditure towards intangible assets that are *not* listed in schedule 14 of the ITA.

35. While it would be inappropriate, from an economic perspective, to allow tax deductibility for expenditure towards creating an asset that would not have been likely to have a finite life if successful, we recognise that technology tends to move at a relatively fast pace and that it is likely that R&D-generated assets will have limited lives, even if those lives are not capable of being estimated with a reasonable degree of certainty at the time of the asset's creation. We were therefore sympathetic towards the submitters' concern.

36. In order to respond to this concern, we considered alternative options that would eliminate black hole R&D expenditure on a prospective basis. This led us to alter the proposals, arriving at option four as our preferred option.

37. The Treasury and the Ministry of Business, Innovation and Employment have been consulted and agree with our conclusions and recommendations.

CONCLUSIONS AND RECOMMENDATIONS

38. We recommend:

- allowing capitalised development expenditure that creates an intangible asset with a useful life that can be estimated with a reasonable degree of certainty at the time of its creation to be depreciated over that life; and

- allowing a one-off tax deduction for capitalised development expenditure upon the intangible asset to which it relates being written off for accounting purposes, for taxpayers who have developed intangible assets that are not depreciable for tax purposes. This would apply irrespective of whether the asset was useful for a period or a completely unsuccessful investment; and

- introducing appropriate claw-back rules that would apply when an intangible asset that has been written off for accounting purposes becomes useful or is sold.

39. The proposals would enable all capitalised R&D expenditure to be deducted (thereby providing certainty of tax treatment) and would reduce the cases where tax rules discourage R&D investments that would be undertaken in the absence of taxation, but without potentially providing a tax-subsidy to investment in R&D-generated intangible assets with uncertain useful lives.

40. The proposed tax treatment of successful capitalised development expenditure on intangible assets with reasonably certain useful lives is consistent with the usual tax treatment of capitalised expenditure that has created a depreciable asset.

41. The proposed tax treatment of failed capitalised development expenditure is consistent with the usual tax treatment of failed capitalised expenditure. While the proposed tax treatment of capitalised development expenditure that creates useful assets with uncertain useful lives is unusual, it has the effect of restricting deductions to cases where it is clear that the expenditure is of no on-going value. For this reason, we prefer it to depreciating the expenditure over a given period of time, which will inevitably be too short in some cases (implying a tax-subsidy) and too long in others. As technology tends to move at a relatively fast pace, it is likely that R&D-generated assets will have limited useful lives, even if those lives are not capable of being estimated with a reasonable degree of certainty at the time of the asset's creation. Therefore, the proposed treatment improves upon the status quo, as not allowing any deduction for expenditure that has created an asset with a finite useful life is inappropriate.

42. While there may be some additional compliance costs (as compared to the status quo) in order to get a deduction, taxpayers will only incur these additional costs where they consider that the benefit to them of the increased allowance of deductions outweighs the costs. The preferred option minimises these compliance costs by allowing a one-off tax deduction for capitalised development expenditure rather than requiring taxpayers to depreciate failed expenditure or successful expenditure on assets with uncertain useful lives over time.

IMPLEMENTATION

Transitional approach

43. We considered three options (set out in the table below) for transitioning to the proposed new rules. We note that most of these options are linked in some way to the date of release of the discussion document (that is, 7 November 2013). The reason why this date was chosen, as opposed to a prospective date, is that this latter alternative may have created an undesirable incentive for taxpayers to defer their R&D spending in anticipation of the proposed new rules.

Table 2: Transitional options

	Option 1 (preferred option)	Option 2	Option 3
R&D that creates a depreciable intangible asset	Only capitalised R&D expenditure incurred from 7 November 2013 would be eligible for depreciation deductions.	All capitalised R&D expenditure (whenever incurred) relating to assets created (that is, recognised for tax purposes) from 7 November 2013 would be eligible for depreciation deductions.	In addition to allowing all capitalised R&D expenditure (whenever incurred) on new assets to be depreciated, pro-rated depreciation deductions would be allowed for capitalised R&D expenditure that relates to existing assets.
R&D that does not create a depreciable intangible asset	Only capitalised R&D expenditure incurred from 7 November 2013 would be eligible for the one-off tax deduction upon write off for accounting purposes of the intangible asset to which it relates.	All capitalised R&D expenditure (whenever incurred) relating to intangible assets written off for accounting purposes from 7 November 2013 would be eligible for the one-off tax deduction.	All capitalised R&D expenditure (whenever incurred) relating to intangible assets written off for accounting purposes from 7 November 2013 would be eligible for the one-off tax deduction.

Analysis of options

44. Option 1 only gives deductions for new R&D expenditure, whereas options 2 and 3 would give windfall gains to those who have incurred sunk costs in developing assets. Therefore, option 1 is the most targeted of the three options, with options 2 and 3 providing increasing recognition that the status quo is a poor outcome under tax policy frameworks through providing relief from black hole expenditure on an increasingly wider ambit of historical R&D expenditure.

45. Although option 3 would allow the widest ambit of depreciable expenditure, there would be higher compliance costs associated with apportionment and integrity issues in relation to old documentation of costs. Option 1 could have slightly higher compliance costs than option 2, associated with the need to go back and attribute expenditure to pre- and post- 7 November 2013.

46. The annual fiscal cost of all three options would eventually converge. However, over the short to medium term, option 1 would be the least fiscally expensive, and option 3 would be the most fiscally expensive.

47. Options 2 and 3 offer an additional benefit in that they would reduce the bias that those who have incurred sunk costs developing an asset have towards selling the resulting asset over continuing to hold it. This bias exists because, currently, a purchaser of one of these assets can depreciate the entire purchase cost, which means that such assets are potentially more valuable to purchasers than to the person who has developed them.

Preferred transitional approach – conclusion

48. We prefer option 1, which only gives deductions for new R&D expenditure, because the fiscal cost incurred as a result of the proposed changes would be more closely aligned with the Government's objective of increasing new business R&D.

49. Options 2 and 3 would give windfall gains to those who made an economic decision to proceed with developing an asset in the expectation that development expenditure incurred from the point of asset recognition for accounting purposes would be neither immediately deductible nor depreciable. These options are estimated to be considerably more fiscally expensive over the short to medium term, but would provide limited additional benefit in reducing the bias that those who have incurred sunk costs developing an asset have towards selling the resulting asset over continuing to hold it.

Further implementation details

50. If approved, the proposals will require changes to the Income Tax Act 2007. These changes would be included in the next available taxation bill after Budget 2014 and take effect from the 2015/16 income year.

51. When introduced to Parliament, commentary will be released explaining the amendments, and further explanation of their effect will be contained in a Tax Information Bulletin, which would be released shortly after the bill receives Royal assent.

52. The proposals would have no systems implications for Inland Revenue but may result in some additional administrative costs, such as costs associated with publications to communicate the changes. These costs are expected to be insignificant and would be met within existing baselines.

MONITORING, EVALUATION AND REVIEW

53. 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 contemplates the implementation and review stage, which can involve 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.

Regulatory Impact Statement

Calculating the fringe benefit arising from employment-related loans

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

It provides an analysis of options for a remedial change to widen the group of employers who are eligible to use the market interest rate method of determining the fringe benefit arising from an employment-related loan. The issue arose out of concerns that some subsidiaries within banking groups could not use the method, even though the parent could. This leads to the subsidiaries overpaying fringe benefit tax, compared to the parent bank.

The proposed change is consistent with the key objective as per the original policy intention, which was to ensure that persons who are able to easily determine the market interest rate on comparable loans to third parties can use the market interest rate method. A second objective was to ensure that tax considerations did not impact on economic efficiency.

While our understanding is that only a limited number of organisations will be affected by the change, limitations on the available fiscal data have constrained the analysis. Estimates of the fiscal costs ($720,000 per annum) and other costs have relied on an extrapolation of industry provided figures, combined with the use of Inland Revenue's available information.

Limited targeted consultation was undertaken. The New Zealand Bankers' Association brought the issue to Inland Revenue's attention, and wider consultation was not undertaken, due to the narrow, technical nature of their issue, the fact that they represent a large number of the affected persons, and the potential to address the issue promptly through an up-coming bill.

Widening the group of entities eligible to use the market interest rate is unlikely to impose additional costs on businesses, particularly given that the use of the method is voluntary. Businesses that choose not to use the method may continue to use the prescribed rate, as set by regulation.

None of the policy options impair private property rights, restrict market competition, reduce the incentives on businesses to innovate and invest, or override fundamental common law principles.

Marie Pallot
Policy Manager, Policy and Strategy
Inland Revenue

10 October 2014

STATUS QUO AND PROBLEM DEFINITION

Fringe benefits

1. Remuneration received by a person in exchange for providing employment services is taxable. To prevent erosion of the tax base at the margins, certain non-monetary benefits provided by employers to their employees are also taxed, as fringe benefits. Fringe benefit tax (FBT) helps to ensure neutrality between paying employees in cash and in kind. One kind of fringe benefit that may be provided by an employer is a discounted loan.

2. Where an employer provides an employee with a loan with terms that are more favourable than the terms that the employee would be able to obtain from a third party, a fringe benefit arises. The amount of the fringe benefit is the additional amount of interest that would have been payable for a loan with similar terms, compared to the amount actually paid under the terms of the loan.

Tax treatment of employment-related loans

3. There are two methods that may be used to calculate the fringe benefit arising from an employment related loan. Most employers use the prescribed rate method to determine the amount of the fringe benefit that arises. The prescribed interest rate is set by regulation, with reference to the prevailing variable first-mortgage housing rate determined by Reserve Bank survey. This ensures that the prescribed rate is in line with market rates.

4. In some cases, the prescribed rate will exceed the rate that a third party lender would offer an individual. This is because the prescribed rate is determined based on publicly advertised interest rates for first mortgages. However, many individuals can negotiate a lower rate than the advertised rate for this type of borrowing.

5. Since 2006, persons in the business of lending money to the public (generally, financial institutions such as banks) have been able to elect to use the market interest rates to determine the fringe benefit that arises in relation to an employment-related loan, as an alternative to the prescribed rate method. The relevant market rate is the interest rate that would apply to a loan of the same kind, provided to a borrower belonging to a group of persons with comparable credit risk to the employee, dealing on an arm's length basis.

6. Employers who are not in the business of lending money to the public are not able to use the market interest rate method to value the fringe benefit from a loan, as they are not expected to have systems in place to monitor market rates without incurring undue compliance costs. In contrast, lenders will have these systems.

7. Where an employer who is in the business of lending money to the public elects to use the market interest rate method in relation to a loan, they are required to notify the Commissioner of Inland Revenue at least one year before the income year in which they will first apply the method, and must apply the method for at least two income years. This requirement is to prevent persons from switching between methods, to gain an advantage.

Problem definition

8. The banking sector has found that the focus solely on the business of the employer has created issues in practice. A company may provide fringe benefits to the employees of other companies within the same group. In the case of a financial institution, the benefit may be a loan. However, the FBT rules treat the employees' employer as providing this benefit, so they may only use the market interest rate method to value the benefit if they are a lender themselves.

9. In practice groups of companies will share information among the members, and a financial institution within a group of companies can provide the information necessary to determine the market interest rate to other companies within the group. These companies form a readily identifiable class of employers who may be able to easily apply the market interest rate method, and may be treated as an extension of the policy that persons in the business of lending money to the public can apply the method.

10. The consequence of the status quo may be a higher FBT liability for the employer, and more FBT revenue for the Government. The status quo also creates some concerns regarding economic efficiency, as it encourages employing personnel through the lender(s) within the group, over other companies in the group that do not lend money to the public.

11. This may lead to tax considerations affecting decisions around which entity to employ persons through. This is particularly so for wholly owned groups, which function as a single economic unit, and who may otherwise be indifferent between separating certain (non-lending) functions into other companies or retaining them within the company which is lending.

OBJECTIVES

12. The objectives of the proposed change are to:
   (a) ensure that persons who are able to easily determine the market interest rate of an employment-related loan can use the market interest rate method to determine their FBT liability;
   (b) maximise economic efficiency; and
   (c) minimise compliance costs.

13. One of the key features of the current rules for taxing employment-related loans is that persons do not incur undue compliance costs. Consistent with this policy choice, allowing a wider group of persons to apply the market interest rate method should not be pursued at the expense of increased compliance and administrative costs. Ensuring that persons who are able to easily determine the market interest rate of an employment-related loan may use the market interest rate method is consistent with limited compliance implications.

14. Maximising economic efficiency is a secondary consideration. The identified efficiency concern results from hiring decisions within groups which include a lender. Achieving this objective is likely to follow from widening the group of persons who may apply the market interest rate method, to include those associated with financial institutions.

REGULATORY IMPACT ANALYSIS

15. Two options have been identified to address the problem and meet the stated objectives, along with the status quo:

- ***Option one:*** Employers who are a member of a wholly owned group of companies (which includes a person in the business of lending to the public) may use the market interest rate method.
- ***Option two:*** Employers who are a member of a group of companies (which includes a person in the business of lending to the public) may use the market interest rate method.
- ***Option three:*** Only employers who are in the business of lending to the public may use the market interest rate method (status quo).

Groups of employers

16. The Income Tax Act 2007 provides rules for grouping companies which share common ownership. The test looks at the ownership of the companies and the extent to which the same owners have the same interest in each company.

17. For a company to be part of the same *group of companies* as another company, the same person or persons must generally have common voting interests of at least 66%. A person has a common voting interest where they own voting rights in both companies.

18. For a company to be part of the same *wholly owned group of companies* the common voting interest required is 100%. Therefore, a person who is in the same wholly owned group of companies as another person will always also be within the same group of companies as that person.

Option	*Meets objectives*	*Impacts*				*Net impact*
			Fiscal/economic impact	*Administrative and compliance impacts*	*Risks*	
One *Employers who are in the same wholly owned group*	a, b and c	Tax system	Fiscal cost of approximately $720,000 p.a.	Minimal additional administrative costs for Inland Revenue. Self-assessment means that costs are mostly confined to updating communications products	Minimal. Affected employers are expected to possess the necessary sophistication to correctly apply the method.	Expands eligibility to apply the market interest rate method to a wider group of persons, while minimizing compliance costs.
		Employers	Fiscal benefit of approximately $720,000 p.a. for companies within the same wholly owned group as a lender. Efficiency gain as FBT will not affect employment decisions within the wholly owned group.	The affected employers are expected to be able to apply the market interest rate method without difficulty. Employers may choose to continue to use the existing method.		
Two *Employers who are in the same group*	a, b and c	Tax system	Fiscal cost of approximately $720,000 p.a.	As for Option one.	As for Option one.	Option two more fully meets the objectives than Option one, as it expands eligibility to a wider group of persons. This may not make a material difference now given that most banking group companies are wholly owned, but provides greater flexibility for the future. The wider group is not expected to incur additional compliance costs or pose a significantly increased risk over Option one.
		Employers	Fiscal benefit of approximately $720,000 p.a. for companies within the same group as a lender. Efficiency gain as FBT will not affect employment decisions within the group.	As for Option one.		

Three *Status quo*	c	Tax system	No fiscal cost.	No change.	The status quo maintains the current approach of confining the use of the market interest rate method to a narrower group of persons, within those expected to have the technical ability to apply it correctly.	No change.
		Employers	Maintains the existing FBT preference for groups including financial institutions to employ persons through the financial institution. The taxpayers will continue to return FBT using the prescribed interest rate method, which will result in an approximately $720,000 p.a. larger FBT liability than if they could use the market interest rate method.	No change.		

Fiscal and economic impact

19. Option one is likely to have a fiscal cost of approximately $720,000 p.a. This represents a decrease in FBT of $1 million p.a. However, since FBT is deductible for the employer, there will be a corresponding increase in company tax by $280,000. The fiscal cost is based upon an extrapolation of information provided by the banking sector, for groups of companies. The reduced revenue will translate to a benefit for the affected employers, whose FBT liability has decreased by a corresponding amount.

20. The cost of Option two is expected to be largely similar to that of Option one (approx. $720,000 per annum) on the basis that most of the FBT effect is attributable to entities within the narrower wholly owned group. However, the wider coverage could be more relevant in the future, for example if a wholly owned subsidiary of a bank was to be partially sold.

21. The reduction in revenue arises because the market interest rate method and the prescribed rate method ascribe different values to the loan, with the prescribed rate method generally calculating a slightly greater benefit.

22. In both Option one and Option two there is a potential efficiency gain as the FBT outcome will no longer potentially impact on placement of employees within the group. The potential gain is greater for Option two, as it applies to a wider group; however this may be partially offset by the fact that employment through the financial institution or a company within the same wholly owned group is likely to be more substitutable than between the financial institution and the group companies which are not wholly owned.

Social, environmental or cultural impacts

23. There are no social, environmental or cultural impacts associated with any of the options.

Net impact

24. Option one achieves all three stated objectives. It expands the group of persons able to apply the market interest rate method to a slightly wider group of taxpayers who could be expected to easily apply the method, without posing significant risk.

25. Option two is similar to Option one, in that it meets all three of the stated objectives. However, Option two expands eligibility, and increases economic efficiency for to a slightly wider group of persons than Option one.

26. Option three presents no changes.

CONSULTATION

27. Limited targeted consultation was undertaken. The New Zealand Bankers' Association (NZBA) advocated for members of groups of companies (common ownership of 66% or more) which include a lender to be able to apply the market interest rate method. The NZBA strongly supported this threshold, as some entities associated with its members are not wholly owned, but have minority interests. In support of their submission, they cited the fact that group companies would have the same information available as the lender, and identified

concerns that the status quo could lead to tax-induced biases in employing staff through lenders, where normal commercial considerations may favour other entities.

28. Wider consultation was not undertaken, in the interest of responding to this identified concern in as timely a manner as possible. This was seen as a potential opportunity for an incremental change consistent with the established policy. It was also seen as taxpayer-friendly and low-risk, and could be included in the upcoming taxation omnibus Bill, to secure prompt benefit for those affected.

CONCLUSIONS AND RECOMMENDATIONS

29. Option one benefits employers within the same wholly owned group of companies as a lender. Extending eligibility to apply the market interest rate method to these employers poses little risk as they are expected to be able to easily apply the method correctly. The exact cost of this option is estimated at approximately $720,000 p.a.

30. Option two benefits a slightly wider group of employers, those within the same group of companies as a lender. This necessarily includes all the persons affected by Option One and will affect a number of additional banking group companies which have minority shareholders. This option provides greater flexibility for the future.

31. Extending eligibility to these employers likewise poses little risk. This option is expected to have a fiscal cost to the government, and a corresponding benefit to the affected employers largely similar to that of Option one (approximately $720,000 p.a).

32. Either of these options would potentially result in an efficiency gain, as FBT outcomes would not affect hiring decisions within the affected group.

33. Inland Revenue's preferred approach is Option two: allowing employers in the same group of companies as a lender to apply the market interest rate method, on the basis that it better meets the first objective, by enabling a wider group of persons who could easily apply the market interest rate method to do so. Group companies should still have access to the necessary information, and the potentially wider approach does not seem to pose any additional risk. Several other provisions in the FBT rules are based on whether companies are within the same group.

IMPLEMENTATION

34. Both Option one and Option two would require changes to the Income Tax Act 2007 to allow the groups of affected employers to use the rules. Option three (the status quo) does not require any changes to implement.

35. An amendment to the Income Tax Act 2007 could be included in the tax bill scheduled for introduction in November 2014. Legislative amendments could apply from the date the Bill receives Royal assent.

36. The current legislation imposes requirements on a person who wishes to use the market interest rate method – they must notify the Commissioner at least one year before the income year in which they wish to use the method. They must then use the method for that and the following income year, to avoid flip-flopping. This would mean that, for an amendment Act

receiving assent in 2015, taxpayers with standard balance dates could give notice before 1 April 2016, and begin applying the method from 1 April 2017.

37. To facilitate adoption of the method, affected employers could be temporarily given the opportunity to elect to apply the method from the FBT quarter following the election. To integrate this with the requirement that the person apply the method for two income years, where this does not correspond with the start of an income year, the part of an income year where the rules are applied could be treated as a full income year. Such an exception to the ordinary rule is unlikely to lead to flip-flopping.

38. Implementation is not expected to lead to compliance costs for the affected employers.

39. If the amendment is made, it would be publicised through inclusion in the commentary to the implementing bill. Inland Revenue would also include the item in a Tax Information Bulletin once the bill received Royal assent.

40. Inland Revenue would administer the changed rules through the ordinary business processes.

MONITORING, EVALUATION AND REVIEW

41. There are no plans to monitor, evaluate and review the changes after they become law. This is because the remedial change is consistent with the policy underlying the rules. If any specific concerns are raised, officials will determine whether there are substantive grounds for review under the Generic Tax Policy Process. Also, the Income Tax Act 2007 is subject to regular review by officials. As per the normal process, there will be an opportunity for submissions to be made on the proposed changes during the select committee stage of the tax bill that any legislative change is contained in.

Regulatory Impact Statement

Bodies corporate GST obligations

This Regulatory Impact Statement has been prepared by Inland Revenue.

It provides an analysis of options to determine the appropriate GST treatment of bodies corporate. This is the second RIS that considers the GST treatment of bodies corporate; the first was prepared on 28 March 2014. This analysis follows submissions received on the discussion document *GST Treatment of Bodies Corporate* released on 6 June 2014, which sought public feedback on the approach preferred under the previous RIS (option 2 in this RIS).

As a result of feedback received on the discussion document, the preferred option has changed to being option 4 (optional approach).

There are four key constraints / caveats on the analysis:

1. Because of data limitations it is not possible to determine exactly how many bodies corporate are currently registered for GST, or would be required to register because they exceed the $60,000 registration threshold. (This threshold is made up of levies received by unit owners but could also be made up of sales of goods and services to third parties).

2. Again because of data limitations it is not usually possible for Inland Revenue to identify whether a GST return is from a body corporate. This means we have incomplete information on the number of bodies corporate which may have taken a tax position to claim input tax deductions in respect of leaky building repairs.

3. The estimate of the potential fiscal cost of refunds for leaky buildings is uncertain as it is based on a 2009 PricewaterhouseCoopers estimate of the costs associated with fixing weathertightness problems in multi-unit dwellings.

4. The estimate of the potential fiscal cost of cashing out reserves if all bodies corporate were to be deregistered is uncertain again due to data limitations. The estimate is based on an assumption about the average level of cash reserves held by registered bodies corporate.

A range of options has been considered and measured against the objectives of providing certainty, consistency and fairness of GST treatment whilst minimising compliance costs and disruption to current practices. There are no environmental or cultural impacts from these recommended changes.

There are no other significant constraints, caveats or uncertainties concerning this regulatory impact analysis other than those noted above.

None of the policy options would restrict market competition, reduce the incentives for businesses to innovate and invest, unduly impair private property rights or override fundamental common law principles.

Marie Pallot
Policy Manager,
Policy and Strategy
Inland Revenue
25 November 2014

STATUS QUO AND PROBLEM DEFINITION

Background

Bodies corporate

1. The GST system requires businesses and other entities to register for GST if they supply goods or services worth more than $60,000 in a 12-month period. Generally, GST-registered persons are required to file GST returns and pay GST on the majority of the goods and services they supply. In simple terms, the amount of GST that they pay is based on the value of these supplies less the GST cost of any inputs that they purchase from other GST registered persons. In this respect the GST system only taxes the "value added" by each business in a supply chain.

2. A body corporate is a legal entity created under the Unit Titles Act 2010[1] when multiple owners have unit title properties in an apartment building or similar complex. The body corporate is made up of all of the property owners and provides a way for the owners to act together with regard to their common and shared interests. Because bodies corporate always intend to spend all of their money, they are, in the ordinary course of events, largely tax neutral over time.

Historic position

3. Currently, most bodies corporate (of which there are approximately 13,800 in total) are not registered for GST and Inland Revenue's historic position has been to not allow bodies corporate to register. A High Court decision in *Taupo Ika Nui Body Corporate v CIR* (1997) appeared to support this position by suggesting that most residential bodies corporate would not be required to register for GST because they did not make supplies to unit owners for consideration.

4. However, despite this longstanding view, some bodies corporate have registered for GST (which is likely due to inconsistent administrative practice), including some that have been able to claim refunds in relation to leaky building repairs.

Inland Revenue legal analysis

5. In an effort to resolve the inconsistency, Inland Revenue more recently undertook a legal analysis of the existing law and came to a view that bodies corporate could be considered to be providing services to their owners for consideration (in the form of body corporate fees). Under this interpretation, bodies corporate that receive more than $60,000 in levies (and potentially other payments) should be registered for GST. As with other taxpayers, bodies corporate below the $60,000 threshold would be able to register voluntarily.

6. This legal view was consulted on in *IRRUIP7: Bodies Corporate – GST Registration* which was released in May 2013. Forty-two submissions were received on the legal position and the appropriate policy outcome. Many submissions raised policy arguments as to why bodies corporate should not be required to register for GST.

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[1] Previously the Unit Titles Act 1972.

The problem

7. The main problem is that Inland Revenue's new interpretation of the law does not align with the longstanding practices of a large number of bodies corporate, who are not GST-registered.

8. Absent any policy or law change, these bodies corporate would need to change their behaviour to comply with Inland Revenue's new interpretation of the law. This could create compliance costs.

9. In addition, the fact that property owners in bodies corporate would be able claim GST refunds, whilst others such as stand-alone property owners could not, could lead to perceptions of unfair tax outcomes.

Policy process

10. In response to these submissions and concerns about the potential tax outcomes which could arise under this interpretation, the Minister of Revenue instructed officials to consider policy options for the GST treatment of bodies corporate. The Minister of Revenue indicated that a policy response was required to address three main concerns:

- *Uncertainty concerns* – To ensure bodies corporate have certainty over how the GST rules apply to them.
- *Compliance cost concerns* – To ensure bodies corporate that believed they were not required to register do not have to do so as a consequence of the recent Inland Revenue interpretation of the existing rules.
- *Fairness concerns* – To ensure that owners of residential property affected by leaky building issues that have received compensation and who carry out repairs through a body corporate are not tax advantaged compared to residential property owners that do not have a body corporate through which to carry out the repairs.

11. Earlier this year, Cabinet agreed to the development of draft legislation to exempt supplies made by bodies corporate to their unit owners from GST. This would mean the majority of bodies corporate would not be able to register for GST.

12. This decision was publicly announced by the Minister of Revenue on 6 June 2014 along with a proposed rule to allow GST-registered members of a body corporate to claim input deductions on their share of the expenditure incurred by the body corporate (known as the "look-through rule"). The exemption and look-through rule would apply from the date of announcement. The announcement was accompanied by a short discussion document *GST treatment of bodies corporate*. The document provided further detail on the exemption and sought comment on the proposed draft legislation.

13. On 18 July 2014, submissions on the discussion document *GST treatment of bodies corporate* closed. Fifty submissions were received. The majority of submitters did not support the proposal. Submitters argued that the compliance costs associated with the proposal would be significant (discussed further under option 2).

Affected bodies corporate and impacts

14. Because of data limitations it is not possible to determine exactly how many bodies corporate are currently registered for GST, or would be required to register because they collect more than $60,000 in levies (and other payments in some cases). Despite this, it is likely that around 2,500 bodies corporate are currently registered for GST.[2] These taxpayers would be the least affected if the new interpretation of the law was followed.

15. The number of bodies corporate that would be required to register, if the current interpretation of the law was followed, could be as many as 3,100.[3] For most of these bodies corporate there would be compliance costs associated with GST registration but, in most cases, little or no net GST to pay.

16. Compliance costs would include transitional costs imposed on bodies corporate that are not currently registered, but would be required to register because they collect more than $60,000 in levies. These bodies corporate would need to be informed that their existing practice of not being registered for GST was incorrect (and the reasons why). There will also be compliance costs relating to what they need to do to comply with their ongoing GST obligations. These ongoing obligations would involve compliance costs associated with filing GST returns. These include charging GST and providing tax invoices to unit owners, paying GST to Inland Revenue, keeping tax records and possibly hiring the services of tax agents.

17. Most bodies corporate would have little or no net GST to pay over time. This is because the GST charged on body corporate fees would generally be offset by the ability for the body corporate to claim GST input credits when they spent the fees on insurance, repairs, maintenance and so on.

18. There would be GST to pay in some cases such as when the funds were used to pay for ground rent.[4] These GST costs would be passed on to underlying property owners in the form of higher body corporate fees.

19. Some bodies corporate may want to register, particularly those that would be able to receive GST refunds. For example, some bodies corporate may have built up long term maintenance funds. If these funds were raised while the body corporate was not registered, no GST would have been collected when they were levied, but input tax deductions would be available if they later registered. Given GST should be neutral for these taxpayers, the ability to claim input tax deductions with no output liability represents a windfall gain to these bodies corporate.

20. It is difficult to estimate the amount of GST refunds that bodies corporate could claim, nevertheless based on the number of bodies corporate required to register and an estimate of the average amount of cash reserves held by bodies corporate, the fiscal cost could be around

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[2] There are approximately 2,500 registered persons with either the words "body corporate" in the name they registered under, or who have separately identified themselves as a body corporate through their industry classification or their reported nature of business.

[3] We have obtained information from Land Information New Zealand (LINZ) about the total number of bodies corporate (approximately 13,800) and the number of units in each body corporate. Consequently, if we make an assumption about the average body corporate fee we can work out roughly how many bodies corporate would exceed the $60,000 threshold based on the number of units.

[4] Ground rent can be paid when the land underneath the building is owned by a person outside the body corporate.

$116 million or $23.2 million per annum over 5 years.[5] The fiscal cost could be higher if bodies corporate that were not required to register (bodies corporate that have supplies below $60,000) decided to voluntarily register. The windfall gain to this group would further lead to perceptions of unfairness.

21. GST refunds are also likely to be available in cases where a registered body corporate has received a leaky building compensation payment[6] and has used the compensation to pay for repairs. There would be a fiscal cost associated with these refunds. The actual cost would depend on many factors, such as the cost of the repairs, how these costs are funded, and how many bodies corporate register for GST. Based on a 2009 estimate of the costs associated with fixing weathertightness problems in multi-unit dwellings, the fiscal cost could be as much as $58 million spread over the next 6 years.[7]

22. It could be viewed as unfair for the GST system to allow GST refunds for a certain group of property owners but not for other property owners. Residential property owners are not generally able to register for GST so could not claim GST refunds if they paid for repairs themselves as opposed to the repairs being paid for by a registered body corporate.[8] This could lead to perceptions that the tax system is subsidising repairs for some owners but not for others.

Key figures	
Total number of bodies corporate	13,800
Number of bodies corporate already registered for GST	2,500
Number of bodies corporate that might be required to register if the new interpretation of the law was followed	Up to 3,100
Fiscal cost of refunds if unregistered bodies corporate decided to register for GST	$116 million
Fiscal cost of refunds associated with leaky building repairs	$58 million spread over the next 6 years

OBJECTIVES

23. New Zealand's GST system applies broadly with very few exemptions. Accordingly, a wide range of businesses, clubs and other organisations are required to register for GST. This

5 A maximum of 3,100 bodies corporate may be required to register under the status quo option. As bodies corporate are not required to file annual accounts centrally, it is difficult to estimate the level of these reserves. However, a conservative estimate would suggest these reserves for a body corporate over the registration threshold could be over $250,000.

6 Compensation payments are not generally subject to GST as they do not relate to a supply of anything in return, or to a normal transaction through the supply chain. In contrast, when a GST-registered person makes an insurance claim, they are generally required to return GST in relation to the insurance payout due to a special deeming rule in the GST Act.

7 In the 2009 PwC report Weathertightness – Estimating the Cost, it was estimated to cost $1.402 billion to fix weathertightness issues in multi-unit dwellings and that up to 31% of all weathertightness costs could be funded from compensation payments. (The remaining 69% would be funded by the building owners themselves.) This $1.402 billion cost was increased to $1.433 billion to take into account the increase in GST from 12.5% to 15%; 31% of $1.433 billion is $444 million. The GST input credits that could be claimed on $444 million would be $58 million, or $8 million per year until 2020.

8 In the case of owner-occupiers there is no supply or consideration for GST to apply to as the owner provides accommodation to themselves. When a landlord rents a house to a tenant, the GST Act exempts this supply of residential accommodation to ensure that tenants are not disadvantaged relative to owner-occupiers.

broad-base, low-rate framework is a key reason why New Zealand's GST is regarded to be efficient, fair and relatively simple.

24. Other aspects of the GST system recognise that public acceptance and compliance with GST depends on minimising undue compliance costs and on taxpayers' perceptions of fair and consistent tax outcomes. These include the $60,000 registration threshold which reduces compliance costs for smaller suppliers, and the exemption for the supply of residential accommodation which ensures renters are not disadvantaged relative to owner-occupiers.

25. As described above, the new interpretation of the law regarding the GST treatment of bodies corporate has raised predominantly practical concerns related to certainty, compliance costs and fairness. Unlike most other entities, however, bodies corporate are expected to be fiscally neutral over time because they expect to spend all of the money they accumulate.

26. The objectives against which the options are to be assessed are:

a) To provide certainty of GST treatment. Ideally, the policy should provide certainty for past periods as well as the future.

b) To minimise compliance costs. This includes transitional costs such as requiring bodies corporate to adopt a different practice (by requiring registration or deregistration) or change a previous tax position as well as ongoing costs such as filing tax returns or paying GST. There are also potential flow-on costs to unit owners to consider.

c) To provide fair and consistent tax outcomes between bodies corporate, other property owners, and other taxpayers who have similar circumstances. When assessing fairness there are three different comparisons that can be made:

- *Other property owners.* One comparison is that a person who owns property through a unit title should face similar tax outcomes to a person who owns property under another type of property ownership (such as freehold property).
- *Other types of taxpayer.* Consideration of the extent to which a body corporate is similar to other types of taxpayer such as a property management business or a sports club which provides organisational services for its members.
- *Other bodies corporate.* To ensure consistency between different bodies corporate the policy should apply broadly with few exceptions. In saying this, in a GST system where most supplies are taxable, it is recognised that some entities that supply the same types of goods may be in or out of the GST system depending on whether they are over the compulsory registration threshold.

27. We recognise that there are trade-offs between these policy objectives. For example, because taxpayers have taken different tax positions, a policy which sought to reduce transitional costs by preserving a previous tax position could result in different tax outcomes for one taxpayer compared to another in a similar situation.

REGULATORY IMPACT ANALYSIS

28. Four policy options and the status quo were considered for addressing the policy problem and meeting the objectives. These were:

Option 1: Retain the new interpretation of the law (status quo);

Option 2: Change the law to remove all bodies corporate from the GST system (previously preferred option);

Option 3: Exempt only supplies made by a body corporate to residential unit owners (apportionment model);

Option 4; Give bodies corporate the option of whether or not to register for GST (preferred option); and

Option 5: Introduce a higher GST registration threshold for bodies corporate.

Option 1: Retain the new interpretation of the law (status quo)

29. Under option 1, Inland Revenue would finalise our interpretation of the existing law. Based on the work to date, this interpretation would conclude that bodies corporate that receive more than $60,000 of annual fees are required to register for GST. Other bodies corporate that receive less than $60,000 of annual fees could voluntarily register for GST.

30. As mentioned previously, this legal view was consulted on in *IRRUIP7: Bodies Corporate – GST Registration* which was released in May 2013. Forty-two submissions were received. Many submissions raised policy arguments as to why bodies corporate should not be required to register for GST. Much of the discussion below reflects submitter's comments.

Certainty

31. The purpose of an interpretation statement is to provide certainty. However, it only provides certainty as to Inland Revenue's view of the law. Some bodies corporate who disagreed with Inland Revenue's interpretation of the law may choose to challenge the interpretation in the courts. This risk is increased by the fact that in the only New Zealand court case on this issue, *Taupo Ika Nui Body Corporate v CIR (1997)*, the High Court suggested that most residential bodies corporate would not be required to register for GST.

32. In addition there could be uncertainty as to whether bodies corporate would be required to revise past tax positions that were inconsistent with Inland Revenue's new interpretation, particularly for those bodies corporate who have not registered for GST. An operational practice statement could be used to provide guidance on how Inland Revenue planned to administer the new interpretation but this may not provide the affected bodies corporate with sufficient comfort on their prior tax positions.

Fairness

33. Applying GST to unit title property ownership could be seen to be unfair because GST registration involves compliance costs that would not apply to other types of property ownership (i.e. individuals who own standalone houses). It could potentially discourage unit title ownership.

34. On the other hand, it could also be viewed as unfair that the GST system allowed GST refunds for a certain group of property owners but not for other property owners. Residential property owners are not generally able to register for GST so could not claim GST refunds if they paid for leaky building repairs themselves as opposed to the repairs being paid for by a body corporate. GST refunds could amount to $58 million. This could lead to perceptions that the tax system is subsidising repairs for some owners but not for others.

Compliance costs

35. Requiring bodies corporate to register for GST could impose compliance costs on thousands of property owners and in most cases would result in little, if any, tax to pay. These costs and their impacts are described in paragraphs 15 to 18 of this RIS. The number of bodies corporate that may be required to register could be up to 3,100.

36. Bodies corporate could potentially be required to file or reassess GST returns for prior tax years and pay penalties and interest in respect of unpaid GST obligations. The impact on past tax positions could, however, be reduced by providing a grace period (either through legislation or operational practice) whereby the GST obligations would only be enforced prospectively, after the date that the interpretation statement was finalised.

Option 2: Change the law to remove bodies corporate from the GST system

37. Option 2 would require a legislative amendment to the Goods and Services Tax Act 1985 which would explicitly remove any body corporate that was established under the Unit Titles Act 2010 from the GST system.

38. This option would also be accompanied by a "look-through rule" that deems any third-party services provided to a body corporate (such as insurance and cleaning) to be provided directly to the underlying unit owners in proportion to their shares in the body corporate. Under this approach, if an underlying owner was running a GST-registered business on their property, they would be able to claim back their portion of the GST costs of goods and services purchased by the body corporate on their behalf. If instead, the owner was simply living in the property, they would not have to do anything and would be treated like any other final consumer.

39. This option was the preferred option in the previous RIS, and was consulted on in the 6 June 2014 discussion document. The discussion document suggested that the new rule take effect from the date that the document and draft legislation were released (6 June 2014). A savings provision was also proposed to preserve the tax positions of those bodies corporate which had registered for GST and taken tax positions prior to 6 June.

40. After receiving feedback from submitters, officials no longer prefer this option.

Certainty

41. The proposed law change would provide certainty of GST treatment for future periods after the date the law was changed, while the savings provision would also preserve the tax positions of those bodies corporate which had registered for GST and taken tax positions prior to 6 June.

42. There has however been some uncertainty since the Minister made the announcement on 6 June 2014, especially because the proposal is not yet enacted. An operational statement was

released soon after the announcement (28 June 2014) which was intended to give bodies corporate guidance as to what they should do in the interim. The operational statement advised registered bodies corporate to continue to file GST returns until the proposal was enacted.

Fairness

43. The look-through rule element of this option would ensure that a person who owns property through a unit title should face similar tax outcomes to a person who owns property under another type of property ownership.

44. The option would also prevent bodies corporate from claiming further GST refunds after 6 June 2014. Removing this ability to claim further GST refunds can be justified on the basis that it removes a tax advantage that is not available to other types of residential property owners such as standalone home owners.

45. Submitters considered this option to be unfair for those bodies corporate that would be required to deregister. Specifically, these bodies corporate would have returned GST on fees received while they were registered but would be unable to claim input tax when they spent the fees after deregistration. Given GST is meant to be neutral for these taxpayers, if this option were to be pursued there is a policy argument that registered bodies corporate should be able to claim a GST refund on cash balances held at the time of deregistration. While the fiscal cost of cashing out reserves would over time be neutral, the cost in year one could be around $77 million.[9]

46. Finally, an issue with removing bodies corporate from the GST system is that other taxpayers may argue that they should also be removed from the GST system. For example, a sports or social club may argue that, like a body corporate, they face undue compliance costs from having to register for GST.

Compliance costs

47. For the vast majority of bodies corporate that are not registered for GST, a retrospective law change would align the law with their existing practice and previous tax positions. This means they would not have to take any action with regard to either their past or future behaviour.

48. Submitters argued that the compliance costs associated with this option would be significant. The main compliance cost concern relates to the on-going cost of applying the look-through rule.

[9] This estimated is based on the assumption that 2,500 bodies corporate would be required to deregister with average reserves of around $250,000.

49. The proposed look-through model has the advantages of being conceptually "pure" in that it would ensure that GST-registered unit owners would be entitled to input deductions on their share of expenses incurred at the body corporate level. However, submissions highlighted that achieving any degree of accuracy in these calculations would mean imposing significant compliance costs on bodies corporate and unit owners. These concerns would largely fall into the following categories:

- Measuring ownership interests in a body corporate;
- Managing information flows;
- Transitional issues associated with filing returns in the period between 6 June 2014 and the date of enactment of any changes.

50. It was stressed that, because the look-through calculations would need to be undertaken for every taxable period (possibly monthly), these costs would be recurring.

Measuring ownership interests

51. The proposed look-through rule suggested that a registered unit owner would be able to claim input tax deductions in proportion to their "ownership interest", as defined in the Unit Titles Act 2010. Submissions noted, however, that an owner's share of the expenses incurred by the body corporate is measured in a number of different ways. For example, a ground floor tenant may not be required to contribute to elevator maintenance. As a result, allowing expenses to be claimed on an ownership interest basis could result in owners being attributed with a greater or lesser share of expenses than should be the case.

52. In practice, to ensure owners are attributed the correct share of expenses, the body corporate would be required to examine each invoice received and attribute it to the owners in the appropriate proportions. This would be a significant compliance burden – particularly for large bodies corporate.

Managing information flows

53. In order for the look-through model to work, unit owners would need accurate information on expenses incurred at the body corporate level. Because input tax deductions represent the equivalent of cash refunds to unit owners, they will, like most registered persons, be motivated to access this entitlement as soon as they can. Bodies corporate would therefore be under pressure to report to suit the unit owner that has the most frequent filing obligations (potentially monthly). Currently bodies corporate are only required to report to owners on a very limited basis.

54. An additional complication could arise when registered unit owners enter or exit a body corporate (through the sale of units). The exiting member will want to know their entitlement up to the date of departure, which could result in further "out of cycle" calculations needing to be undertaken by the body corporate.

Transitional issues

55. If the look-through model was legislated for, the estimated 2,500 bodies corporate currently registered would need to deregister as of 6 June 2014. They would also need to file final returns that unwound the position of returns filed in the period between 6 June 2014 and the date of enactment (which may be in late 2015).

56. As well as calculations required at the body corporate level, individual registered unit owners would also need to perform a "wash-up" calculation, so their GST position accurately reflected the new law for the period.

57. Measures could be put in place to lower the compliance costs of the look-through but, in doing so, the rules will need to trade off simplicity for accuracy. A set of minimum requirements may be relatively easy for a body corporate to administer (although some may even struggle with this), but they are unlikely to result in unit owners' input tax deductions being truly representative of their share of costs incurred at the body corporate level. Irrespective of whether a simple or more complicated method is chosen, these costs will be recurring.

Option 3: Exempt only supplies made by a body corporate to residential unit owners (apportionment model)

58. The apportionment model requires bodies corporate to calculate and claim the appropriate amount on input tax, as opposed to the unit owners. This approach involves deeming bodies corporate to be supplying accommodation to their unit owners. This would mean:

- Supplies of accommodation in residential units would be exempt. Fees charged to residential units would not be taxable and the body corporate would not be able to claim input tax deductions in relation to those supplies.
- Supplies of accommodation in units used for commercial purposes would be taxable. Fees charged to commercial units would be taxable and the body corporate would be able to claim input tax deductions in relation to those supplies.

59. Bodies corporate associated entirely with residential units would not be able to register for GST. Bodies corporate associated with commercial units or a mix of residential and commercial units would either be required to register for GST (if supplies exceed $60,000), or could voluntarily register (if supplies are below $60,000). Bodies corporate with a mix of residential and commercial units would need to apportion their input tax deductions based on the proportion of residential and commercial units.

60. This option and option two have much the same advantages and disadvantages in respect of certainty, fairness and compliance costs. Like the look-through model, the apportionment model has the potential to be conceptually pure, in that GST costs incurred at the body corporate level would be accessed by registered unit owners, but not by unregistered owners. However, the apportionment model has the advantage of not requiring details of invoices and payments to be passed through to unit owners.

61. On the other hand, this model has potential to impose significant compliance costs on bodies corporate. The body corporate will be required to identify the status of its underlying units and/or unit owners. This could be difficult given there are specific GST rules that define what is a commercial and residential dwelling, consequently, the status of the underlying unit may not always be clear. This may also give rise to privacy concerns for the unit owners concerned. If the body corporate did not make enquiries of unit owners this may result in input tax deductions being incorrectly claimed at the body corporate level or denying input deductions to unit owners that would, if they owned a stand-alone residence, be entitled to claim them.

Option 4: Give bodies corporate the option of whether or not to register for GST

62. Option 4 (preferred option) involves giving bodies corporate an option to register. This option would also require a legislative amendment to the Goods and Services Tax Act 1985 and the option would only extend to supplies made to unit owners. Supplies to third parties (for example, car park rental to third parties) would be governed by the ordinary rules (i.e. a body corporate would be required to register if supplies to third-parties exceeded $60,000). Other legislative amendments would be necessary to:

- clarify that services provided by bodies corporate to their members are "supplies" for GST purposes; and
- address a base maintenance risk associated with bodies corporate choosing to register and deregister at times that would effectively mean that the majority of their spending was subsidised by the tax system.

Certainty

63. Option 4 would provide certainty by clarifying that services provided by bodies corporate to their members are "supplies" for GST purposes. It would then allow bodies corporate the option of whether to make those supplies "taxable" by registering for GST.

64. Like option 2, this option would need to apply retrospectively in order to preserve tax positions taken by bodies corporate who had not registered for GST.

65. Unlike option 2, a savings provision would not be required to preserve tax positions taken by bodies corporate who had registered for GST as an optional approach would not prevent bodies corporate from being able to register for GST.

Fairness

66. Previous fairness concerns surrounding registration of bodies corporate centred on their ability to access input tax deductions (and therefore refunds) for leaky building repairs. Because compensation payments are not subject to GST, this would result in a windfall gain for a registered body corporate when compared to an unregistered one, or a standalone homeowner. However, consultation has suggested that a practice may have emerged whereby the payers of compensation payments are reducing the amounts paid to registered bodies corporate to reflect any GST that the body corporate may be able to claim. This makes rational sense because a payer will always be motivated to make any settlement as small as possible. If this practice is now routine, the original concern regarding bodies corporate receiving windfall gains at the expense of the tax base (and gains that would not have been available to stand-alone homeowners) is mitigated.

67. Bodies corporate are only likely to register for GST if they expect to receive GST refunds. Not only would this raise revenue concerns, it could also lead to perceptions of unfairness. This concern could be addressed by imposing an output tax liability on relevant reserves (including funds from compensation payments) held by the body corporate at the time of registration. Such a liability would remove any windfall gain resulting from registration.

68. If this option were to be pursued, it will be necessary to align the application date with the introduction of the relevant legislation. This is necessary to prevent unregistered bodies corporate from registering before the enactment of any legislation in order to avoid the payment of output tax on their reserves.

69. Some bodies corporate may argue that since they are required to pay output tax when they register they should be entitled to an input tax refund on cash reserves held at the time of deregistration. This should not be necessary, however, as a body corporate would be able to deregister at any point in time and therefore is able to choose the most appropriate time to deregister – such as a time when their reserves are low. Cashing out reserves would also have fiscal implications as described in paragraph 45. In addition, those bodies corporate that are currently GST registered will not have entered the system in the expectation that their reserves would be cashed out on deregistration. To do so would provide those bodies corporate with a windfall gain.

70. To remove any residual incentives that bodies corporate may have to register and deregister on a regular basis, it would be desirable to also create a lock-in rule, whereby if a body corporate chooses to register after the effective date of these changes, they must stay registered for a minimum of four years. This would provide some clarity to a body corporate of the minimum compliance costs of registration and would also ensure that those looking to register only for short term gain, such as the GST advantages arising from a future compensation payment, would be discouraged from doing so.

71. Finally, adopting this option may set a precedent for other non-profit bodies to lobby for an increased threshold or a similar optional approach.

Compliance costs

72. Option 4 has the lowest compliance cost of any option, as bodies corporate will be able to decide whether it is worthwhile to register for GST and bear the cost associated with registration. It is anticipated that this approach would require very few, if any, bodies corporate to take immediate action.

73. It is likely that only bodies corporate with GST registered unit owners (commercial bodies corporate) will want to register for GST. Registration may be worthwhile for these bodies corporate to avoid tax cascades – where the body corporate incurs unrecoverable GST which in turn would be passed on to unit owners. However, it is likely that many commercial bodies corporate may already be registered for GST, in which case they could remain registered.[10]

74. There may be an onus on some bodies corporate to decide whether or not they should choose to register for GST. For some bodies corporate there would be costs associated with making this decision which could include paying fees to a tax agent to provide advice on their situation.

Option 5: Introduce a higher GST registration threshold for bodies corporate

75. Taxpayers currently need to register for GST if they have more than $60,000 of taxable supplies. Option 5 would involve increasing the GST registration threshold for bodies corporate so that registration would be compulsory above the threshold and voluntary below the threshold. Like options 2, 3 and 4, this would require a legislative amendment to the Goods and Services Tax Act 1985.

[10] Of the number of registered persons that identified themselves as a body corporate, 60 percent identified themselves as a "commercial" body corporate. The remaining 40 percent identified themselves as a "residential" body corporate.

76. This option has the same advantages and disadvantages as option 4 with one exception: even with a very high threshold there could still be cases where a body corporate exceeds the threshold but does not wish to be GST registered. Consequently, these bodies corporate would still have to deal with all the compliance costs associated with GST registration. In this regard, the threshold would create a "cliff-face", particularly for those bodies corporate that temporarily breached the threshold temporarily due to a large one-off transaction.

77. Option 4 is preferred because it does not have the "cliff-face" associated with option 5. Some may argue that large bodies corporate should be required to register, however, for the reason discussed in paragraphs 15 to 18 there would be little benefit in these taxpayers registering.

Summary of impact analysis

78. The following table summarises for each option which of the objectives it meets or partly meets (for the reasons described above) as well as the economic, administrative, fiscal and fairness impacts. None of the options have environmental, social or cultural impacts.

Option	Objectives met or partly met	Economic impact	Compliance cost & administrative impact	Fiscal impact	fairness impacts
Option 1: Retain the new interpretation of the law	a) Certainty (partly)	No significant impact	Approx. 3100 bodies corporate could face transitional and ongoing costs Inland Revenue would experience difficulties in contacting affected bodies corporate to assist with compliance	Most bodies corporate would have little net GST to pay Cost of refunds associated with leaky buildings could be up to $58 million over the next 6 years	Could be seen to provide a tax advantage (GST refunds) for some unit title owners compared with other property owners
Option 2: Remove all bodies corporate from the GST system	a) Certainty b) Fairness (partly) Improves fairness relative to other property owners but would create unfairness between bodies corporate which have received refunds and those which have not	No significant impact	Bodies corporate with registered unit owners would face on-going compliance costs associated with applying the look-through rule GST registered bodies corporate would face a one-off cost associated with de-registration. Transitional impacts on Inland Revenue in dealing with delay between announcement and enactment of legislation.	Fiscally neutral as it preserves existing tax positions and prevents further GST refunds to bodies corporate Upfront refund of reserves could amount to $92.3 million (although this would be recouped over time)	No significant impact

Option 3: Exempt only supplies made by a body corporate to residential unit owners (apportionment model)	a) Certainty b) Fairness (partly) Improves fairness relative to other property owners but would create unfairness between bodies corporate which have got refunds and those who have not	No significant impact	Bodies corporate with registered unit owners would face on-going compliance costs associated apportioning deductions. GST registered bodies corporate with only residential units would face a one-off cost associated with de-registration. Low administrative impact on Inland Revenue	Same as option 2	No significant impact
Option 4: Give bodies corporate the option of whether or not to register for GST	a) Certainty b) Minimise compliance costs	No significant impact	For most bodies corporate there would be no impact or need to take action Low administrative impact on Inland Revenue	Cost of refunds associated with leaky buildings could be up to $58m over the next 6 years Bodies corporate only likely to be register if they expect to receive GST refunds (estimated to be $116 million). However, a requirement to return output tax on reserves should remove that incentive and address any revenue risk	Other non-profit groups may request similar treatment
Option 5: Higher GST registration threshold for bodies corporate	a) Certainty b) Minimise compliance costs	No significant impact	For most bodies corporate there would be no impact or need to take action Could be compliance costs and "cliff face" issue for bodies corporate that exceed the new threshold Low administrative impact on Inland Revenue	Same as option 4	Other non-profit groups may request similar treatment

CONSULTATION

79. As mentioned earlier, Inland Revenue undertook a legal analysis of the existing law in order to resolve the uncertainty that had arisen as a result of body corporate GST refund claims.

Inland Revenue Issues Paper – new interpretation of the law

80. In May 2013, Inland Revenue released Issues Paper *IRRUIP7: Bodies Corporate – GST Registration* to consult on our initial view that existing law would require bodies corporate that receive more than $60,000 of annual fees to be registered for GST. The issues paper set out an initial interpretative position for consideration and also raised some alternative views. It invited submissions on both the legal position and the appropriate policy outcome.

81. Forty-two submissions were received. Six submissions agreed with the approach taken in the issues paper, considering it both technically correct and appropriate. Three submissions were neutral. Thirty-three submissions disagreed with the approach taken in the issues paper.

82. Many submitters raised policy arguments as to why bodies corporate should not be required to register for GST. These included arguments that a body corporate is, in substance, just a vehicle through which various property owners co-ordinate to pay costs related to accommodation, through a central account, and that requiring bodies corporate to register for GST would impose compliance costs but would collect little additional tax revenue.

Discussion document – policy proposal

83. To address these concerns, on 6 June 2014, the Minister of Revenue publicly announced his intention to introduce legislation that would exempt supplies made by bodies corporate to their unit owners from GST and that the exemption would apply from the date of announcement. The announcement was accompanied by a short discussion document *GST treatment of bodies corporate*. The document included and sought comment on the proposed draft legislation.

84. On 18 July 2014, submissions on the discussion document *GST treatment of bodies corporate* closed. Fifty submissions were received, some on behalf of a large number of bodies corporate. The majority of submitters did not support the proposal. Submitters argued that the compliance costs associated with the proposal would be significant. The main compliance cost concerns related to the application of the look-through rule as discussed in paragraphs 48 to 57. In addition, submitters were concerned with the transitional costs associated with the proposal, such as the unfairness of not refunding input tax on reserves (see discussion in paragraph 45) and the compliance costs associate with the retrospective application date (see discussion in paragraph 55).

85. As a result of the feedback received the preferred option is now option 4 as compared to the previous RIS that recommended option 2. Many submitters preferred the optional approach (option 4) or a higher threshold (option 5).

Next steps

86. Once the Government has made a policy decision, officials will prepare draft legislation for introduction in the next omnibus tax bill scheduled for early in 2015.

87. The Treasury were consulted on and agree with the preferred option (option 4).

CONCLUSIONS AND RECOMMENDATIONS

88. We recommend that the law be changed to give bodies corporate the option of whether to register for GST (option 4). For the reasons explained above, this option best achieves the objectives of providing certainty, consistency and fairness whilst minimising compliance costs and disruption to existing practices. The most effective way to meet these objectives would involve a date of introduction application date with a savings provision for tax positions taken prior to the date of introduction.

89. Retaining the existing law (option 1) is not supported as it does not address the problem, would only provide partial certainty and would not achieve the other objectives.

90. A GST exemption to remove all bodies corporate from the GST system (option 2) is not preferred as the compliance costs of applying the look-through rule would likely be high. Option 3 is not supported for compliance cost reasons associated with bodies corporate apportioning their input tax deductions.

91. A higher GST registration threshold (option 5) is not supported because of the "cliff-face" it creates for those bodies corporate that may make supplies in excess of the higher threshold.

IMPLEMENTATION

92. The preferred option (option 4) would need to be implemented through a taxation bill. Draft legislation can be included in a bill scheduled for early 2015.

93. The proposed application date would be date of introduction. This is necessary to prevent unregistered bodies corporate from registering before enactment to avoid the payment of output tax on their reserves. While it is recognised retrospective application dates should generally be avoided, in this case it is necessary for the fairness and fiscal reasons discussed in paragraph 68.

94. The existing operational statement that was released on 28 June 2014 offers some certainty for the interim. It advises taxpayers to continue to follow the existing law until any legislation is enacted. This means that registered bodies corporate should continue to file GST returns in the normal manner. The operational statement also makes it clear that Inland Revenue will not require bodies corporate to register in the interim.

95. The new rules will be administered by Inland Revenue through existing channels. Compliance costs can be minimised by releasing clear and helpful guidance as to the operation of the new rules using existing Inland Revenue channels. Administration costs are expected to be negligible.

MONITORING, EVALUATION AND REVIEW

96. Inland Revenue will monitor the outcomes pursuant to the Generic Tax Policy Process ("GTTP") 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.

97. 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. Any necessary changes identified as a result of the review would be recommended for addition to the Government's tax policy work programme.

Regulatory Impact Statement

Cashing-out research and development tax losses

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

It provides an analysis of:

- whether the current tax treatment of losses for research and development (R&D)-intensive start-up businesses is appropriate; and
- the options to allow R&D-intensive start-up businesses more timely access to their tax loss deductions.

Consultation on these issues took place via an officials' issues paper, *R&D tax losses*, released in July 2013, which sought feedback on various features of a proposed set of tax rules that would allow R&D-intensive start-up companies early access, by way of a "cash-out" (refund), to tax losses arising from qualifying R&D expenditure. Following a review of written submissions, officials from Inland Revenue and the Treasury met with a number of interested parties. Submissions were received from professional services firms, industry and other professional bodies, R&D companies and individuals, and were generally in favour of the proposal. Submitters raised issues with some of the proposed policy settings as well as overall concerns around the compliance costs of the initiative. Of particular concern were the proposed rules for the R&D wage intensity threshold, the proposed administration regime and the neutrality and integrity measures.

The preferred option is to allow R&D-intensive start-ups to cash-out, or refund, their tax losses arising from qualifying R&D expenditure. This proposed initiative removes a barrier to investment in R&D start-ups which arises from the current treatment of tax losses.

The estimated average fiscal cost of the proposed initiative is $15 million per annum. The accuracy of this estimate could be affected by changes in key assumptions, especially the number of companies who receive a cashed-out loss, the overall repayment rate of the cashed out loss (which depends on both the firm survival rate, and the ability to recover the value of the cashed-out loss from companies that sell intellectual property or undergo a change in ownership), and the timeframe for repayment. If the number of firms that receive a cashed-out loss or the repayment rate is higher or lower than expected, both the average fiscal cost and year-to-year variation could change.

The administration regime for the proposed initiative has not yet been decided. This will be the subject of a Business Case scheduled to be determined by Cabinet in June 2014. It is therefore not possible to assess the compliance costs arising from the proposed administration regime in this RIS. However, the relative compliance costs of the various administration options will be one of the key criteria considered in the Business Case. Finalisation of the administration regime is also necessary before any changes can be legislated for.

The proposed initiative will apply from income years starting on or after 1 April 2015. Legislative amendments to give effect to the measure should therefore be included in the next available omnibus tax bill which in turn means that the legislation is unlikely to be passed ahead of the 1 April 2015 start date. It is anticipated that there would be a degree of retrospectivity compared to the start date, but as this initiative is advantageous to taxpayers this should not be of concern. Even with legislative introduction in early 2015, it should be passed by the time that taxpayers' losses crystallise for the first year of the proposed initiative at the end of 2015/16 income year.

The Treasury were involved in the development of the policy options discussed in this RIS.

There are no significant constraints, caveats or uncertainties concerning the regulatory analysis undertaken. None of the policy options considered impair private property rights, reduce market competition, or override common law principles. Instead, the preferred option is likely to increase incentives for businesses to be innovative. Taxpayers will incur compliance costs to satisfy the eligibility and reporting requirements of the initiative, but on the whole the proposed initiative is advantageous to taxpayers.

David Carrigan
Policy Director, Policy and Strategy
Inland Revenue

21 March 2014

STATUS QUO

1. The tax system in New Zealand is based on the principle of broad-base, low-rate taxation, as set out in the Government's Revenue Strategy. This means that alternative forms of income and expenditure are taxed as comprehensively and as evenly as possible. These principles ensure that overall tax rates can be kept low and even (thereby minimising the influence that taxation has over economic decisions), whilst also maintaining New Zealand's revenue base.

2. The Government's policy of broad-base, low-rate taxation means that the current tax treatment of research and development (R&D) expenditure in New Zealand is largely consistent with the tax treatment of other forms of business expenditure. There are very few provisions that we expect will distort incentives to innovate.

3. There is an asymmetric tax treatment of profits and losses under the status quo which is particularly pronounced for R&D start-ups. This asymmetry arises because profit-making businesses can deduct expenses from their, or their group companies', assessableincome in the year that these expenses are incurred. In contrast, loss-making businesses typically have to carry expenses that contribute to tax losses forward to future years, so they can be offset against future income.

4. This treatment for losses ensures that any deductions for expenses incurred during periods of loss can be offset against profitable group companies or eventually be utilised when the business begins to earn profits. It can, however, cause a delay in the utilisation of deductions for loss-making businesses relative to profitable ones or ones with profitable group companies.

5. Although the status quo creates a timing asymmetry which can disadvantage loss-making businesses, there are good reasons for requiring taxpayers to carry losses forward or allowing taxpayers to offset their losses against the profits of another company in the same group of companies. Without these provisions there would be a strong incentive for businesses to create artificial losses as a means of receiving value from the loss. Under current tax settings, however, this risk will always be capped at the level of the otherwise net income of the group. As such, allowing offsets within a group or requiring taxpayers in general to carry losses forward are essential integrity measures in the tax system.

PROBLEM DEFINITION

6. Small businesses can face particular challenges when carrying out R&D, often because of restricted access to capital and uncertain cash-flows during their early development. Although there are a number of possible reasons for this (see problem scope), these challenges are likely to be compounded by status quo tax settings, which delay the ability of loss-making businesses to use their tax deductions.

7. There are two key tax issues here. Firstly, although the status quo provides mechanisms for tax losses to be utilised, they do cause a delay for loss-making start-ups relative to profitable ones. This creates a cash-flow bias against loss-making businesses or groups which is expected to be particularly significant for small, R&D-intensive start-ups. This is expected to have a negative impact on such businesses' propensity and ability to invest in R&D, and the probability of successful innovation.

8. Secondly, the status quo can also penalise businesses that do not generate sufficient profits to fully utilise their deductions or offset their losses. This is because current tax provisions effectively mean that losses can only be used going forward if the original owners subsequently engage in a profitable business. In cases where this does not occur, businesses will have incurred tax-deductible expenditures that cannot be utilised. While this is less of a problem for R&D start-ups as they are able to defer R&D expenses, the status quo still makes the use of expenditure contingent upon successful innovation (or future income earned by the same group of investors). The risk of incurring this potential additional sunk cost represented by expenditure that will not create a tax benefit is likely to provide an additional disincentive to invest in R&D projects at the margin.

9. Thus, the core problem considered in this RIS is the inability of R&D start-ups to access their tax deductions in a timely fashion, or even at all.

10. As mentioned above however, there are good reasons for the status quo. Refunding tax losses, instead of requiring these to be carried forward, would give rise to significant tax base risk. Specifically, this could encourage the creation of artificial losses by taxpayers to reduce their taxable income and could have the effect of reducing government tax revenue. As such, requiring taxpayers to carry losses forward is an essential integrity measure in the tax system, and there needs to be a strong case for changing this treatment of tax losses, particularly as the proposed initiative could be seen as a precedent for wider changes to the tax treatment of losses.

Scope of the problem

11. Although many other businesses can also be said to suffer from similar cash-flow and capital constraints, there are strong theoretical and empirical grounds for believing that R&D-start-ups face particularly challenging obstacles. This is because of:

- Information asymmetries – these arise when potential lenders have less information about the value of an R&D project than the company itself, which can lead to a break-down in the provision of financing that would be worthwhile if both parties were equally well informed. This is especially prevalent for R&D start-ups given:
    - the novel and/or experimental nature of R&D;
    - the lack of proven commercial experience; and
    - the lack of a proven market for the final product.

- High sunk costs – which mean that R&D expenditures often have a low, or zero, resale value in the event of failure. This means that R&D start-ups often have little in the way of collateral that can be used to secure debt-financing.

- High up-front costs – the natural profit cycle for innovative projects tends to involve high up-front costs and consequently, longer periods in tax loss. This implies that the problem faced by R&D start-ups is not just their overall ability to access capital, but also timely access to capital.

12. These challenges interact, potentially making it very difficult for R&D start-ups to access capital in a timely manner at an important stage of their development. In contrast, other businesses do not normally face the same difficulties when seeking lending, nor do they face the same level of uncertainty over their ongoing profits/losses. As a result, we consider the

scope of the problem to be limited to R&D-intensive businesses, particularly those that are small and in their start-up phase.

Scale of the problem

13. There is an inherent difficulty in assessing the scale of the problem as the counterfactual is highly uncertain. Specifically, it is not possible to gauge the number and value of R&D businesses that could potentially have been successful (or would not otherwise have been impeded) in the absence of the capital and cash-flow constraints outlined above.

14. However, empirical evidence shows that small R&D-intensive businesses have a significantly lower probability of being successful with long-term loan applications than other businesses and that the probability of success decreases as R&D intensity increases. Venture capital can address some of these problems, but evidence from different countries indicates that small and medium businesses tend to rely on internal equity financing, and prefer to seek bank loans if external financing is required. However, recent evidence indicates that banks in New Zealand are not necessarily well engaged with the financing needs of small start-up businesses, and have relatively high levels of risk aversion compared with UK and US banking models in supporting early stage companies or projects.[1]

15. Nearly all submitters who commented on the problem definition, as presented in the issues paper, agreed with our overall characterisation of the problem, and that the scope should be targeted to R&D-intensive start-ups and pre-revenue taxpayers.

OBJECTIVES

16. The overall objective of this policy review is to reduce a bias against investment in R&D start-ups arising from the current treatment of tax losses. Any policy option should also satisfy the objectives of the Government's Revenue Strategy, which seeks to achieve a fair and efficient tax system by:

- maintaining revenue flows;
- minimising economic distortions;
- minimising compliance and administrative costs; and
- minimising scope for avoidance and evasion.

17. It is also necessary to consider the objectives of the Government's Business Growth Agenda (BGA). The BGA identifies business innovation as one of six key areas for building national innovation and growth. Current work in the business innovation work stream involves ensuring the business environment, including regulatory settings, is set to give businesses confidence to innovate. Removing barriers to investment in R&D start-ups arising from tax settings is entirely consistent with the Government's objectives in the BGA.

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[1] Boven, R., Harland, C., and Grace, L. *Plugging the Gap: An Internationalisation Strategy.* (Auckland: The New Zealand Institute, 2010).

18. We recognise that there are likely to be trade-offs between the policy objectives. For example, the preferred option minimises economic distortions but will involve some compliance costs to ensure the integrity of the tax system.

REGULATORY IMPACT ANALYSIS

Options identification

19. As the core policy problem stems from the asymmetric treatment of tax losses under the status quo, the nature of the solution set is essentially binary; we can either maintain the status quo or consider ways to remove the asymmetry for the desired target group.

20. Removing the asymmetry would involve allowing certain businesses to access an amount of their tax loss deductions arising from qualifying R&D expenditure in the year that the expenditure is incurred. In practice, this means that eligible businesses would be entitled to a receipt (the cash-out) from the Government amounting to 28 per cent of their tax losses in each relevant tax year. In turn, businesses that access their tax losses early through a cashed-out loss would no longer be able to carry these losses forward to be deducted against future income.

21. This is the main policy option that has been developed as it directly addresses the identified policy problem. Although other options were initially considered as ways of removing the asymmetry, these were discounted early on as they were not considered to directly address the core policy problem. Other options considered during the policy process were:

- a profit-contingent loan;
- a grant;
- allowing taxpayers to carry their tax losses forward with interest; and
- lowering the shareholder continuity threshold.

22. A profit-contingent loan was discounted because it did not address the tax distortion arising from the inability of R&D start-ups to access their tax losses in a timely fashion, or even at all.

23. A grant to R&D start-ups was also discounted as it did not remedy the policy problem, and would have had a significantly greater fiscal impact.

24. Allowing R&D start-ups to carry their tax losses forward with interest was discounted as it would not assist R&D start-ups with their cash-flow and capital constraints. While it would have addressed the distortion arising from R&D start-ups not being able to access their tax losses in a timely fashion, it would not have addressed the distortion arising from the potential wasting of the tax loss asset had the business failed to make a return.

25. Lowering the shareholder continuity threshold was raised by submitters as an alternative, and was briefly considered as a replacement for allowing R&D start-ups to cash-out R&D tax losses. Lowering the shareholder continuity threshold, with accompanying safeguards and measures to reduce risks around existing losses being used inappropriately,

would allow for greater changes in ownership without tax losses being forfeited. Companies that are capital-constrained would be able to take on further equity from new shareholders without having to balance this against the forfeit of (some of) their accumulated tax losses.

26. Lowering the shareholder continuity threshold would not have addressed the same core policy problem. The R&D tax losses initiative is specifically targeted at assisting cash-flow and capital-constrained R&D start-ups who are unable to access their tax losses while the alternative proposal would be much broader, assisting any business that risked forfeiting tax losses through changing or introducing new shareholders.

27. In addition, sections EJ 22 and EJ 23 of the Income Tax Act 2007 allow taxpayers to allocate deductions for R&D expenditure taken under section DB 34 to a later income year after the shareholder continuity breach takes place. This means that R&D start-ups can already introduce new equity without forfeiting tax losses arising from R&D expenditure. Consequently, lowering the shareholder continuity threshold was not seen as a sufficiently close replacement to allowing R&D start-ups to cash-out R&D tax losses, and was not considered any further in the context of the current policy review.

28. As a result, although only one core policy option has been developed fully in this RIS, many variants of this option have been considered and consulted upon. These are discussed in the "options analysis" section below, and have been assessed with reference to the status quo.

Description of the preferred option

29. Under the preferred option taxpayers that meet certain eligibility criteria will be entitled to cash-out a certain amount of their R&D tax losses. The benefit of the tax losses will be delivered by way of a cash refund equal to 28 percent of the tax loss. Only certain qualifying R&D expenditure will be permitted to contribute to the tax loss that can be cashed-out. A loss which has been cashed-out will no longer be eligible to be carried forward to be deducted against future income.

30. The key design features of the preferred option are set out below.

Administration

31. In response to submissions concerned about the potential compliance costs of the proposed administration process, the administration process for the initiative is still under revision. This will be the subject of a Business Case that will determine whether the policy will be administered either by Inland Revenue only, or in partnership with Callaghan Innovation, the Crown entity that administers government funding to innovative businesses. This is scheduled to be determined by Cabinet in June 2014.

Eligibility criteria

32. The proposed initiative will apply to R&D-intensive start-up companies who are in a tax loss position and resident in New Zealand for tax purposes. These requirements must also be met on a group basis, if the company is part of a group.

33. The initiative is restricted to certain companies only to ensure effective targeting. Companies listed on a recognised stock exchange are ineligible because they are not cash-flow and capital-constrained to the same degree as unlisted R&D start-ups. Also, companies

that have flow-through treatment of tax losses, such as look-through companies, are excluded. Any developments in this area, such as the establishment of a stock exchange that targets high-growth and innovative firms, will be followed closely.

R&D wage intensity

34. Additionally, R&D-intensive start-up companies must spend at least 20 per cent of their total wage and salary expenditure on R&D to be eligible for a cashed-out loss. This measure includes shareholder salaries, contracted labour, and 66 per cent of expenditure on contracted R&D. This requirement must also be met on an overall group basis, if the company is part of a group.

Definition of R&D

35. To be eligible for a cashed-out loss, a taxpayer must be carrying out eligible R&D. The proposed definitions of "research" and "development" are based on the New Zealand equivalent to International Accounting Standard 38 (NZIAS 38). This is consistent with the current definitions of "research" and "development" used in the Income Tax Act as well as by Callaghan Innovation. Guidance will be provided to support potential applicants.

36. The agency that administers the definition (Callaghan Innovation or Inland Revenue) and the way in which the definition is legislated for (as a process or as a statutory test) is dependent on the result of the Business Case.

Excluded expenditure

37. Certain expenditure items will not be eligible expenditure. They are:

- interest expenses on R&D;
- the purchase of existing R&D assets;
- R&D undertaken offshore; and
- finance lease payments for R&D equipment.

38. Expenditure on "operating leases", as defined in the Income Tax Act, will be included as eligible expenditure. Operating leases are typically shorter-term leases that are not substitutes for financing a purchase with debt (these are "finance leases" and will remain excluded).

Amount of R&D tax losses to be cashed out

39. Qualifying taxpayers will be able to cash out, for the relevant year, the lesser of:

- 1.5 times their eligible R&D salary and wage expenditure;
- total tax losses;
- total qualifying R&D expenditure; and
- the overall cap on eligible R&D tax losses.

40. The initial cap will be set at $500,000 of losses, which amounts to a cashed-out loss of $140,000. This will rise eventually to $2 million, equivalent to a cashed-out loss of $560,000. This cap reduces its fiscal risk, especially in the early years of the new rules when there will be uncertainty over the response of R&D start-ups to the changes. Gradually increasing the cap will help ensure that the benefits of the cashed-out loss will not be reduced by an increase in demand for R&D inputs that will result in an increase in the cost of carrying out R&D, rather than an increase in R&D itself.

41. The 1.5 times multiplier applied to the R&D salary and wages expenditure is intended to help R&D start-ups cash-out losses that are incurred as a result of other non-salary and wage R&D expenditure. The different ways of calculating the amount of the cashed-out loss is necessary to ensure R&D start-ups with and without a large proportion of salary and wage expenditure to total expenditure (subject to meeting the wage intensity threshold) have similar access to the policy.

Loss recovery events

42. The overall policy intent is to provide a temporary cash-flow benefit for R&D start-ups that will be repaid out of their future taxable income. However, of the R&D start-ups that derive a return from the investment, not all derive a return that is taxable. Often the return is not realised until the intellectual property is sold. If the value of the cashed-out loss is not recovered from the sale proceeds, then the interest-free loan becomes a grant, and the fiscal risk of the policy is much greater.

43. As an integrity measure, we propose that loss recovery should take place for the R&D start-up when a taxpayer with a cashed-out loss or investor makes a capital return, but only to the extent of the cashed-out loss. The "loss recovery events" would be when:

- the company sells intellectual property;
- when 90 per cent of shares in the company are sold;
- the company becomes non-resident (for tax purposes); or
- the company is liquidated.

44. The liability to return the value of the cashed-out loss is the responsibility of the company rather than the shareholder for compliance reasons. A threshold of 90 per cent, rather than 100 per cent, accounts for management interests being retained in situations when private equity sells out. Although the liability is on the company, we expect that shareholders will indirectly bear this liability as any buyer knowing of the loss recovery rules should pay less for the shares than they would otherwise.

45. If the company changes its tax residence or liquidates, we propose that there be a deemed sale of intellectual property at its market value and that losses be recovered to the extent that a profit is made on that deemed sale.

Mechanism to recover losses

46. R&D start-ups will be required to reinstate their tax losses through a cash payment if a loss recovery event takes place. The payment to reinstate losses will not be deemed income

for tax purposes, but represents the loan repayment necessary to convert their cashed-out losses back into losses arising from R&D expenditure to carry forward to apply against future income.

47. To illustrate how this would work in practice, a taxpayer eligible for a cashed-out loss has in year 1 a $100 cashed-out loss (equivalent to $28) and $100 of losses being carried forward. In year 2, the taxpayer sells intellectual property receiving a capital return of $500. This is a loss recovery event and the taxpayer is required to return the value of the cashed out loss - $28 - to Inland Revenue in order to have their loss of $100 reinstated. Consequently, the loss is reinstated and the taxpayer will now have $200 of losses being carried forward to apply against future taxable income.

Analysis of the preferred option

Economic implications

48. The preferred option is expected to:

- provide some relief for the financing constraints faced by R&D-intensive start-ups during the initial loss-making phase of the innovation cycle; and

- reduce the amount of any tax losses accumulated by R&D start-up companies that will be forfeited in the event of failure.

49. This is expected at the margin to have a positive impact on incentives to invest in R&D and the likelihood of successful innovation. It is not possible to quantify these benefits as there are no comparable policies in operation elsewhere. However, in bringing forward the benefits of deductibility, the proposal essentially transfers a timing advantage from the Government to eligible businesses. It is expected that this timing advantage will be much more valuable to target businesses (cash-constrained R&D start-ups) than to the Government. Therefore, the primary economic impact of the proposal (taking into account the opportunity cost to the Government of delayed tax revenue, but before taking into account administration/implementation costs) is expected to be positive at the margin.

50. It is important to point out that this option is not the same as a conventional tax subsidy such as an R&D tax credit. This is because, prima facie, this option does not alter a company's overall tax liability as any tax deductions that are taken early can no longer be taken in the future. However, the option does provide a time value of money benefit to eligible businesses as it reallocates tax benefits from the future to the present. This benefit is expected to be of value for target businesses as the reallocation across time also coincides with a rebalancing of tax liabilities from periods of loss to periods of profit.

51. Since the start of initial policy development, the OECD have also recently indicated that 'R&D tax incentives should be designed to meet the needs of young, innovative "stand alone" firms without cross-border tax planning opportunities'[2]. This is because:

- Young businesses are considered to play a crucial role in employment creation, with evidence from 15 OECD countries over 2001-11 indicating that young firms (aged 5

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[2] Maximising the benefits of R&D tax incentives for innovation. OECD policy brief, October 2013

years or less) generated almost 50 per cent of all new jobs created despite accounting for only 20 per cent of total (non-financial) business employment.[3]

- The global tax system is considered to create an uneven playing field for small, domestic businesses *vis-a-vis* large multinationals which can take advantage of cross-border tax planning opportunities.[4]

52. As a result, this option is expected to be well targeted.

Fiscal costs

53. Allowing early access to tax losses involves an opportunity cost to the Government from the tax loss that is cashed-out. Although this amounts to a reduction in tax revenue in the year that losses are cashed-out, this is partially recovered when businesses eventually make assessable income. This is because losses that are accessed early can no longer be carried forward to be offset against future income. As a result, the direct fiscal costs of the policy largely amount to a timing concession (relative to the status quo) for businesses at the expense of the Government.

54. However, in the case of those businesses that never become profitable (or do not generate profits sufficient to cover the value of the cashed-out loss), the cashed-out loss will effectively amount to a (partial) grant. Technically however, this is the "correct" (i.e. neutral) tax treatment for businesses that do not generate sufficient profits.

55. Our estimates of the fiscal costs of the policy indicate that the net effect of these various factors will result in an annual average fiscal cost to the Government of $15 million per annum. This estimate is based on evidence from the R&D business survey on the number of businesses expected to satisfy the eligibility criteria for the policy, and information from IR4 income tax returns about the value of their losses.

Administration/implementation costs

56. The overall administration and implementation costs for a scenario where Inland Revenue partners with Callaghan Innovation are currently estimated at $2.9 million for 2014/15, $4.4 million for 2015/16 and $1.8 million thereafter from 2016/17. These estimates are expected to be an upper limit for a range of options.

57. As noted above, the administration regime for the initiative has not yet been decided. This will be the subject of a *Business Case*, This is scheduled to be determined by Cabinet in June 2014.

Compliance costs

58. Compliance is an important element of this initiative, as although the overall policy is business-friendly, the desired target group (R&D-intensive start-ups) is unlikely to be well equipped to deal with a high compliance burden. In addition, evaluation of the recently discontinued R&D tax credit revealed that a non-trivial portion of the benefits were captured by professional tax advisory services rather than R&D businesses. However, certain

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[3] Maximising the benefits of R&D tax incentives for innovation, OECD policy brief, October 2013

[4] Maximising the benefits of R&D tax incentives for innovation, OECD policy brief, October 2013

compliance measures are necessary to ensure that the initiative is not gamed or abused by applicants.

59. Key changes made to reduce compliance costs for taxpayers have seen the R&D wage intensity measure change and the loss recovery rules simplified, which are discussed in detail in the consultation section.

60. It is not possible to assess the compliance costs arising from the proposed administration regime, as this has not yet been determined. However, it is known that R&D start-ups are not equipped to handle a high compliance burden. Consequently, the relative compliance costs of the various options will be one of the key criteria considered in the Business Case. Regardless of the outcome of the Business Case, the information that taxpayers will be expected to provide as part of the application process is intended to be consistent with the information an R&D start-up would be expected to have on hand as part of effective project management, and maintaining intellectual property records and accounting systems.

61. Although the initiative will inevitably place a compliance burden on applicants, and it is not possible to quantify these compliance costs, it is expected that these costs will (for most businesses) be outweighed by the benefits, especially for R&D start-ups with appropriate information management systems, as noted above. The compliance costs of applying to Callaghan Innovation for a government grant for R&D funding also provide a useful guide on reasonable compliance costs proportionate to the size of the cashed-out loss. It is also expected that compliance costs would be highest in the first year that a taxpayer applies for a cashed-out loss. With many R&D start-ups likely to be eligible to receive a cashed-out loss for a number of income years, compliance costs should reduce over time as taxpayers become increasingly familiar with the compliance requirements of the policy.

Risks

62. The primary policy risk is that the initiative could be seen as a precedent for a more general change to the tax treatment of losses, noting that the stock of tax losses was calculated to be $44 billion in 2010. This risk should be mitigated by making it very clear that this is a very narrow proposal targeted specifically at removing a tax impediment to innovative start-up ventures.

63. We have explored the sensitivity of the estimated fiscal cost to changes in key assumptions. In particular, this includes the number of firms who receive a cashed-out loss, the overall repayment rate of the cashed out loss (which depends on both the firm survival rate, and the ability to claw-back from firms that sell intellectual property or undergo a change in ownership), and the timeframe for repayment. This additional sensitivity analysis indicates that if the number of firms who receive a cashed-out loss or the repayment rate is higher or lower than expected, both the average fiscal cost and year-to-year variation could change.

64. Another risk is that the initiative is poorly targeted and includes taxpayers outside the target group of R&D start-ups. This would reduce the effectiveness of the policy while increasing its fiscal cost. This occurrence is thought to be of relatively low risk as the eligibility requirements are relatively narrow and focus on excluding companies that are able to use their tax losses or are not cash-flow and capital-constrained.

65. There is some risk that taxpayers could attempt to recharacterise non-R&D expenditure as R&D expenditure to meet the eligibility requirements or inflate the size of their cashed-out

loss. This risk will be mitigated by using wage and salary expenditure to determine eligibility and as a basis (with a multiplier to approximate other R&D expenditure) for calculating the amount of the cashed-out loss. Wage and salary expenditure is harder to recharacterise compared with other types of expenditure.

Social, environment and cultural impacts

66. There are no social, environmental or cultural impacts associated with the preferred option.

Net impact of the preferred option

67. As mentioned above, the proposal can be considered as transferring a timing advantage from the Government to eligible businesses. On balance, this timing advantage is expected to be much more valuable to target businesses (cash-constrained R&D start-ups) than to the Government, and is therefore expected to have a positive impact at the margin on incentives to invest in R&D as well as the likelihood of successful innovation.

68. On balance, the preferred option largely meets the objectives of the project. Allowing R&D start-ups to access their tax losses from qualifying R&D expenditure reduces the distortion from the current tax treatment of losses. There is some fiscal risk but the overall estimated cost of the option is lower than that of a grant as this option only provides a timing advantage to R&D start-ups that is repayable out of future returns. Particular emphasis has been placed on providing a balance around reducing compliance and administration costs with minimising avoidance and evasion following public consultation; however, the administration regime is still to be determined. The proposed initiative is consistent with the Business Growth Agenda as it removes a barrier to investment in innovative businesses.

69. As a result, it is expected that the net benefits of the policy (before taking into account administration and implementation costs) will be positive relative to the status quo. We also consider it highly unlikely that the overall administration costs will change the nature of this assessment as this analysis has considered an administration regime option with a relatively high cost – although we note that these are still subject to finalisation in the Business Case.

CONSULTATION

70. An officials' issues paper, R&D tax losses was released by the Treasury and Inland Revenue for public consultation on 23 July 2013. A total of 24 submissions were received from a range of submitters including professional services firms, industry and other professional bodies, R&D companies and individuals.

71. Officials have also undertaken discussions with tax policy officials from the United Kingdom and Australia to discuss their experience with the operation of similar R&D tax initiatives.

Submissions on the policy framework

72. The response from submitters was broadly positive, with the intent of the policy generally well received. Submitters were concerned with the overall complexity and compliance burden of the proposed solution, which would make it difficult and/or expensive for small R&D start-ups to comply with the policy's requirements. They felt that the overly

restrictive nature of the eligibility criteria and a possibly time-consuming and complex application process were likely to be most problematic in this area.

73. Submitters also suggested alternatives to a cashed-out loss. It was questioned whether the tax system is the appropriate vehicle to provide an R&D incentive. The Ministry of Business, Innovation and Employment has much greater expertise in assessing what is "true" R&D, and using the tax system adds complexity to what could be a much simpler loan scheme. A relaxation of the shareholder continuity rules was also proposed. The current requirement of 49 per cent of the original shareholding to maintain continuity is seen as a problem for many R&D start-ups, who breach the continuity threshold through the addition of new equity, and forfeit tax losses. Allowing taxpayers to cash-out losses addresses a problem, rather than the root cause of the current shareholder continuity rules.

74. As a result of consultation, we focused on updating the policy design with changes that we believed would alleviate compliance costs and complexity. These changes are noted in the policy detail section.

75. The alternatives suggested have not been considered further as they do not address the particular policy problem of the inability of R&D start-ups to access in a timely fashion, or at all, their tax losses. The loan scheme suggestion will reduce the cash-flow constraint faced by R&D start-ups, but not the wasted losses. The shareholder continuity proposal is less targeted and there are already provisions in the Income Tax Act which allow losses arising from R&D expenditure to be protected from a breach.

Submissions on policy details

76. As mentioned above, submitters generally agreed with the overall objectives of the proposals as described above. However, written submissions on the issues paper and later meetings and conversations between submitters and Inland Revenue and Treasury officials also focussed on the detailed policy proposals put forward in the issues paper.

77. Although many of the features of the final policy proposal are consistent with the issues paper, the following table sets out the specific proposals that attracted the most submissions. For each issue it restates the original policy proposal and, if the final policy proposals have been altered as a result of consultation, what has changed and why. Where key submission points were not advanced as part of the final proposal, it explains the reasons why they were not considered appropriate:

Issues paper proposal	**Submissions**	**Officials' response**
R&D definition The issues paper proposed using the definitions of "research" and "development" that are already used in NZIAS 38 and the Income Tax Act 2007.	One group of submitters (mostly from professional services firms and industry bodies) noted that there is already a level of familiarity with this definition, which makes it more appropriate than developing new one. The alternative view (mostly from R&D companies) is that this definition will require R&D start-ups, which are understandably unfamiliar with accounting standards, to seek expensive external assistance.	It is proposed that Callaghan Innovation will determine the R&D eligibility of the applicant on behalf of Inland Revenue. The agencies' definitions of "research" and "development" do not materially differ as Callaghan Innovation's definitions of "research" and "development", like the ones currently in use in the Income Tax Act 2007, are based on the New Zealand equivalent to International Accounting Standard 38 (NZIAS 38). Concerns raised by submitters are valid, but some sort of definition of R&D is inevitable. Guidance to applicants should help reduce compliance costs in this area. The agency that administers the definition (Callaghan Innovation or Inland Revenue) and the way in which the definition is legislated for (as a process or as a statutory test) is dependent on the result of the Business Case.
R&D wage intensity The issues paper proposed that companies must spend at least 20 percent of their total PAYE wage and salary expenditure on R&D to be eligible for a cashed-out loss. This measure excluded shareholder-employee salaries and would require suppliers of outsourced R&D to provide an invoice to the company detailing the R&D wage and salary costs of the contracted work. This approach was intended to reduce potential abuse of the policy.	Submitters raised concerns that using the R&D wage intensity measure proposed in the issues paper would severely curtail access to the policy because R&D start-ups often use alternatives to PAYE wages and salaries. R&D start-ups may use shareholder-employee salaries, contracted labour and sweat equity (where equity replaces salary compensation for employment) instead of PAYE wages and salaries because of the greater flexibility they offer to companies with cash-flow constraints. Submitters also noted that the costs for outsourced R&D are commercially sensitive; for example it could indicate their profit margin. The contracted supplier of the R&D would be unlikely to provide this information to the contractor in the invoice.	It is proposed that companies must spend at least 20 percent of their total wage and salary expenditure on R&D to be eligible for a cashed-out loss. This includes shareholder salaries, contracted labour and contracted R&D within the measure in addition to PAYE wage and salary expenditure. For contracted R&D, this will be achieved by deeming 66% of contracted R&D expenditure as wage and salary expenditure on R&D; this is consistent with the 1.5 times multiplier method for determining other R&D expenditure used as part of calculating the amount of tax losses that can be cashed out. Sweat equity, where an employee receives shares in the company as remuneration, remains excluded from the R&D wage intensity measure as the equity provided cannot be valued objectively or accurately
Exclusion of listed companies	Submitters advised that listed R&D-intensive companies remain capital-constrained. It was noted that excluding	The proposal is consistent with the issues paper. Any developments in this area, such as the establishment of a stock

The issues paper proposed that companies listed on a recognised stock exchange are ineligible because they are not cash-flow and capital-constrained to the same degree as R&D start-up companies.	listed companies provides a disincentive for growing R&D companies to list on a stock exchange.	exchange that targets high-growth and innovative firms, will be followed closely by officials.
Excluded activities The issues paper proposed a list of excluded activities based on the previous R&D tax credit, as well as excluding clinical trials and late stage software development. This was based on officials' concerns, based on experiences with the previous R&D tax credit, that despite these activities being associated with technological progress, they may not actually meet the definition of R&D. Including these activities could pose a fiscal risk as expenditure on these activities is significant.	Submitters opposed the exclusions of clinical trials, and provided further information of what they entail. Clinical trials go through a number of stages. In general, stage one and two clinical trials are exploratory in nature while stage three (and four, if undertaken) confirms existing findings from earlier trials. Submitters also opposed the exclusion of late stage software development and requested greater clarity around the exclusion. Submitters generally accepted that there were aspects of software development that were not R&D, especially in the area of 'end-user testing', but detailed guidelines should be provided around what is and what isn't R&D in this space.	We propose using Callaghan Innovation's list of specific exclusions from their Growth grant, which lists excluded activities that will not be considered R&D. This is similar to the list of excluded activities already proposed in the issues paper and that was used for the previous R&D tax credit. The list is not exhaustive and activities not listed must still satisfy the R&D definition. If the Business Case is not approved and Callaghan Innovation is not involved in the administration of the policy, it is likely to be preferable to revert to the list of excluded activities proposed in the issues paper. The two lists are materially the same, but using the list based on the previous R&D tax credit will provide additional familiarity for Inland Revenue.
Excluded expenditure The issues paper proposed the following exclusions: - Interest expenses on R&D. - The purchase of existing R&D assets. - R&D undertaken offshore. - All lease payments for R&D equipment. - Expenditure funded by government grants or research funding.	Submitters noted that many R&D start-ups are not able to finance the purchase of capital equipment with either debt or equity, but can only afford to lease the equipment initially.	The proposal is largely consistent with the issues paper. These expenses were excluded on the basis that they may distort economic decisions, endanger the integrity of the policy, or create inequity between taxpayers in a similar position. Leasing and financing with debt are not substitutes in this situation. Excluding this expenditure would reduce the qualifying R&D expenditure unnecessarily for the targeted group. Officials therefore propose not excluding expenditure on operating (shorter-term) leases. Expenditure funded by government grants has also been removed from the exclusion list as this expenditure is generally not deductible, and therefore does not contribute to a loss.
Loss recovery rules The issues paper proposed that loss recovery should take	Submitters were concerned that such an approach would involve significant compliance and administration concerns around knowledge of the level of cashed-out	To address these concerns, we propose that when 90% of the shares in the company are sold, loss recovery is triggered for the company.

place when: - the company sells intellectual property; - the sale of the company; - a 5% shareholding was sold and that loss recovery income should arise to the shareholder involved. The overall policy intent is to provide a temporary cash-flow benefit for R&D start-ups that will be repaid out of their future taxable income. However, of the R&D start-ups that derive income, not all derive income that is taxable. If the value of the cashed-out loss is not recovered from capital (non-taxable) gains, then the interest-free loan becomes a grant, and the fiscal risk of the policy is much greater. Therefore measures are proposed to recover the value of the cashed-out loss where investors or the R&D start-up makes a capital return.	loss the company held. The 5% threshold was also much too low.	Loss recovery should take place when a taxpayer with a cashed-out loss or investor makes a capital return, or to protect the integrity of tax base. "Loss recovery events" are: - the company sells intellectual property; - 90% of the shares in the company are sold; - the company becomes non-resident (for tax purposes); or - the company is liquidated. The 90% threshold, rather than 100%, is to account for possible private equity ownership interests being retained. We expect that shareholders will indirectly bear this liability as any buyer knowing of the loss recovery rules should pay less for the shares than they would otherwise. We propose requiring R&D start-ups to reinstate their tax losses if a loss recovery event takes place. The payment to reinstate losses will not be deemed income for tax purposes, but represents the loan repayment necessary to convert their cashed-out losses back into losses arising from R&D expenditure to carry forward to apply against future income. This also reinforces that cashed-out losses are in the nature of a loan and not a grant.

CONCLUSIONS AND RECOMMENDATIONS

78. For the reasons set out in the "Regulatory Impact Analysis" section of this statement, we recommend that a set of tax rules be enacted that would allow R&D-intensive start-up companies to "cash out" (or refund) their tax losses arising from qualifying R&D expenditure, rather than carrying the loss forward to deduct against future income.

79. We also recommend that the revised rules have the key features set out from paragraph 29 of the "Regulatory Impact Analysis" section.

80. The Treasury was consulted and agrees with our conclusions and recommendations.

IMPLEMENTATION

81. The proposed initiative will have some system implications for Inland Revenue which contribute to the implementation costs. Both the systems implications and implementation cost will vary depending on the administrative option chosen.

82. The proposed initiative should apply from income years starting on or after 1 April 2015. It should therefore be included in the next available omnibus tax bill scheduled for later this year, which in turn means that the legislation will not be passed ahead of the 1 April 2015 start date. It is anticipated that there would be a degree of retrospectivity compared to the start date, but as this initiative is advantageous to taxpayers this should not be of concern. Even with legislative introduction in early 2015, it would be passed by the time that taxpayers' losses crystallise for the first year of the policy on 31 March 2016.

83. The changes will be communicated to taxpayers through the usual legislative means, including a detailed commentary to the bill when introduced and a summary of the final rules in a Tax Information Bulletin once the enacting legislation has received Royal Assent. Inland Revenue will also provide guidance for potential applicants on eligible R&D.

84. The proposed initiative is a complement to other tax and non-tax R&D incentives. The R&D grant programmes administered by Callaghan Innovation target more mature innovative businesses relative to the smaller and younger R&D start-ups targeted by the R&D tax losses policy.

85. Taxpayers will continue to self-assess their tax liability; however, their R&D eligibility and R&D expenditure will be assessed by either Inland Revenue or Callaghan Innovation. This is necessary to reduce a fiscal risk arising from taxpayers outside the target group of R&D start-ups erroneously claiming a cashed-out loss or applicants recharacterising non-R&D expenditure to obtain a larger cashed-out loss.

MONITORING, EVALUATION AND REVIEW

86. Monitoring the effect of these changes will fall under Inland Revenue's responsibilities under the generic tax policy process (GTTP). The GTTP is a multi-stage process that has been used to design tax policy in New Zealand since 1995. The final stage of this process contemplates the implementation and review stage, which can involve Inland Revenue conducting a post-implementation review of the legislation and identifying any remedial issues.

Regulatory Impact Statement

Review of the implementation of the simplified filing requirements for individuals' legislation

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

The question addressed in this statement is whether the implementation of legislation for simplified filing requirements for individuals (SFRI), which was enacted in 2012 and is not due to take effect until the 2016-17 year, is a sound investment.

Inland Revenue considers that a significant proportion of the projected revenue gains of $217 million from SFRI will be eroded due to the changes expected under Inland Revenue's Business Transformation (BT) Programme, which is aimed at simplifying New Zealand's tax administration system. As a result, the SFRI legislation should not be implemented.

The policy underlying the SFRI legislation was set three years ago. At that time, the Government was concerned about the inherent tension between individuals who are not required to file an income tax return and those who are. This tension gives rise to complexity in meeting obligations and creates fairness and equity concerns for some individuals. Individuals who are required to file an income tax return may have a tax debt in one year and receive a refund in another year. For individuals who are not required to file, however, there is no incentive to file an income tax return in order to square-up in years of tax debt, but they can easily claim any available refunds. The practice of filing income tax returns in those years in which an individual is due a refund is referred to as "cherry picking" and has become prevalent especially with the introduction of personal tax summary (PTS) intermediaries. This practice has also resulted in a situation where large amounts of revenue are being paid out in refunds, without a reciprocal obligation on taxpayers to pay any tax debt.

SFRI legislation is aimed at addressing the fairness and equity concerns by removing the ability for people to cherry pick and by removing the requirement for others to file income tax returns.

Inland Revenue's current BT thinking for individual salary and wage earners is for more streamlined processes with salary and wage earners' information being provided by third parties such as employers and banks to Inland Revenue and Inland Revenue undertaking the necessary calculations. This should lead to a more accurate PAYE structure, which means fewer people in a refund or tax debt position at the end of the year. If it were adopted, the current BT vision will represent a significant change in direction in dealing with end of year tax debts and refunds and draws into question the assumptions on which the SFRI legislation is based, and therefore whether it should now be implemented.

Inland Revenue's review of the implementation of the SFRI legislation concluded that the benefits and policy outcomes sought by SFRI can be delivered by BT but in a more coherent way that aligns with our vision of a proactive and efficient tax administration.

The preferred option is to repeal the SFRI legislation. This is intended to reduce compliance costs and confusion for a large group of individuals who would need to change their interactions with Inland Revenue under SFRI and then again under BT. We acknowledge, however, that there may be a negative effect on public trust and confidence in the tax administration system due to major changes being enacted and then repealed prior to implementation.

Repealing the SFRI legislation will also reduce administration costs for Inland Revenue as it will avoid creating resource contention issues across Inland Revenue's entire change portfolio and BT. In particular, highly skilled FIRST resources would have been needed to work on SFRI at a time when these resources would be required for BT.

The most significant dependency of the analysis is the ability of Inland Revenue to deliver the BT programme by the indicative timeline. If Inland Revenue does not implement the BT programme and deliver the expected benefits of an improved PAYE structure by 2019-20, then this will affect Inland Revenue's assessment of the SFRI investment.

No public consultation was undertaken on the option to repeal the SFRI legislation. We considered there would be very little benefit in consulting with the affected groups because repeal would be taxpayer-friendly, and the affected groups would not have adjusted their behaviour in line with the SFRI changes as these changes are not due to take affect for another three years. Even so, Inland Revenue hosted a conference "A Tax Administration for the 21st Century" in June 2014. Some tax practitioners and representatives from PTS intermediaries who attended the conference questioned the relevance of the SFRI legislation given the current BT vision and supported the repeal of the SFRI legislation.

There are no other significant constraints, caveats or uncertainties concerning the regulatory analysis undertaken.

The preferred option does not impact private property rights, restrict market competition, or override fundamental common law principles.

The status quo option will reduce the net amount of refunds available to individuals and this will also affect the current business model of the personal tax intermediary market. These implications were canvassed in the July 2011 Regulatory Impact Statement *Simplifying filing requirements for individuals and record-keeping requirements for businesses.*

Ron Grindle
Acting Deputy Commissioner, Change
Inland Revenue

22 July 2014

STATUS QUO AND PROBLEM DEFINITION

Background

1. New Zealand's current tax administration is heavily reliant on paper-based processes such as the annual return-filing system. These processes are both costly and time consuming as they increase taxpayer contacts with Inland Revenue. In the last 10 years, the number of contacts with taxpayers has increased significantly and the resulting processing has created considerable 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 and the requirement for social policy recipients to file an income tax return.

2. Also driving the increase in contacts is the large number of individuals able to self-select to file an income tax return in years in which they are due a refund. This has resulted in a significantly increased workload for Inland Revenue as people re-enter the annual filing system. Some taxpayers are required to file an income tax return (and pay any tax debts) simply because they are, for example Working for Families (WfF) recipients, whereas other taxpayers who are not required to file, have the ability to "cherry pick" the years they filed on the basis of whether they are to receive a tax refund or have a tax debt. This practice has become prevalent especially with the introduction of personal tax summary (PTS) intermediaries and has also resulted in a situation where a large amount of revenue is being paid out, without a reciprocal obligation on taxpayers to pay any tax debt.

3. The simplified filing requirements for individuals (SFRI) initiatives introduced in 2012 are aimed at addressing fairness and equity concerns by stopping people cherry picking, and removing the requirement for WfF recipients to file income tax returns.

Previous Cabinet decisions

4. In June 2010, Cabinet agreed to the release of the discussion document, *Making tax easier,* which outlined various proposals for transforming the way that Inland Revenue engages with employers, businesses and individuals [EGI Min (10) 11/10].

5. In August 2011, in response to feedback on the discussion document, several initiatives were developed and considered by Cabinet, namely:

- an "e" awareness campaign and enhancements to Inland Revenue's online service for individuals (no legislation was required);
- amalgamating two major tax returns, the IR 3 and personal tax summary (PTS) returns;
- delinking the requirement to file a personal tax return if the person is receiving Working for Families (WfF) tax credits. ("WfF delinking"); and
- requiring a person to file income tax returns for the past four years, if they are not otherwise required to file, but they choose to do so, to prevent cherry picking of refunds ("4+1 square-up").

6. The three legislative initiatives were to take effect from 1 April 2015.

7. Cabinet agreed to the package of initiatives and their inclusion in the Taxation (Annual Rates, Returns Filing, and Remedial Matters) Bill. [EGI Min (11) 17/14, CAB Min (11) 30/8]

8. In early April 2012, it was identified by Inland Revenue that if the package of initiatives were to be implemented it would have placed significant pressure on Inland Revenue's ability to implement any future change initiatives, including the Student Loan Redesign Project (which was already underway) and the Child Support Reform Programme (which was in the initial stages of implementation).

9. At the time, Cabinet was advised by Inland Revenue that there was a way to deliver a less resource intensive and system-reliant solution for the package of initiatives, but it would involve not proceeding with the amalgamation of the IR 3 and the PTS returns. Cabinet agreed that in the interest of maintaining maximum organisational stability for and flexibility within Inland Revenue, the amalgamation of the two returns was removed from the Bill. Cabinet also agreed that the implementation dates for the two remaining legislative initiatives; WfF decoupling and the 4+1 square-up would be deferred for two years (the 2016-17 income year). [EGI Min (12) 6/17, CAB Min (12) 12/6C]

10. The Cabinet decisions were included in the officials' report that was delivered to the Finance and Expenditure Committee on 30 April 2012. There were no other significant changes made to the package of initiatives in the following Parliamentary stages.

11. The Bill containing the SFRI initiatives was enacted in November 2012.

12. The "e" awareness campaign and enhancements to Inland Revenue's online service for individuals are well underway. Key initiatives under this campaign include eUptake specific marketing to migrate more taxpayers to Inland Revenue's digital space and direct taxpayer education on Inland Revenue's online services and reduce use of cheques.

High-level review of the implementation of the SFRI legislation

13. In December 2013, the Minister of Revenue directed Inland Revenue to undertake a high-level review of the benefits, costs and impacts of implementing the SFRI legislation and to consider the viability of the SFRI investment in the light of the recent progress on the Business Transformation (BT) Programme. This direction was in response to concerns raised by Inland Revenue about its ability to implement the legislation by the legislative dates and the need to seek further funding to implement the legislation.

14. Inland Revenue's review concluded that the likely outcomes from BT will mean that implementing the SFRI legislation is now no longer a sound investment. This conclusion was based on Inland Revenue's examination of the benefits and costs of implementing SFRI and how BT will affect the policy outcomes sought under SFRI.

SFRI impacts

15. The estimated revenue gains expected from SFRI were $217 million over a period of seven years, starting from the 2016-17 year. These gains mainly result from the 4+1 square-up initiative, as individuals will no longer be able to cherry pick the years in which to file an income tax return based on whether they receive a refund. They will instead be required to file tax returns for the last four years in addition to the current year in which they have chosen to file an income tax return.

16. The estimated cost to implement SFRI is in the vicinity of $35 million to $45 million. Inland Revenue currently has $14.463 million to implement the SFRI legislation[1]. A further $20 million to $30 million will be required to implement the legislation.

17. By the end of the 2018-19 year (the year before BT is expected to start delivering benefits linked to streamlining PAYE), Inland Revenue would have spent a cumulative $35 million to $45 million implementing the SFRI legislation for estimated revenue of $36 million.[2] This means the return on investment for the period up to 2018-19 would be between $0.80 to $1.03 for every dollar spent.

18. The original analysis undertaken in 2011 determined that the 4+1 square-up would affect 310,000 individuals and the WfF decoupling change would affect 330,000 individuals. The 4+1 square-up group has now increased to over 500,000 due to the efforts of PTS intermediaries. The impacts of these initiatives were canvassed in the July 2011 Regulatory Impact Statement *Simplifying filing requirements for individuals and record-keeping requirements for businesses.*

How Business Transformation affects SFRI

19. Inland Revenue is currently embarking on a Business Transformation (BT) programme, a once-in-a-generation opportunity to simplify New Zealand's tax administration system. This is more than a "computer" project – rather, it is a comprehensive transformation of Inland Revenue's operating model. This is likely to include future policy changes.

20. The outcome roadmap for BT noted by Cabinet in August 2013 displays the desired outcomes of transformation, grouped in four stages. Stage 1 focuses on securing digital services including streamlining the collection of PAYE information and is due to be delivered between years 1 to 6 of the programme. Stage 2 of BT envisages streamlining business taxes and will include work on improving the accuracy of PAYE deductions. Stage 3 will focus on the delivery of social policies Inland Revenue administers. Stage 4 looks at other taxes.

21. Inland Revenue's current BT thinking for salary and wage earners is for more streamlined processes with salary and wage earner information being provided to Inland Revenue by third parties and Inland Revenue undertaking the necessary tax calculations. This should lead to a more accurate PAYE structure, which means fewer people in a refund or tax debt position at the end of the year. With real-time information and analytical tools, refunds would automatically be given out removing the need for people to file an income tax return to get a refund, and debts would be automatically rolled over to new periods, so "cherry picking would be non-existent.

22. If it were adopted, the current BT vision would represent a significant change in direction in dealing with end of year under and over payments of PAYE and draws into question the assumptions on which the SFRI legislation are based, and therefore whether it should now be implemented.

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[1] This amount comprises appropriated funds of $6.263 million and delegated authority for Inland Revenue to spend up to $8.2 million from its capital reserves.

[2] The $36 million is based on the revised revenue gains expected from SFRI. It comprises $4 million in 2016-17, $7 million in 2017-18, and $25 million in 2018-19.

23. On current plan, it is envisaged BT will deliver a more improved PAYE structure by the 2019-20 year. This would make PAYE more accurate and make a significant difference to reducing, over time, the number of individuals who would need to square-up at the end of the year.

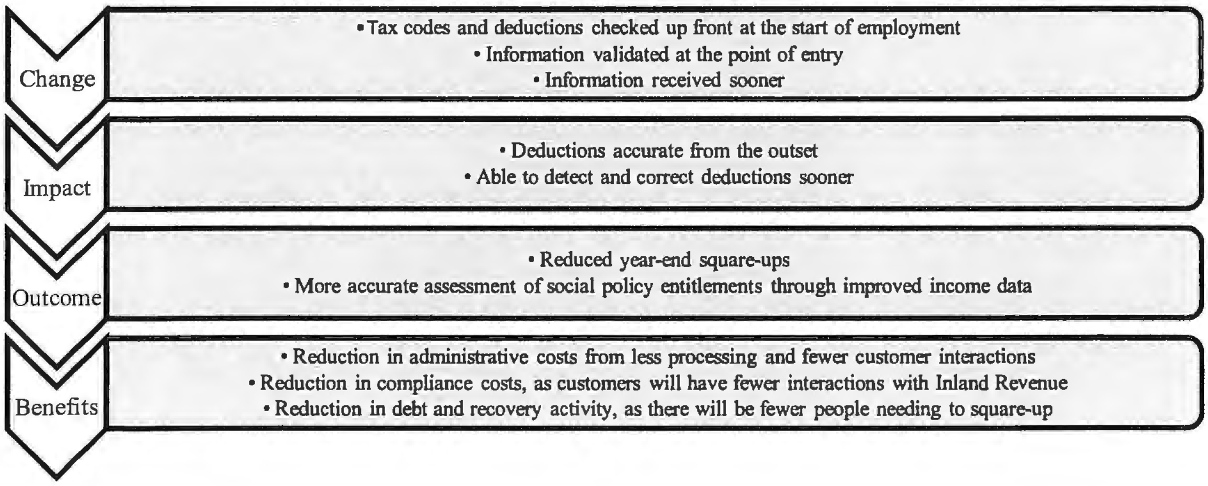
24. The benefits arising from BT stages 1 and 2 that are relevant to the consideration of SFRI are as follows:

- BT stage 1 will deliver more accurate PAYE, therefore reducing the need for square-ups by improving the accuracy of tax codes being used by customers, providing near real-time validation of tax codes, and integrating information collection requirements and rules for PAYE into payroll software to minimise errors on a pay-period basis. Inland Revenue's recent experience with student loans has shown that getting people on the right tax code early reduces down-stream errors and increases repayment levels.

- BT stage 2 will follow with further improvements in PAYE, including integrating withholding requirements and rules for PAYE into payroll software to increase the accuracy of withholding deductions on a pay-period basis and deploying upfront analytical tools to validate and verify data.

25. The BT changes for individual salary and wage earners and their expected impacts, outcomes and benefits are set out in diagram 1. Improving the accuracy of tax codes being used by individual salary and wage earners and providing near real-time validation of tax codes would mean deductions are accurate from the outset. This will mean reduced year-end square ups and more accurate assessment of social policy entitlements through improved income data. The benefits from BT would include reduced administrative costs for Inland Revenue and compliance costs for individuals.

Diagram 1

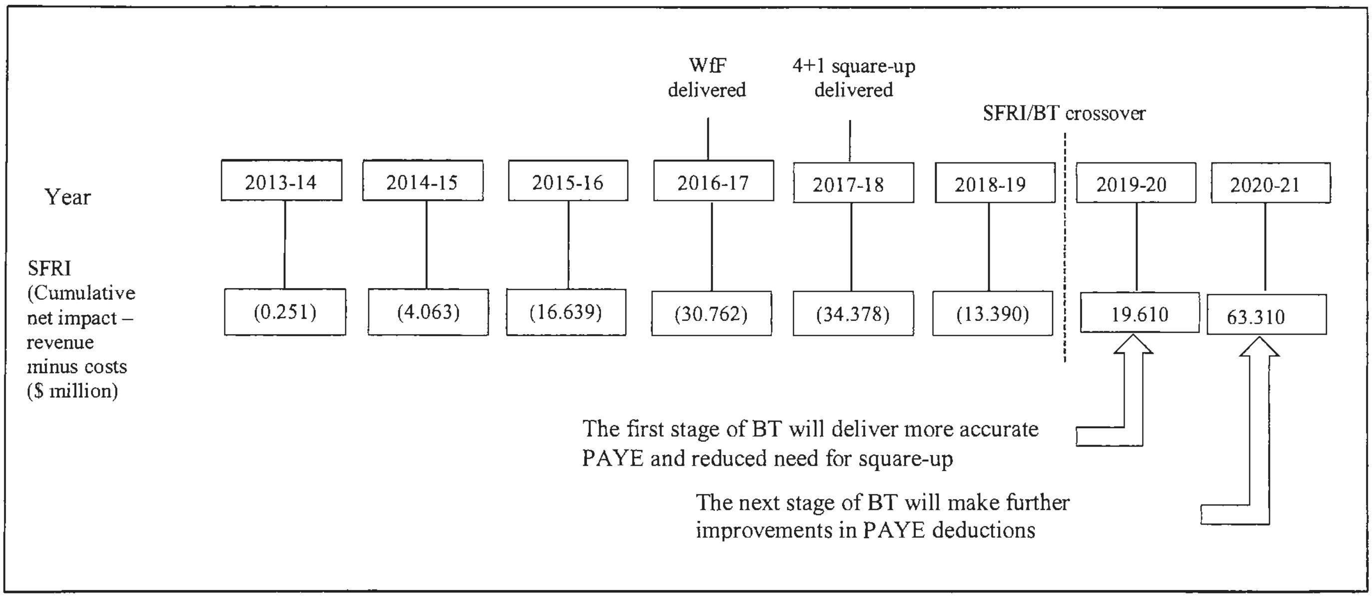


26. The revenue gain estimates for BT stage 1 indicate financial benefits of $500 million–$700 million and economic benefits (improved customer experience and compliance cost savings) of $1 billion–$2.2 billion over a 10-year period. Most of these benefits are expected to be realised from 2019-20 onwards. Inland Revenue is not in a position to provide a detailed yearly break-down at this time.

27. The estimates of the BT benefits will be validated as part of the first detailed design business case, which is expected to be completed in November 2014. This process will include consultation with customers and third parties to confirm the nature, extent and timing of these benefits.

28. Diagram 2 highlights the interplay between BT and SFRI. The bottom row of boxes indicates the cumulative net effect of the SFRI investment for the period from 2013 to 2021. The first year in which the SFRI investment becomes positive (the estimated revenue exceeds estimated costs) is the 2019-20 year, and this is when BT is also expected to start delivering its benefits of more accurate PAYE and reduced need for individuals to square-up. The positive outcomes which were expected to arise from SFRI in 2019-20 and beyond will not now be realised as the revenue gains from SFRI will cease from that point.

Diagram 2



29. In the 2019-20 year the SFRI benefits will cease as the SFRI policy settings are superseded by the BT policy settings.

30. The intersection of SFRI and BT would also potentially cause significant taxpayer confusion given that the two projects are operating to significantly different policy settings. This could lead to increased taxpayer contacts with Inland Revenue as taxpayers require more assistance to understand the changes and this would give rise to increased costs for both parties.

31. Inland Revenue's review concluded that the SFRI legislation should not be implemented on the basis that the revenue gains of $217 million from SFRI will be eroded by BT. On current plan, BT will deliver a more improved PAYE structure, which will make PAYE more accurate and substantially reduce the number of individuals with a material refund or tax debt at the end of the year. Consequently, as SFRI was only ever seen as a "back-end" solution (i.e., stopping people "cherry picking" thereby reducing the incentive to file) to a "front-end" problem of inaccurate PAYE deductions during the year, the policy outcomes sought under SFRI will not be realised from 2019-20 onwards.

OBJECTIVES

32. The objectives of this review are to ensure that:

a) changes made to the current tax administration for individual salary and wage earners align with the BT vision of a proactive and efficient tax administration;

b) the Government's revenue base is maintained;

c) Inland Revenue can maintain its organisational stability and flexibility so that it can manage its change portfolio including BT;

d) individual salary and wage earners have certainty of tax treatment and compliance costs are minimised.

33. The key objective in this analysis is objective (a). This is because the BT vision will set the future framework in which all policy changes will need to comply with. There may need to be a trade-off between the objective of maintaining the Government's revenue base and the other objectives. For example, implementing the status quo will address the cherry picking issue (and the revenue leakage) but it is also inconsistent with the BT vision and is likely to put pressure on Inland Revenue to manage its current change portfolio.

REGULATORY IMPACT ANALYSIS

34. Inland Revenue's high-level review considered a range of options for addressing the problem definition and achieving the objectives. These options ranged from implementing the SFRI legislation in whole, in part and not at all.

35. We also considered scaling back the SFRI legislation in order to minimise implementation costs. However, as the underlying premise of the SFRI initiatives did not align well with the BT vision, the scale back options were not further explored. Furthermore, although it would have been possible to implement the 4+1 square-up change without the need to deliver WfF delinking, it would not have been sensible to deliver WfF delinking without the 4+1 square-up as it would still have allowed WfF customers to cherry pick.

36. The options analysed in this RIS are:

- Option 1 – implement the SFRI legislation as enacted (status quo). This option would commence with the development of a better business case, which would examine both the solution and costs in more detail and establish how this initiative will be funded.

- Option 2 – repeal the SFRI legislation. Under this option taxpayers will continue to have the ability to cherry pick until the BT measures are implemented in 2019-20.

Analysis of options

37. The tables below set out our assessment of the two options against the objectives and summarises the impacts of each of option relative to the status quo.

TABLE 1: ANALYSIS OF OPTION 1

Option	Meets objectives	Impacts				Net impact
			Economic and fiscal impacts	**Administrative and compliance impacts**	**Equity and risks**	
1. **Implement the SFRI legislation**	b	Government	Estimated revenue gains of $217 million over 7 years starting from the 2016-17 year were expected from SFRI These gains will be eroded by BT from the 2019-20 year onwards – this means that the expected estimated revenue gains from SFRI would actually be $36 million only $5 million has been counted in the current baselines (up to 2017-18)	The cost to implement SFRI is in the vicinity of $35 million to $45 million Inland Revenue currently has $14.463 million to implement SFRI – it will need a further $20 million to $30 million to complete implementation Increase in administration costs for Inland Revenue due to more taxpayer contacts as people will require assistance to understand the SFRI changes and then the subsequent BT changes	Fairer for WfF recipients as they will be treated like other non-filing individuals Maintains revenue flows up to 2018-19 Inland Revenue will be seeking a further $20 - $30 million additional funding to make changes that would yield only $36 million in revenue Changes would be made to Inland Revenue's current FIRST system that could compromise system integrity Inland Revenue will have resource contention issues across its entire change portfolio including BT. In particular, it is highly likely that skilled FIRST resources will be required to work on SFRI but will be needed on BT	**Not recommended** Does not address the problem definition or achieve most of the stated objectives
		Salary and wage earners and personal tax summary intermediaries	Individuals do not have the ability to cherry pick the years in which they have a refund across the four years – therefore, there would be a reduction in the net amount of refunds available for salary and wage earners Personal tax summary intermediaries will also be affected as there will be fewer people seeking their services	Increase in compliance costs and confusion for a large group of individuals who would need to change their interactions with Inland Revenue under SFRI and then again under BT - this could affect their willingness to comply with their tax obligations and overall trust in the tax administration Increase in compliance costs for PTS intermediaries as they will need to change current business model and systems		

TABLE 2: ANALYSIS OF OPTION 2

Option	Meets objectives	Impacts				Net impact
			Economic and fiscal impacts	Administrative and compliance impacts	Equity and risks	
2. **Repeal the SFRI legislation**	a, c, and d	Government	Although the projected revenue gains were $217 million only $36 million will be expected due to BT The revenue cost is $5 million. (This is because only $5 million of the expected estimated revenue gains from SFRI have been "counted" in current baselines, which extend out four years to 2017-18)	Avoids the cost of $35 million to $45 million to implement SFRI Inland Revenue must return $6.293 million in appropriated funds to the Crown Decrease in administration costs for Inland Revenue due to fewer taxpayer contacts as people will not require assistance to understand the SFRI changes and then the subsequent BT changes	Although this option does not maintain the revenue flows from SFRI the impact on the government's baselines is only $5 million due to the four-year baseline period The groups directly affected will likely see the repeal of SFRI as a positive measure but those who currently are unable to cherry pick will view repeal of SFRI as unfair Possible negative effect on public trust and confidence in the tax administration system due to major changes being enacted and then repealed prior to implementation	**Recommended** Addresses the problem definition and achieves most of the stated objectives
		Salary and wage earners and PTS intermediaries	Individuals will continue to have the ability to cherry pick the years in which they have a refund until the BT changes take effect in 2019-20 PTS intermediaries will be unaffected until the BT changes take effect in 2019-20	Decrease in compliance costs and confusion for a large group of individuals as they would not need to change their interactions with Inland Revenue under SFRI and then again under BT Decrease in compliance costs for PTS intermediaries as their current business model will be unaffected until BT changes take effect in 2019-20		

Social, environmental or cultural impacts

38. There are both social and cultural impacts associated with the options considered above. The SFRI initiatives address concerns of fairness and equity with the current tax administration system. Although some taxpayers are required to file (and pay any tax debts) simply because they are, for example WfF recipients, other taxpayers who are not required to file, have the ability to "cherry pick" the years they filed on the basis of whether they were to receive a tax refund or had a tax debt. Repealing the SFRI legislation will mean that the current tax administration will continue to be unfair for those taxpayers that are required to file and may negatively affect their trust and confidence in the current tax administration system. This could in turn impact on taxpayer compliance overall.

39. There are no environmental impacts associated with any of the options.

Net impact of all options

40. The preferred option to repeal the SFRI legislation (option 2) addresses the problem by removing an inefficient means to reforming the tax administration for salary and wage earners in the light of the BT vision. It also achieves most of the objectives – that is, it ensures changes that are inconsistent with the BT vision are not made, and compliance and administrative costs are minimised overall.

41. Inland Revenue does not support the status quo (option 1) because it does not address the problem and is inconsistent with the current BT vision.

CONSULTATION

42. Inland Revenue has not undertaken public consultation on the option to repeal the SFRI legislation. We considered there will be very little benefit in consulting with the affected groups on the preferred option of repealing the SFRI legislation on the basis that repeal will be see as taxpayer friendly, and these groups would not have adjusted their behaviour in line with the SFRI changes as these changes are not due to take affect for another three years.

43. In June 2014, Inland Revenue hosted the conference "A Tax Administration for the 21st Century". Some tax practitioners and representatives of PTS intermediaries who attended the conference questioned the relevance of the SFRI legislation in the light of BT vision and supported its repeal.

CONCLUSIONS AND RECOMMENDATIONS

44. Inland Revenue recommends that the SFRI legislation be repealed, as:

- it is now no longer a sound investment given the BT programme of change;
- on current plan, BT will deliver the benefits of SFRI (i.e., stop "cherry picking" and reduced return filing leading to fewer customer contacts) but will do so in a more proactive and efficient way.

- the intersection of SFRI and BT is likely to cause compliance costs and confusion for taxpayers given that the two initiatives are operating under significantly different policy settings;
- it will help Inland Revenue to better manage its entire change portfolio and BT.

45. Given the above, we consider the repeal of the SFRI legislation to be preferable to implementing the legislation. Furthermore, repealing the SFRI legislation would reduce administrative and compliance costs overall. The status quo option would have the opposite effect.

IMPLEMENTATION

46. Repeal legislation should be included in the next available taxation bill, which is scheduled for introduction in November 2014.

47. Although the SFRI legislation is enacted it still has a further three years before it takes effect. Therefore, repealing the legislation as soon as possible will ensure that there is sufficient time to signal to the affected groups that the SFRI changes are not being implemented. The Minister of Revenue will issue a media statement on the proposed repeal when the tax bill containing the repeal legislation is introduced into the House. Once enacted, Inland Revenue will communicate the repeal as part of its business as usual communications relating to legislative changes.

48. Repealing the SFRI legislation will not negatively impact the affected groups. Individuals will continue to have the ability to cherry pick the years in which they have a refund and WfF recipients will file annual income tax returns but most of these recipients are either in a refund position and will file anyway, or are required to file under another tax law. Additionally, repealing the SFRI legislation should avoid taxpayer confusion that could have resulted from the intersection of SFRI and BT – two reforms operating under significantly different policy settings.

MONITORING, EVALUATION AND REVIEW

49. There will be opportunities for interested parties and the general public to comment on the SFRI legislation and its repeal if the preferred option is adopted, both through submissions on the taxation bill containing the repeal, and as part the BT programme. This is because Ministers instructed officials to ensure that the policy outcomes that the SFRI legislation sought to address are included in the BT programme.

50. In general, Inland Revenue's monitoring, evaluating and reviewing of new legislation takes place takes under the 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.