

# Taxation (Annual Rates for 2017–18, Employment and Investment Income, and Remedial Matters) Bill

## Bill Number 249

### Regulatory Impact Statements

1. Changes to the tax administration of investment income information.....	3
2. Demergers .....	57
3. Insurance businesses and the controlled foreign company rules .....	69
4. Lloyd’s of London – tax simplification.....	79
5. Proposed changes to PAYE and GST.....	89
6. Requiring non-resident IRD number applicants to have a New Zealand bank account.....	151
7. Tax treatment of petroleum mining decommissioning .....	163
8. Taxation of employee share schemes.....	177

Prepared by Policy and Strategy, Inland Revenue

April 2017



## Regulatory Impact Statement

### Changes to the tax administration of investment income information

#### Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue. It provides an analysis of options to improve the tax administration of investment income information.

The options considered are intended to reduce compliance costs for recipients of investment income and administrative costs for Government, while improving the administration of investment income to ensure that taxpayers' tax obligations and social policy entitlements are calculated more accurately during the year. The changes are also likely to reduce compliance costs for payers of investment income that make payments to small numbers of recipients as they will be able to shift from paper returns to digital filing. Payers of investment income that make payments to large numbers of recipients are expected to have systems change costs initially and may have some ongoing cost increases, however, options to improve their ability to administer withholding taxes and to reduce some costs going forward have also been included in the options. The options were developed in the context of the wider tax policy framework of a clear and coherent broad-base, low-rate tax system.

A key gap in the analysis is that Inland Revenue is not able to accurately forecast the administrative and compliance cost impacts of these proposals. Indications of the direction and order of magnitude of the impacts have been provided where appropriate. A further gap in the analysis is that Inland Revenue does not hold sufficient data to fully analyse the benefits of the proposals. For example, Inland Revenue does not know how many people receive dividend income and social policy payments, or how many people receive non-locked in PIE income and social policy payments.

None of the policy options restrict market competition, impair property rights, reduce incentives for small businesses to operate, or override fundamental common law principles.



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8 November 2016

## **Reader's guide to this Regulatory Impact Statement**

This document covers a number of discrete proposals which have been grouped into two themes – 'getting it right from the start' and 'compliance and administration costs'. Within these two themes are a significant number of proposals.

To manage this large number of topics we have shifted the detailed analysis of each theme, and the component proposals within that theme, out of the Regulatory Analysis section and into two appendices.

The body of the Regulatory Impact Statement (RIS) still contains an overview of the options considered but the detailed analysis of the costs, benefits, impacts and recommendations is contained in the corresponding appendix. Within the overview tables the following symbols are used:

- ✓✓ Significantly better than the status quo
- ✓× Better than the status quo
- ×× Worse than the status quo

The consultation section of the RIS provides a summary of our consultation approach with the feedback received on each proposal set out in the corresponding appendix.

## **STATUS QUO AND PROBLEM DEFINITION**

### **Inland Revenue's transformation programme**

1. The Government's objective for the revenue system is for it to be as fair and efficient as possible in raising the revenue required to meet the Government's needs. For taxpayers the tax system should be simple to comply with, making it easy to get right and difficult to get wrong. It should serve the needs of all New Zealanders, put taxpayers at the centre and help them from the start, rather than when things go wrong.
2. The shift to digital and greater globalisation has reshaped how businesses and individuals interact and connect, and their expectations of government.
3. Businesses are increasingly using software packages to automate processes and reduce their compliance burden. Businesses have consistently ranked tax as their highest compliance priority, and it often contributes the most to their overall compliance burden. Compliance costs could be reduced by making better use of businesses' everyday processes and systems to meet tax obligations. Enabling businesses to spend less time on tax and more time on running their business will support Government's wider goals of building a more competitive economy and delivering better public services.
4. The amount of income New Zealanders earn from savings and investments is likely to grow over the coming years as the population is aging. People tend to accrue capital as they grow older and then become more reliant on their capital producing investment income as they leave the workforce.
5. There are a large number of payers of investment income, often making payments to small numbers of recipients. For example, 92% of the 16,600 interest payers who filed interest certificates with Inland Revenue for the 2015 tax year filed less than five certificates and 570,000 of the 573,000 registered companies in New Zealand as at 21 April 2016 had between one and ten shareholders. In contrast to this, some of the payers of investment income making payments to large numbers of recipients make payments to hundreds of thousands of recipients.
6. To protect the Government's ability to collect sufficient revenue to keep providing services, it is important that New Zealand's revenue system keeps pace with change and is as efficient as possible. The fiscal challenges associated with an ageing population and associated demand for high quality healthcare and other services will add impetus to the need for a highly efficient and responsive revenue system. To meet these challenges, Inland Revenue requires a fundamental shift in the way it thinks, designs, and operates.
7. The Government has agreed to change the revenue system through business process and technology change. A digitally-based revenue system, simplified policies, and better use of data and intelligence to better understand customers will simplify how services are delivered and change how customers interact with the revenue system.
8. Having a good overall revenue system means having both good policies and good administration. While the policy framework is fundamentally sound, there is an opportunity to review current policy, legislative and administrative settings as levers to help modernise the revenue system and ensure it is responsive to global changes.
9. There is no doubt that Inland Revenue's computer systems (known as FIRST) need replacement to improve resilience and agility. They have reached the end of their life and are

not sustainable in the medium to long term. The FIRST systems are aging, extremely complex, very difficult and costly to maintain, and inflexible. Since FIRST was implemented, a number of income-related social policies have been added to the platform. Implementing social policies within a platform designed for tax administration has added layers of complexity and risk to Inland Revenue's business processes and technology infrastructure. This in turn limits the department's ability to respond to government policy priorities.

10. However, Business Transformation is far more than just updating a computer system. Rather, it is a chance to fundamentally improve the tax administration system with a view to:

- Helping customers get it right from the start;
- Making it harder to get into debt, and easier to get out;
- Lowering the cost of engaging with the tax system; and
- Embedding tax in existing business systems.

11. This RIS outlines options for improving the tax administration system as it relates to the provision of income information from investment. Income from investment refers to interest, dividends, portfolio investment entity (PIE) income and income distributed by Māori authorities.

## **PROBLEM DEFINITION**

### **Getting it right from the start**

12. Inland Revenue wants to make it easy for taxpayers to get their tax obligations right the first time and wants to be proactive in helping them to do that. Addressing errors after the event imposes significant costs on both Inland Revenue and the taxpayer. It is more effective and efficient to consider what can be done to enable taxpayers to get their tax obligations and social policy entitlements correct during the year, in other words, to get it right from the start. This will reduce the chance of taxpayers having a tax or social policy debt at the end of the year, or from paying too much tax or not receiving their full social policy entitlement during the year. There are two issues with the administration of investment income that impede Inland Revenue's ability to help customers get it right from the start.

#### ***Issue one: detail and frequency of investment income information***

13. Currently, Inland Revenue does not receive sufficiently detailed and frequent information about the investment income that taxpayers earn and the tax withheld or paid on that income. For interest and portfolio investment entity (PIE) income, Inland Revenue doesn't receive information about the income taxpayers earned and the tax deducted from that income until after the end of the tax year. For dividends, Māori authority distributions and interest income that is exempt from RWT or subject to the approved issuer levy (AIL), Inland Revenue doesn't receive information about the amounts received by recipients at all, unless it is specifically asked for.

14. This affects Inland Revenue's ability to ensure taxpayers' tax and social policy obligations/entitlements are correct during the year. For example, if Inland Revenue does not know how much investment income a taxpayer earns during the year, it will not be in a position to advise the taxpayer of the appropriate withholding rate to use. Further, it reduces Inland Revenue's effectiveness in ensuring a taxpayer's social policy entitlements, such as working for families, are correct during the year. Taxpayers who have not paid the correct tax or received the correct social policy entitlements during the year will need to square up at the

end of the year, resulting in a debt or refund. Often taxpayers are unaware of these obligations, resulting in Inland Revenue paying out more in social policy entitlements than it otherwise should and taxpayers paying less tax and social policy obligations than they should. Under the current rules it is also easier for taxpayers to ignore their tax and social assistance obligations, for example, by not declaring dividend income in their tax returns. As Inland Revenue gets no detailed recipient information on this type of income, it would be difficult to identify and correct this.

### *Issue two: Identifying information*

#### *IRD numbers*

15. Inland Revenue is not able to attribute income to a taxpayer if Inland Revenue does not have the taxpayer's IRD number. Data shows that 20% of the end of year interest certificates that Inland Revenue receives do not include an IRD number. This means that this interest income will not be taken into account for tax and social policy purposes – potentially resulting in the IRD paying too much in social policy entitlements and/or the taxpayer paying too little in social policy obligations.

#### *Date of birth information*

16. Another problem preventing Inland Revenue from helping taxpayers get it right from the start is that Inland Revenue does not have sufficient information to confirm some taxpayers' identities. In order to be able to ensure income is allocated to the correct taxpayer, Inland Revenue needs the taxpayer's date of birth information in some circumstances<sup>1</sup>. Obtaining date of birth information would also enable Inland Revenue to associate information received from other Government agencies (for example, Customs information on passenger movements) with the correct taxpayer.

17. Having date of birth information will also help other Government agencies to use information that Inland Revenue shares with them by enabling them to match the information with the "customer" information in their own systems.

#### *Joint accounts*

18. Inland Revenue is only provided with one IRD number for a joint bank account. The reporting of income information for joint investments lacks IRD number information for owners other than the owner treated as the primary owner by the investment provider. All the income from that account is allocated to the owner whose IRD is associated with the account. The joint account owners then may need to file tax returns to correct their tax positions.

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<sup>1</sup> Date of birth information may be necessary to identify taxpayers where two or more taxpayers have the same name, where no IRD number or an incorrect IRD number has been provided or where a change of name or address has occurred.

*Identifying information for recipients of income subject to AIL and income that is treated as exempt*

19. Inland Revenue does not receive any information on the recipients of income subject to AIL or that is treated as exempt, so is unable to check that the payment of AIL or the exempt treatment is appropriate.

**Compliance and administration costs**

20. Inland Revenue wants to minimise the costs that taxpayers face complying with the tax system, as well as the costs to the government of administering the tax system. Greater use of electronic and internet-based technology is a key enabler to achieve these objectives. The Government also wants to leverage existing business processes – for example by aligning the provision of information with the payment of the income and the withholding of the tax. The following problems with the current system result in increased compliance and administration costs.

*Compliance costs for recipients of investment income*

*Filing tax returns*

21. The current process of filing a tax return can be cumbersome as taxpayers are required to gather information about the interest, dividends and Māori authority distributions they have received from payers during the year and include it in their tax return.

*Selecting a withholding rate*

22. Currently, taxpayers need to have an indication of the income they will earn in the tax year in order to select an appropriate withholding rate. Often taxpayers will select a withholding rate and forget to change it as their circumstances change (or they may not realise that their income has reached a threshold that requires a higher tax rate), resulting in under or over taxation. Having to work out the appropriate withholding rate, update it as circumstances change, and file a tax return wherever an incorrect rate is used, entails significant compliance costs for taxpayers. This is a particular issue for PIE investments as usually the amount of tax paid by the PIE is a final tax.

*Social policy*

23. Because Inland Revenue does not receive information throughout the year about the investment income of individual taxpayers, it is not able to calculate social policy payments during the year to reflect this income. This necessitates the need for an end of year square-up, which often results in hardship for people who have amounts to repay, or who received too little during the year when they needed the assistance.

*Compliance costs for payers of investment income*

*End of year tax certificates*

24. Payers of resident withholding income are currently required to provide end-of-year tax certificates to the recipients of the income – such as year-end interest certificates and PIE investor statements. These certificates set out the amount of income earned and tax deducted, which recipients can then include in their tax return. Providing these certificates imposes

compliance costs on payers of investment income which may be unnecessary if that information was already held by Inland Revenue and able to be viewed by the taxpayer.

### *Certificates of exemption*

25. Taxpayers holding certificates of exemption (“COEs”) from RWT are entitled to be paid interest and dividends without having any tax deducted by the payer. The holder of the COE is required to provide a copy to the relevant withholder and must inform the withholder if their COE is cancelled. Cancellations and issues of COEs in the previous quarter are published in the New Zealand Gazette each quarter. Taxpayers exempt under Acts other than the Income Tax Act 2007 and the Tax Administration Act 1994, for example the Education Act, are entitled to an exemption without needing to obtain a COE.

26. The current exemption process involves compliance costs for payers as they need to:

- receive exemption certificates from taxpayers;
- check the appropriate New Zealand Gazette to see if the taxpayer’s certificate has been cancelled; and
- assess whether the customer can appropriately claim to be exempt under non-tax legislation.

27. The New Zealand Gazette listing is only published quarterly so may lead to delays in recognizing a COE has expired and can also show a COE as expired even though it has been renewed from the first day of the following quarter. This frustrates payers of investment income and can lead to customer complaints where the renewed COE is removed because the Gazette list shows it has been cancelled.

### ***Compliance costs for payers and administrative costs for Inland Revenue***

#### *Electronic filing*

28. A number of withholding returns are paper based (with no option of electronic filing). For those returns that are able to be filed electronically, there is no electronic filing threshold to require payers of a certain size to file electronically. Paper filing is slower, more expensive in terms of compliance costs for taxpayers and administrative costs for Inland Revenue and more prone to errors.

#### *Error correction*

29. Currently, payers of investment income are able to correct errors in a period by adjusting payments in a subsequent period (i.e. if a payer does not withhold enough tax from a payment of interest, it can withhold more tax from the next payment of interest). However, the ability to correct errors in subsequent periods is limited – for example, there is no ability to correct errors between tax years, or even during tax years for dividends where the error resulted in an underpayment of tax. The inability to correct errors in subsequent periods results in increased compliance costs as in order to correct the error, returns must be re-filed.

30. Errors also impose a monetary cost on investment income payers as they often bear the cost where they have under-withheld from a taxpayer in error, but will refund the taxpayer the money where they have over-withheld in error. Further, UOMI is payable to Inland Revenue at 8.27% pa on underpayments of tax, but receivable from Inland Revenue at 1.62% on overpayments.

31. Payers of investment income currently report summary information by period that matches the payment that they are making. This makes the correction of errors more difficult as an amount needs to be added or subtracted from a subsequent period in the event of an error. Some payers of investment income resolve this by calculating a year-to-date total and then deducting previous payments to determine their current payment obligation.

## OBJECTIVES

32. The main objective of the options is to simplify the tax system by making it easy to comply, and difficult not to, through making better use of investment income information to improve the administration of tax and social policy. The criteria against which the options have been assessed are:

- (a) **Fairness and equity:** to support fairness in the tax system, options should, to the extent possible, seek to treat similar taxpayers in similar circumstances in a similar way.
- (b) **Efficiency of compliance and administration:** the compliance cost impacts on taxpayers and the administrative costs to Inland Revenue should be minimised as far as possible.
- (c) **Sustainability of the tax system:** options should collect the revenue required in a transparent and timely manner while not leading to tax driven outcomes and enable the efficient administration of the social policies administered by Inland Revenue.

33. These criteria are weighted equally.

34. There are no social, environmental or cultural impacts associated with the recommended changes.

## REGULATORY IMPACT ANALYSIS

35. Officials have developed options to address the above issues. These options have been organised under the themes described in the problem definition section, and are summarised below. Further detail on these problems and their associated options is contained in the appendices at the end of this document.

### Getting it right from the start

#### *Information on income*

##### *More income information - options:*

36. At present Inland Revenue does not receive investor level income information in relation to dividends, taxable Maori authority distributions and income that is exempt or subject to AIL. The following options were considered in relation to Inland Revenue obtaining more information from investment income payers. Further detail is contained in appendix A.

Options	Analysis against the objective and criteria
Option 1 – Status quo	Doesn't meet the main objective
Option 2 – payers to provide taxpayer specific information on the amount of income earned and tax withheld (if any) for dividends and taxable Maori authority distributions. This information will continue to be required for PIE income and interest.	Meets the main objective Fairness & equity: ✓✓ Compliance and administration: ✓× Sustainability: ✓✓  Overall comment: Significant improvement on status quo

### *Recommendation*

37. Option 2 was recommended over the status quo as receiving this information would help Inland Revenue make it easier for taxpayers to comply with their tax obligations by prepopulating tax returns, more accurately determining social policy entitlements during the year, and correcting withholding tax rates.

### *Identifying information for recipients of income subject to AIL and income that is treated as exempt*

38. The following options were considered for obtaining the identity of recipients of exempt income or income subject to AIL. These options are further considered in appendix A.

Options	Analysis against the objective and criteria
Option 1 – Status quo.	Doesn't meet the main objective
Option 2 – Identifying information obtained for exempt income and income subject to AIL.	Meets the main objective Fairness & equity: ✓✓ Compliance and administration: ✓× Sustainability: ✓✓  Overall comment: Significant improvement on status quo
Option 3 – Identifying information obtained for exempt income and income subject to AIL, but carving out any information already provided under AEOI.	Partially meets the main objective Fairness & equity: ✓✓ Compliance and administration: ×× Sustainability: ✓×  Overall comment: Improvement on status quo

### Recommendation

39. Option 2 was recommended over the status quo as receiving this information would help Inland Revenue ensure that the AIL and exemption regimes were being used appropriately. It would also enable Inland Revenue to proactively contact taxpayers incorrectly using these regimes to help them to get it right.

40. Option 3 was not recommended as investment income payers were clear during consultation that they wanted the information they provided under the withholding tax regimes to be kept separate from the information they provided under the FATCA and AEOI regimes. The investment income payers also noted that there were some types of investments and investors that they were not required to report on under those regimes so the income provided would be likely to be incomplete if used for other purposes.

### Frequency - options:

41. At present investor level income information, if required, is provided on an annual basis after the end of the relevant tax year. In order to fully realise the benefits mentioned above (paragraph 37), Inland Revenue needs to receive information more frequently than it does now. The options for provision of more frequent information are summarised below and outlined further in appendix A.

Options	Analysis against the objective and criteria
Option 1 – Status quo	Doesn't meet the main objective
Option 2 – provision of the information in the month following the month in which the income was paid.	<p>Meets the main objective</p> <p>Fairness &amp; equity: ✓✓</p> <p>Compliance and administration: ✓x</p> <p>Sustainability: ✓x</p> <p>Overall comment: Improvement on status quo, but a significant impact on PIEs.</p>
Option 3 – provision of the information on the 20 <sup>th</sup> of the month following the quarter in which the income was paid for interest, dividends and taxable Maori authority distributions. Provision of PIE information remains at the end of the year (although by 15 May rather than 31 May for non-locked in PIEs and interest <sup>2</sup> as well as 6 monthly reporting of PIRs for all PIEs). Provision of details for recipients of interest income treated as exempt to be required yearly.	<p>Meets the main objective</p> <p>Fairness &amp; equity: ✓✓</p> <p>Compliance and administration: ✓x</p> <p>Sustainability: ✓x</p> <p>Overall comment: Significant improvement on status quo, but potentially limits options for the future administration of social policy.</p>

<sup>2</sup> Note that for interest this will be a transitional measure, as from 1 April 2020 monthly reporting of taxpayer specific information will be required.

Options	Analysis against the objective and criteria
<p>Option 4 – provision of the information on the 20<sup>th</sup> of the month following the <b>month</b> in which the income was paid for interest, dividends and taxable Maori authority distributions. Provision of PIE information remains at the end of the year (although by 15 May rather than 31 May for non-locked in PIEs and interest<sup>3</sup> as well as 6 monthly reporting of PIRs for all PIEs). Provision of details for recipients of interest income treated as exempt to be required yearly.</p>	<p>Meets the main objective</p> <p>Fairness &amp; equity: ✓✓</p> <p>Compliance and administration: ✓x</p> <p>Sustainability: ✓✓</p> <p>Overall comment: Significant improvement on status quo</p>

### *Recommendation*

42. Option 4 was recommended over the other options as:

- Obtaining more frequent information will make it easier for taxpayers to comply with their tax affairs – it would enable Inland Revenue to prepopulate taxpayers’ tax returns, adjust their social policy entitlements/obligations and work out the appropriate tax rate for them. It would also provide greater scope for reforming the administration of social policy.
- It strikes a balance between benefits and compliance cost by not requiring additional information from PIEs given the complexity of the systems changes that PIEs would need to make in order to provide information monthly and the limited utility of the PIE information during the year.<sup>4</sup>
- Monthly information was preferred over quarterly information for the reasons set out in paragraph 108 in appendix A.
- Bringing forward the year end detailed information for PIE income (and for interest income until interest information begins being reported monthly) will enable this information to be pre-populated at the end of the year before the personal tax summary process is completed. This means the income will be associated with the taxpayer and they will be able to see it in their online tax records. While PIE income is not included in taxable income unless the PIR selected by the investor is too low, it can be relevant for social policy and for calculating the appropriate PIR for future periods.

### *Identifying information*

#### *IRD numbers - options:*

43. In order to encourage tax compliance, the following options were considered for increasing the provision of IRD numbers. More detailed analysis is contained in appendix A.

<sup>3</sup> Note this is a transitional measure as explained in the above footnote.

<sup>4</sup> Due to the volatile nature of PIE income and because a large amount of PIE income (locked-in) is not relevant for social policy purposes – see paragraphs 92 and 93.

Options	Analysis against the objective and criteria
Option 1 – Status quo.	Doesn't meet the main objective
Option 2 – 45% non-declaration rate for all investment income types.	<p>Meets the main objective</p> <p>Fairness &amp; equity: ✓✓</p> <p>Compliance and administration: ✓x</p> <p>Sustainability: ✓x</p> <p>Overall comment: Improvement on status quo</p>
Option 3 – 45% non-declaration rate just for interest income. For PIEs, provision of an IRD number will be required to open a new account (subject to limited exceptions – see appendix A).	<p>Partially meets the main objective</p> <p>Fairness &amp; equity: ✓x</p> <p>Compliance and administration: ✓✓</p> <p>Sustainability: ✓✓</p> <p>Overall comment: Improvement on status quo</p>

### *Recommendation*

44. Option 3 was recommended over option 2 as it better balances the compliance costs imposed on the investment income payers with the level of non-declaration. As PIE non-declaration is a much smaller problem than interest non-declaration the requirement to provide an IRD number when initially making an investment will cap the level of non-declaration at around 2% (there will be work done to match IRD numbers to these non-declared investors by PIEs and Inland Revenue to further reduce the level of non-declaration).

45. Applying a 45% non-declaration rate for PIEs would also add complexity to the tax system. Non-declared recipients would need to file tax returns in order to get excess tax refunded (PIE tax is usually a final tax). In addition, PIE losses give rise to tax credits at the investors' PIRs. A non-declared investor would get credits for any losses at 45% but, because they would be able to file a tax return, should not pay more than 33% tax on their PIE income.

46. We have not recommended a 45% non-declaration rate for dividends or Maori authority distributions due to capability concerns and because we are unable to determine the extent of the non-declaration problem in relation to these types of income until after we begin to receive detailed recipient information. This makes it very difficult to make a satisfactory analysis of the compliance cost versus the benefit at this stage.

47. Inland Revenue will work with payers of interest income to identify the IRD numbers of non-declared investors prior to the introduction of the increased non-declaration rate

*Date of birth information - options:*

48. The following options were considered in relation to Inland Revenue obtaining date of birth information from investment income payers. Further detail is contained in appendix A.

<b>Options</b>	<b>Analysis against the objective and criteria</b>
Option 1 – Status quo.	Doesn't meet the main objective
Option 2 – Date of birth to be provided if held by payer.	Partially meets the main objective  Fairness & equity: ✓✓ Compliance and administration: ✓✓ Sustainability: ✓x  Overall comment: Improvement on status quo
Option 3 – Date of birth requested by Inland Revenue where it is needed to data match.	Partially meets the main objective  Fairness & equity: ✓✓ Compliance and administration: xx Sustainability: ✓x  Overall comment: Improvement on status quo
Option 4 – Date of birth is required to be provided by the payer.	Doesn't meet the main objective  Fairness & equity: ✓x Compliance and administration: xx Sustainability: xx  Overall comment: Worse than the status quo

*Recommendation*

49. Option 2 was recommended over the other options as it does not impose excessive compliance costs on payers of investment income by requiring them to provide information they do not hold. Further, it improves Inland Revenue's ability to confirm taxpayers' identities by requiring date of birth information they do hold to be provided to Inland Revenue. Date of birth information is already collected by payers as part of "know your customer" processes for anti-money laundering purposes.

50. Option 3 was not recommended as:

- It would be likely to involve significant ad hoc data requests as no IRD number is provided for 20% of interest certificates, which would require investment income payers to go back through their customer records.

- It would also involve additional administrative costs for Inland Revenue as it would add a further step of identifying the recipients that date of birth was needed for and requesting it from the various investment income payers.

51. Option 4 was not recommended as it would require investment income providers to collect additional information from a significant number of their longer term customers. This would be likely to be a very expensive process and would be unlikely to have a high level of success. If date of birth information was absolutely required this would then mean that investment income providers would either be non-compliant or would have to withdraw services from a number of their customers. While the option would be likely to get more information for Inland Revenue it would not be fair, simple or cost effective.

*Joint accounts - options:*

52. Options for allocating income between owners of a joint investment are outlined below and described further in appendix A.

<b>Options</b>	<b>Analysis against the objective and criteria</b>
Option 1 – Status quo.	Doesn't meet the main objective
Option 2 – The investment income payer splits the income and tax among the owners according to their ownership proportions, and passes this information on to IR, as well as details of each owner (i.e. name, address, IRD number and date of birth).	Meets the main objective Fairness & equity: ✓✓ Compliance and administration: ✕✕ Sustainability: ✓✓  Overall comment: Improvement on status quo
Option 3 – The investment income payer informs IR that the taxpayers are operating a joint account, and provides income and identifying information on to IR. IR pre-populates their income by splitting the income and any tax credits evenly between the owners.	Partially meets the main objective Fairness & equity: ✓✓ Compliance and administration: ✓✕ Sustainability: ✓✕  Overall comment: Significant improvement on status quo

*Recommendation*

53. Option 3 was recommended over option 2 as option 2 would impose significant compliance costs to require payers of investment income to obtain the ownership proportions from joint account owners. It would also cause system difficulties as investment income payers would need to split the calculations of the withholding tax on the income. Ownership proportions could also change during periods creating even more system difficulties. Investment income payers were also concerned that having to manage this would likely to cause them to have customer relationship problems.

## Compliance and administration costs

### *Compliance costs for taxpayers who are recipients of investment income*

54. The compliance costs for the recipients of investment income are impacted by a number of the proposals discussed earlier in this document. Getting more information more frequently will allow Inland Revenue to associate the investment income with the recipients and will enable Inland Revenue to pre-populate the recipient's tax records (see paragraphs 37 and 42).

55. Pre-populating the investment income information will reduce the compliance costs of the recipients of investment income by removing the need to gather their various end of year tax certificates and any dividend statements and Maori authority distribution statements received during the year in order to complete their tax return. This would make it easier for them to get their tax position right.

56. More frequent information will also enable Inland Revenue to pro-actively correct withholding tax rates being used by recipients during the income year. This will help to reduce the size of the recipient's tax bill or refund at the end of the year by making sure they are on an appropriate tax rate during the year.

57. The pre-population of investment income information will also enable Inland Revenue to make more informed adjustments to recipients' social policy entitlements (getting information more frequently will be particularly helpful if changes are made to reduce the calculation period for social assistance).

### *Compliance costs for payers of investment income*

#### *End of year tax certificates – options:*

58. It would be unnecessary to require payers of investment income to provide end of year certificates to their customers outlining the amount of income the customer had earned and the tax that had been withheld from that income if Inland Revenue was able to make this information available to the customers. Options for removing end of year tax certificates are outlined below and analysed further in appendix B.

Options	Analysis against the objective and criteria
Option 1 – Status quo.	Doesn't meet the main objective
Option 2 – Remove the requirement for all investment payers to provide end of year interest certificates to their customers. Payers would still need to provide shareholder dividend statements, PIE investor statements and Māori authority distribution statements to their customers.	Meets the main objective Fairness & equity: ✓ x Compliance and administration: ✓ ✓ Sustainability: ✓ x  Overall comment: Improvement on status quo

Options	Analysis against the objective and criteria
Option 3 – Remove the requirement for payers to provide end of year interest certificates to customers who have provided their IRD number. Payers must still provide shareholder dividend statements, PIE investor statements and Māori authority distribution statements to their customers (preferred).	<p>Meets the main objective</p> <p>Fairness &amp; equity: ✓ x</p> <p>Compliance and administration: ✓✓</p> <p>Sustainability: ✓✓</p> <p>Overall comment: Improvement on status quo.</p>

### *Recommendation*

59. Option 3 was recommended over option two as requiring payers to provide end of year interest certificates to customers who have not provided their IRD number is important as it notifies the taxpayer that they are on the non-declaration rate and to file a return (thus helping them to pay the correct amount of tax).

60. Removing the requirement for payers to provide interest certificates to customers who have provided their IRD numbers will reduce compliance costs for payers and was considered appropriate on the basis that Inland Revenue would prepopulate the information onto the taxpayer’s myIR account. In addition, where the interest is paid by a bank, the customers will usually be able to see their interest information on their bank statements or on internet banking services provided by the bank. It was not considered appropriate to remove the requirement to provide this information for other investment income sources such as dividends, because the receipt of the income is sporadic and the taxpayer won’t necessarily know when they are going to be receiving the income.

### *Certificates of exemption – options:*

61. In order to reduce compliance costs for payers of investment income, the following options have been considered for improving the process of checking whether a taxpayer has a valid certificate of exemption from withholding tax. These options are explored further in appendix B.

Options	Analysis against the objective and criteria
Option 1 – Status quo	Doesn’t meet the main objective
Option 2 – Inland Revenue establishes a certificate of exemption database	<p>Partly meets the main objective</p> <p>Fairness &amp; equity: ✓✓</p> <p>Compliance and administration: ✓ x</p> <p>Sustainability: ✓ x</p> <p>Overall comment: Improvement on status quo</p>

Options	Analysis against the objective and criteria
Option 3 – Inland Revenue establishes a certificate of exemption database and requires recipients exempt under other acts to obtain a certificate of exemption.	Meets the main objective  Fairness & equity: ✓✓ Compliance and administration: ✓x Sustainability: ✓✓  Overall comment: Significant improvement on status quo

*Recommendation*

62. Option 3 was recommended as it would allow payers of investment income to easily ascertain whether a taxpayer was entitled to an exemption from RWT, representing a significant improvement over the status quo. Option 2 would be an improvement on the status quo but would have less of an impact on compliance costs than option 3 as investment income payers would still need to work out whether recipients claiming exemptions under other Acts should be treated as exempt.

***Compliance costs for payers and administrative costs for Inland Revenue***

*Electronic filing – options:*

63. To increase electronic filing of investment income returns, the following options are proposed. These options are summarised further in appendix B.

Options	Analysis against the objective and criteria
Option 1 – Status quo	
Option 2 – compulsory for all, with the ability to apply to the Commissioner for an exemption (preferred).	Meets the main objective  Fairness & equity: ✓x Compliance and administration: ✓✓ Sustainability: ✓✓  Overall comment: Significant Improvement on status quo
Option 3 – Online filing compulsory for large payers only (i.e. those with more than a certain number of recipients they pay investment income to).	Meets the main objective  Fairness & equity: ✓✓ Compliance and administration: ✓✓ Sustainability: ✓x  Overall comment: Improvement on status quo

*Recommendation*

64. Option 2 is recommended for the following reasons:

- It would ensure that everyone, other than those who are genuinely unable to access digital services, files online. Electronic filing is a very important enabler of the Business Transformation.
- Statistics show that the majority of companies only have one or two shareholders, and the majority of interest payers only file one or two certificates (see appendix B for further detail), so compulsion is important or else there is a risk that a significant number of paper returns will be filed.
- Currently most of the withholding tax returns must be filed on paper. It is likely that a significant number of investment income payers would simply continue to file on paper if they were not compelled to file digitally.

*Error correction – options:*

65. In order to reduce compliance and administrative costs, the following options have been considered for improving error correction mechanisms:

<b>Options</b>	<b>Analysis against the objective and criteria</b>
Option 1 – Status quo	
Option 2 – Unlimited error correction for all investment income types during a tax year, error correction subject to a threshold of the greater of \$2,000 or 5% of annual tax liability (for the tax type in question) for correction between tax years. Tax subject of an error will be treated as due in the period in which it is corrected, resulting in no UOMI or penalties.	<p>Meets the main objective</p> <p>Fairness &amp; equity: ✓✓</p> <p>Compliance and administration: ✓✓</p> <p>Sustainability: ✓✓</p> <p>Overall comment: Improvement on status quo</p>

*Recommendation*

66. Option 2 is recommended as it provides a flexible method for error correction that will reduce compliance and administrative costs, and will not punish payers where they have made a genuine error.

*Error correction (period reporting) – options:*

67. As part of improving the ability to correct errors, the following options in regards to reporting requirements were considered:

<b>Options</b>	<b>Analysis against the objective and criteria</b>
Option 1 – Status quo	
Option 2 – Year-to-date reporting	<p>Meets the main objective for some types of investment income</p> <p>Fairness &amp; equity: ✓✓</p> <p>Compliance and administration: ✓✓</p> <p>Sustainability: ✓✓</p>

	Overall comment: Significant improvement on status quo
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68. Option 2 is recommended for interest and PIE income because year to date reporting will work well for income types that tend to accumulate across the year such as interest income and PIE income however it will be less appropriate for income that occurs sporadically.

69. Option 1 (i.e. period by period reporting) is recommended for dividends and Maori authority distributions as these are likely to be one-off or sporadic transactions rather than accumulating returns across the income year.

**CONCLUSION**

70. The recommended options under the above themes enable improved service delivery to individuals and lay a foundation for subsequent improvements to social policy. They do this while recognising that ‘one size cannot fit all’ and while maintaining New Zealand’s broad base low rate tax framework. They also enable compliance cost savings for recipients of investment income and payers of investment income to small numbers of recipients while officials recognise that the recommended options will give rise to some increased compliance costs (largely up-front costs) for payers of investment income to large numbers of recipients. The recommended options also enable administrative costs savings,

**CONSULTATION**

71. Several forms of consultation have been undertaken in developing the options outlined in this statement.

72. In June 2014, Inland Revenue, the Treasury and Victoria University hosted a conference entitled *Tax administration for the 21<sup>st</sup> Century*. The conference explored options for making tax easier through reducing both compliance and administration costs, while balancing increased voluntary compliance against the core tax policy objectives of raising sufficient revenue and ensuring fairness and efficiency. The main points made by attendees were to give people the ability to self-manage their tax affairs through improved services and more flexible legislative frameworks, the importance of involving businesses and others in the design of the rules and processes, the need to ensure that there is an overall net benefit to society of the changes not just a cost shift from Inland Revenue to businesses, and to ensure the continued maintenance of the current tax system whilst the reforms occur.

73. Following this conference the Government issued *Making Tax Simpler – a Government green paper on tax administration* which outlined the scope and direction of the review of the tax administration, and sought feedback on the problems taxpayers face with the current system. At the same time the Government released *Making Tax Simpler – Better Digital Services a Government discussion document* which identified the key role envisaged for digital services in the modernised tax administration system.

74. Feedback on these two documents informed *Making Tax Simpler – Investment income information: a Government discussion document* which was released for public consultation in early July 2016. In addition to the discussion document an on-line forum was established and companies were notified of the consultation and encouraged to provide feedback. Over

60 comments were made to the online forum and 32 written submissions were received. This public feedback has informed the development of the options presented in this statement.

75. The main theme from submissions was that the proposals to receive more frequent investment income information lacked justification. While submitters were supportive of providing the additional information, many submitters felt that there would be minimal benefit in adjusting social policy payments on a monthly basis given the low amount of investment income people receive, and the lumpy nature of investment income. Almost all submitters said that the benefits would be significantly outweighed by the compliance costs that the provision of more frequent information would impose. Many submitters were in favour of reporting the information annually, or quarterly if a more frequent reporting requirement were to be introduced. The themes raised in the submissions were not typically sector specific but instead similar themes were raised by a number of submitters. The main exception to this was that most of the banking industry was strongly of the view that 3 years implementation time from the date of enactment was needed to implement the changes.

76. The submissions received were largely from investment income payers, advisory firms and industry organisations. The major benefits of this project are expected to flow to the recipients of investment income. As such the tenor of the submissions may not reflect the wider reaction to the proposals.

77. More detailed feedback from consultation is provided in the appendices.

## **DATA TO ADDRESS FEEDBACK FROM CONSULTATION**

78. The below data highlights the benefits of the proposals:

- In 2015 the interest income of at least 185,000 individuals was not taken into account for working for families purposes.<sup>5</sup> This resulted in the government paying out more in social policy entitlements than necessary - the exact impact of this cannot be quantified given WFF abatement rates depend on numerous factors.
- It is estimated that \$21 to 27 million of income tax per annum is forgone due to interest income not being correctly returned as income. This would be identified if the interest income was pre-populated.

## **IMPLEMENTATION**

79. It is proposed to include the recommended options in a bill to be introduced in February 2017. The proposals will apply from the following dates:

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<sup>5</sup> Based on 27,000 families who reported any investment income compared with the files from interest payers which showed 239,000 individuals (assuming just 2 individuals per family received interest income) received interest income and WFF. The number of people not declaring their investment income is likely to be higher than this given we are comparing families who declared their investment income (i.e. includes interest, dividends and some PIE income etc.) versus individuals earning interest income and receiving WFF. These figures also exclude the recipients of interest income that have not provided their IRD numbers to their interest payers. If taxpayer specific information on dividends were collected, the level of non-declaration would be more apparent.

- 1 April 2018 - PIEs will be required to obtain the IRD number of new investors or alternatively a self-certification that they are non-resident and do not have an IRD number.
- 15 May immediately following the end of the tax year will be the due date for filing the current detailed interest and PIE income information (excluding “locked in” schemes) for tax years beginning on or after 1 April 2018.
- 1 April 2020 is the recommended application date for:
  - Investment income payers (other than PIEs) to provide detailed recipient information on the 20<sup>th</sup> of the month following the month in which the income is paid.
  - Investment income payers to include date of birth information (if held) in the detailed recipient information they provide.
  - Joint ownership information to be provided by investment income payers.
  - AIL and exempt recipient information to be provided.
  - 45% non-declaration rate for interest income.
  - Inland Revenue to provide a database of valid certificates of exemption.
  - Recipients of investment income to have a certificate of exemption to be exempt from withholding taxes on investment income.
  - Removal of the legislation containing the requirement to provide end of year tax certificates to customers.
  - Changes to allow errors relating to prior years to be corrected in the next return (for errors meeting thresholds), as well as improvements to error correction during an income year.
- Investment income payers will be able to elect to begin filing detailed recipient information on a monthly basis from 1 April 2019.

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

81. Inland Revenue would administer the proposed changes. The proposals will have a range of administrative implications for Inland Revenue from needing to be able to process the information that is received to analysing the information and being able to proactively use the information to adjust tax rates. The proposed changes will also improve compliance, support the ability to make future changes to the social policy regime and enable Inland Revenue to reduce the time taken by Inland Revenue staff to complete tasks by better associating income information with each taxpayer’s tax records. Overall the proposed changes are expected to reduce administration costs for Inland Revenue.

## **MONITORING, EVALUATION AND REVIEW**

82. Inland Revenue will monitor the outcomes of the changes pursuant to the Generic Tax Policy Process ("GTTP") to confirm that they match the policy objectives. The GTTP is a multi-stage policy process that has been used to design tax policy in New Zealand since 1995.

83. 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. Post-implementation review is expected to occur around 12 months after implementation. Opportunities for external consultation are 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.

84. Also, as part of Inland Revenue's business transformation programme a benefit management strategy has been developed and endorsed. The programme costs and benefit estimation approach is outlined in Appendix G of the November 2015 Programme Update and Detailed Business Case. The benefit management strategy provides the framework for managing benefits within the programme, and:

- defines benefit components;
- details how programme benefits will be quantified and measured;
- documents how progress will be tracked; and
- describes what governance arrangements will be in place.

85. Both internal and external stakeholders will be actively involved in the on-going assessment of timeframes, benefits identification and benefits realisation for each stage of the transformation programme.

## APPENDIX A – GETTING IT RIGHT FROM THE START

86. In order for Inland Revenue to help taxpayers get their tax obligations right the first time, Inland Revenue needs:

- More frequent and in some cases more detailed information on the investment income the investor receives; and
- Identifying information where Inland Revenue is unable to establish the taxpayer's identity.

### **Status quo and problem definition – detail and frequency of investment income information**

87. Currently, payers of investment income are required to deduct resident withholding tax (RWT) from interest and dividends when they are paid, and pay the RWT to Inland Revenue on the 20<sup>th</sup> of the following month. For PIEs, tax is generally paid to Inland Revenue at the end of the month following the month that an investor exits the PIE, or the month following the end of the year for all other investors.

88. These payments are due on the same date that payers of investment income must provide summary information to Inland Revenue. This summary information shows the total investment income paid and RWT/PIE tax deducted by the payer.

89. Information on each recipient, such as the income earned by the recipient and the tax withheld from that, isn't provided until:

- after the end of the tax year for interest subject to RWT or non-resident withholding tax (NRWT) and portfolio investment entity (PIE) income; or
- not at all for dividends, Māori authorities distributions and interest that is exempt or subject to AIL.

90. The provision of infrequent or in some cases no information means that Inland Revenue is unable to:

- Pre-populate tax returns and personal tax summaries – currently information is received by Inland Revenue too late (or not at all) to pre-populate tax returns. Anyone filing a tax return has to gather information about the interest, dividends and Māori authority distributions they have received from payers during the year and include it in their tax return. Taxpayers with multiple investments can end up with dozens of different tax certificates that they need to keep track of to understand their tax position. This is time consuming and, if information is missed out, can result in incorrect returns being filed. Payers provide the same information to their customers (and for interest to Inland Revenue) that the customers in turn provide to Inland Revenue if they file a tax return, which is inefficient.
- Accurately determine people's social policy entitlements/obligations during the year – social policy entitlements/obligations are based on estimates of income the taxpayer expects to receive for the relevant year. At the end of the year once the taxpayer's income is finalised, the taxpayer needs to perform a square-up. This imposes compliance costs on taxpayers and may also result in hardship for people who have

amounts to repay, or who did not receive their full entitlement during the year. Further, people can find it difficult to estimate their taxable income (which is the basis for their social policy calculations) as the amounts treated as taxable income for some types of income may be different from the actual return on investment. For example, for PIE funds invested solely in New Zealand shares the income for tax and social policy purposes does not reflect the return on investment because capital gains on shares are not income for tax purposes, resulting in taxpayers who use 'return on investment' as a measure of income overestimating their income. Often recipients of investment income are not informed of their taxable income until after the end of the tax year. As they have to estimate income before the start of the tax year for social policy purposes they may have to rely on the information they received for the year 2 years before the year they are making their estimate for. Because Inland Revenue does not receive income information during the year, it cannot adjust the taxpayer's social policy entitlements/obligations where the taxpayer's actual income is different from their estimate.

- Proactively correct errors and withholding tax rate choices – At the moment, a large proportion of taxpayers have tax withheld at the incorrect rate.<sup>6</sup> It is not uncommon for taxpayers to select a withholding rate and forget to change it as their circumstances change. For the majority of tax types, taxpayers can square this up at the end of the year. However, for PIEs it is especially important to ensure the correct rate is being used. This is because if a taxpayer has selected a higher rate than their correct rate, the excess tax withheld cannot be refunded. If a lower rate is selected, the income must be included in the taxpayer's tax return and taxed at their marginal rate. This may result in more tax being paid than if the correct PIR had been selected as the top PIR is 28%, compared to the top marginal tax rate of 33%. As Inland Revenue does not receive investment income information during the year, it is unable to help taxpayers work out the appropriate tax rate for them, resulting in taxpayers being over or under-taxed.
- Redesign the social policies that it administers – social policy schemes are currently based on estimates of annual income (i.e. working for families), or income from previous tax years (i.e. child support). It would be much better if these schemes could use shorter calculation periods and could be based on the actual income the taxpayer receives.

### ***Feedback from consultation – detail and frequency of investment income information***

91. Submitters were generally supportive of providing more detailed information to Inland Revenue, however took issue with providing it more frequently. The majority felt that the costs of providing this information quarterly or monthly would outweigh the benefits. The general consensus was that as the majority of people do not receive much investment income,

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<sup>6</sup> In the 2015 tax year, 33% of taxpayers who filed an IR 3 or PTS had RWT withheld at a higher rate than their marginal tax rate, whereas 45% had RWT withheld at a lower rate. Of those taxpayers who did not file a return or PTS, 38% had RWT withheld at a higher rate than their marginal rate, and 37% had RWT withheld at a lower rate than their marginal tax rate.

the social policy benefits would be minor.<sup>7</sup> Many submitters favoured providing the information annually as is the case now, or quarterly if a more frequent reporting requirement were to be introduced.

92. The provision of more frequent information for PIEs was especially controversial as many felt that reporting it on a more frequent basis would result in significant compliance costs but would not result in any meaningful social policy adjustments. PIE income can be volatile due to unpredictable movements in exchange and interest rates, and lumpy investment returns can mean that it can fluctuate from large positives to large negatives from month to month. Taking this income into account for social policy purposes would result in regular amendments to entitlements, making it difficult for people to budget and resulting in more work for the agencies responsible for managing social assistance. Further, given the nature of the PIE tax regime, taxpayers may have income for tax and social policy purposes despite not actually receiving any income<sup>8</sup>, or where they were in losses.<sup>9</sup>

93. Submitters also outlined that wholesale PIEs and locked in PIEs should be exempt from the requirements to provide more frequent information, given there would be no social policy benefit in obtaining this information.<sup>10</sup>

#### ***Options on obtaining more detailed investment income information***

94. Two options have been considered for addressing the problem and achieving the main objective. The options are:

- Option 1: Status quo.
- Option 2: Require payers of investment income to provide taxpayer specific information to Inland Revenue (officials' preferred option).

#### ***Option 1 – status quo***

95. Under this option the information provided by payers of investment income would remain unchanged.

#### ***Assessment against objective and criteria – option 1***

96. The status quo does not meet the main objective as currently Inland Revenue is unable to prepopulate investment income in tax returns, determine social policy entitlements or proactively correct tax rates with reference to the investment income earned by the taxpayer (as the information is received too late or not at all depending on the tax type). The status

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<sup>7</sup> Statistics show that the average amount of investment income a taxpayer with some form of social policy obligation or entitlement receives is \$539 a year. This figure does not exclude income from locked in PIE funds such as KiwiSaver, which are excluded from social policy calculations, however, it does exclude any non-declared income that should be included in social policy calculations.

<sup>8</sup> Due to the accrual nature of the financial arrangement rules and the foreign investment fund regime.

<sup>9</sup> Foreign shares held by a PIE are taxed at 5% of their opening market value, regardless of whether the share price has gone up or down.

<sup>10</sup> Clients of wholesale PIEs are not individuals, and locked-in PIE income is not taken into account for social policy purposes.

quo has not been assessed against the criteria as it is the option against which all other options are assessed.

Option 2 – require the provision of taxpayer specific information (preferred)

97. Under this option, payers would be required to provide the following information to Inland Revenue:

<b>Payer of investment income</b>	<b>Information that will be required in the future</b>	<b>Information already provided that will continue to be required</b>
Banks and other payers of interest	The same information as currently required.	Banks already provide the following information about individual taxpayers who are not exempt from RWT or have income subject to AIL: <ul style="list-style-type: none"> <li>• The income earned</li> <li>• The tax withheld.</li> </ul>
PIEs	The same information that is currently required.	Like banks, PIEs already provide individual taxpayer information regarding income earned and tax paid.
Companies	Information about individual recipients regarding income earned and tax withheld, including any imputation credits attached to dividends. Currently Inland Revenue only receives summary information from companies (i.e. total dividends paid and tax withheld for all taxpayers, not broken up by taxpayer).	Only summary information is provided.
Maori authorities	Similar to companies, except instead of dividend and imputation credit information, information will be required on Māori authority distributions and any Māori authority credits attached to those distributions.	Only summary information is provided.

98. As shown in the above table, only some investment income payers would be required to provide more information. The key change proposed for all payers of investment income is how frequently that the information will need to be provided (see the next section).

99. Note that this table does not cover all the information that payers of investment income would need to provide. They would also need to provide information to help Inland Revenue identify the recipient of the income (such as date of birth, IRD number, name and address). This is discussed in the identifying information section at paragraph 109. Detailed recipient information will also be required for income that is exempt or subject to AIL. As obtaining

this information is more about determining the identity of the taxpayer in order to determine whether the payment or AIL/exempt income is appropriate, as opposed to using the information for tax and social policy purposes, it has been discussed under the identifying information section.

#### *Assessment against objective and criteria – option 2*

- **Main objective:** This option meets the main objective as receiving taxpayer specific information helps Inland Revenue make it easier for taxpayers to comply with their obligations, for example, by prepopulating tax returns, more accurately determining social policy entitlements and proactively correcting tax rates. It also creates opportunities for the Government to consider how best to deliver and administer social assistance.
- **Fairness & equity:** This option represents a significant improvement on the status quo as it makes it easier for Inland Revenue to proactively correct people's tax rates and determine their social policy entitlements. This ensures that more people are taxed at a rate appropriate for them, and receive the correct entitlements – reducing the disadvantage that people unaware of the tax rules face in dealing with the tax system.
- **Efficiency of compliance and administration:** This option represents a partial improvement on the status quo. While it would help to reduce the compliance costs of taxpayers by prepopulating tax returns and more accurately determining social policy entitlements/obligations, the provision of more information would increase compliance costs for investment income payers at least initially while systems were set up. There is not expected to be any significant long-term increase in compliance costs as they are providing information they already hold. For Inland Revenue this change would reduce administrative costs as more income information would be able to be automatically associated with the recipient's tax record. Inland Revenue expects be able to process the additional information for minimal cost due to the work being undertaken in the Business Transformation programme.
- **Sustainability of the tax system:** This option represents a significant improvement on the status quo as it would improve Inland Revenue's ability to ensure tax and social policy payments were correct the first time around.

#### *Options on obtaining more frequent investment income information*

100. Four options have been considered for addressing the problem and achieving the main objective. The options are:

- Option 1: Status quo.
- Option 2: Payers to provide investment income information in the month following the month in which the income was paid – this is aligned with the process of paying the income and withholding tax and for monthly filers will occur at the same time as summary returns are currently provided.
- Option 3: Payers to provide investment income information by the 20<sup>th</sup> of the month following the **quarter** in which the income was paid for interest, dividends and taxable Maori authority distributions. Provision of PIE information remains at the end of the year (although by 15 May rather than 31 May for non-locked in PIEs and

interest<sup>11</sup> as well as 6 monthly reporting of PIRs for all PIEs). Payers of interest income that has been treated as exempt must provide recipient information yearly. Payers of interest income that are required to remit tax to Inland Revenue less often than quarterly will be required to provide information to Inland Revenue on a quarterly basis but will still remit the tax less frequently.

- Option 4: Payers to provide investment income information by the 20th of the month following the **month** in which the income was paid for interest, dividends and taxable Maori authority distributions. Provision of PIE information remains at the end of the year (although by 15 May rather than 31 May for non-locked in PIEs and interest as well as 6 monthly reporting of PIRs for all PIEs). Payers of interest income that has been treated as exempt must provide recipient information yearly. Payers of interest income that are required to remit tax to Inland Revenue less often than monthly will be required to provide information to Inland Revenue on a monthly basis but will still remit the tax less frequently.

#### Option 1 – status quo

101. Under this option, the frequency that payers of investment income would be required to provide information to Inland Revenue would not change. This means that taxpayer specific information would not be provided to Inland Revenue until after the end of the tax year (for interest and PIE income) or not at all (for dividends, Māori authorities distributions and interest that is exempt or subject to AIL).

#### *Assessment against objective and criteria – option 1*

102. The status quo does not meet the main objective as information is not received often or early enough to enable Inland Revenue to help people to get their tax right from the start (i.e. tax returns cannot be prepopulated and social policy entitlements and tax rates cannot be proactively corrected during the year). Furthermore, it means that the Government cannot reconsider how best to administer and deliver social assistance. The status quo has not been assessed against the criteria as it is the option against which all other options are assessed.

#### Option 2 – month following the month the income was paid

103. Under this option, detailed investment income information would be provided to Inland Revenue on the 20<sup>th</sup> of the month following the month the income was paid for interest, dividends and Maori authority distributions<sup>12</sup>, and the end of the month for PIE income.

#### *Assessment against objective and criteria – option 2*

- **Main objective:** This option meets the main objective as receiving information earlier would make it easier for taxpayers to comply with their tax obligations.

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<sup>11</sup> 15 May end of year reporting for interest is a transitional measure to get the information earlier to facilitate pre-population until monthly reporting comes in from 1 April 2020.

<sup>12</sup> Note that currently summary information on Maori authority distributions is not provided until after the end of the tax year.

- **Fairness & equity:** This option represents a significant improvement on the status quo as all taxpayers are treated equally and a reasonable time period is given to provide the information.
- **Compliance & administration:** This option represents a partial improvement on the status quo as providing this information monthly to Inland Revenue would reduce compliance costs for recipients and administration costs for Inland Revenue, however, it would necessitate extensive upfront system changes for larger payers. It would be especially burdensome on PIEs to report investor level information monthly, as opposed to only when an investor exits the fund. This is because PIEs' systems are only set up to perform tax calculations at the end of the year for non-exiting investors and run a number of year end processes at the same time. Running monthly tax calculations would necessitate a significant system redesign to decouple the tax calculations from the other year end processes.
- **Sustainability of the tax system:** This option represents a partial improvement on the status quo. While receiving information more often improves Inland Revenue's ability to ensure customers get their tax affairs right from the start, the volatility of PIE income means that more frequent adjustments to social policy entitlements to take into account this income would be unhelpful.

### *Option 3 – quarterly tailored approach*

104. Under this option, payers of investment income would be required to provide information on the 20<sup>th</sup> of the month following the **quarter** in which the income was paid for interest (including interest subject to AIL), dividends and taxable Maori authority distributions. PIE information would not have to be provided until the end of the year (although by the 15<sup>th</sup> of May as opposed to 31 May for PIEs where the funds are not locked in). All PIEs would be required to provide Inland Revenue with the PIRs of their investors every 6 months. Payers would be required to provide contact details yearly for recipients of income that was treated as exempt.

105. PIEs were excluded from the monthly reporting requirement because the volatile nature of PIE income (see paragraph 92) means that taking this income into account on a regular basis would be unhelpful. Another factor to take into account is the fact that PIE income from locked in PIEs such as KiwiSaver funds are not taken into account when calculating social policy obligations and entitlements. In addition, a number of PIEs have included their tax calculation in their year-end processes so would need to redesign these processes in order to run the tax calculation more frequently.

106. The requirement to provide yearly recipient information for recipients of income that has been treated as exempt is to allow Inland Revenue to check that this treatment was appropriate.

### *Assessment against objective and criteria – option 3*

- **Main objective:** This option meets the main objective as receiving information earlier would make it easier for taxpayers to comply with their tax obligations.
- **Fairness & equity:** This option represents a significant improvement on the status quo. Whilst PIEs will have less onerous reporting obligations, this is warranted given the issues outlined in paragraphs 92 and 93.
- **Compliance & administration:** This option represents a partial improvement on the status quo as it will reduce compliance costs for recipients and administration costs for

Inland Revenue. However, providing this information more frequently would result in an upfront cost to change systems, although is not expected to result in significant ongoing compliance costs given payers are providing information they already hold.

- Sustainability of the tax system: This option represents a partial improvement on the status quo as receiving the information more frequently better allows Inland Revenue to prepopulate tax returns and adjust social policy obligations. However, receiving information quarterly would mean that adjustments to social policy would be made on a 3 month lag (see further explanation in paragraph 108) compared to receiving the information monthly.

#### *Option 4 – monthly tailored approach (preferred)*

107. Under this option, payers of investment income would be required to provide information on the 20<sup>th</sup> of the month following the month in which the income was paid for interest (including interest subject to AIL), dividends and taxable Maori authority distributions. PIE information would not have to be provided until the end of the year (although by the 15<sup>th</sup> of May as opposed to 31 May for PIEs where the funds are not locked in). All PIEs would be required to provide Inland Revenue with the PIRs of their investors every 6 months. Payers would be required to provide contact details yearly for recipients of income that was treated as exempt.

#### *Assessment against objective and criteria – option 4*

- Main objective: This option meets the main objective as receiving information earlier would make it easier for taxpayers to comply with their tax obligations.
- Fairness & equity: This option represents a significant improvement on the status quo as taxpayers in similar circumstances are treated in similar ways – i.e. companies would no longer receive preferential treatment as they would be required to provide taxpayer specific info at the same time as interest payers.. Whilst PIEs will have less onerous reporting obligations, this is warranted given the issues outlined in paragraphs 92 and 93.
- Compliance & administration: This option represents a partial improvement on the status quo. Providing this information more frequently would result in an upfront cost to investment income payers making payments to large numbers of recipients as they will need to make changes to their systems. The ongoing compliance costs for these payers to large numbers of recipients are not expected to be material given payers will use their systems to generate the information. This will, however, depend on whether automatic checks and reconciliations are built into the systems or continue to be done manually as is the case now. Investment income payers making payments to small numbers of recipients will be likely to have reduced compliance costs as they will be able to file their returns digitally. Administrative costs will also reduce.
- Sustainability of the tax system: This option represents a significant improvement on the status quo as the frequency of the receipt of the information under this option would best help customers get it right from the START.

## Monthly vs quarterly argument

108. Monthly reporting is favoured over quarterly reporting for the following reasons:

- Quarterly reporting would limit Inland Revenue's ability to redesign how social policy is delivered as it makes it more difficult to align income received with any potential changes to social policy income calculation periods.
- Quarterly reporting will result in a delay of at least 3 months as the reporting is done after the end of the quarter and the income calculation for social policy is completed before the start of the period – i.e. if social policy was also calculated quarterly the quarter April – June couldn't be part of July's social policy adjustment as the information wouldn't be reported until 20 July and the calculation would have to have been completed by 1 July. With monthly reporting, the information for April and May would have been received and would be taken into account in the July adjustment. Investment income reporting and social policy calculations are based on the 31 March income year so offsetting the quarters would lead to a number of other issues and costly reconciliations.
- The key compliance cost is the initial system changes required to enable more frequent reporting. Provided these changes are made with a view to automating checks and reconciliations as much as possible then the ongoing period by period costs will be significantly less than the costs large investment income payers incur with their current year end processes. One large financial institution noted in their submission that the difference in compliance costs between quarterly and monthly reporting "would be marginal as systems changes would be needed either way".
- Monthly reporting aligns with the business process of paying the tax to Inland Revenue. Currently Inland Revenue receives payments monthly but no detailed information so has no way of knowing who the tax is attributable to until the end of the year. The change would mean that Inland Revenue would get detailed information relating to the payment with the payment.

## **Status quo and problem definition - Identifying information**

### ***IRD numbers/increased non-declaration rate***

109. Inland Revenue has difficulty attributing income to a taxpayer if Inland Revenue does not have the taxpayer's IRD number. Around 20% of the interest certificates received by Inland Revenue do not contain the recipient's IRD number. For other income types this is a lot lower – for example only 2% for PIE income.

110. Currently, taxpayers are not incentivised to provide their IRD number to Inland Revenue as the non-declaration rate, the rate that applies to taxpayers who do not declare their IRD number, is too low. The non-declaration rate is:

- 33% for interest, dividends and Māori authority distributions over \$200, and
- 28% for portfolio investment entity (PIE) income.

111. These rates equal the top marginal tax rates for the respective income types. As a result, these rates do not incentivise taxpayers on the top marginal tax rate to provide their IRD number. Further, taxpayers with social policy entitlements or obligations may have much higher effective tax rates (taking into account abatement of entitlements or additional

obligations) and may realise that by not providing their IRD number, it is unlikely that their investment income will be taken into account when social policy entitlements/obligations are calculated. This may mean they receive more social assistance or pay less in child support and student loan repayments than they should.

#### Example

Laura is a single mother with sole custody of her two children. She earns \$50,000 a year and has a student loan. She invested some money from an inheritance which returns her \$5,000 income a year. She has not provided her IRD number to her investment income payer. As a result, Laura would receive \$1,352 per year more in working for families than otherwise entitled, and pay \$600 less off her student loan per year than otherwise required, if she does not return this income

#### *Date of birth information*

112. Currently Inland Revenue receives the recipient's IRD number (if held by the payer), name and address information only as identifying information. Date of birth information can help Inland Revenue determine the IRD numbers of non-declared taxpayers. Some people use multiple spellings or versions of their name and it isn't uncommon for two or more people to have the same name. People can also give incorrect IRD numbers by mistake. Date of birth information can also help to identify these people.

#### Example

Jenny and her mother Jane have the same surname and live at the same address. Jenny hasn't given her interest payer her IRD number, but her mother has supplied hers. There is a risk that Jenny's investment income could be matched with her mother's Inland Revenue records. Inland Revenue could allocate their income to the right accounts if their dates of birth were provided by their investment providers.

#### *Joint accounts*

113. Each of the owners of a joint investment is taxable based on their share of ownership of the investment. It is important to accurately allocate the income to each owner to ensure that their tax and social policy obligations and entitlements are correctly calculated.

114. Currently Inland Revenue is only provided with one IRD number and contact details for a joint account. This makes it hard to allocate income between the owners. Unless all joint account owners file tax returns, tax is withheld at the tax rate chosen by the owner whose IRD number is associated with the account. This can result in the income being over or under taxed where the owners are on different marginal tax rates or an inappropriate rate is chosen.

#### Example

David and Danielle have a joint account earning \$2,000 income a year. David is on a 33% marginal tax rate, whereas Danielle is on a 10.5% rate. Because David's IRD number is associated with the account, Danielle's share of the income is taxed at 33%, rather than 10.5%, and Danielle has to file a tax return to claim back the additional \$225 tax that is withheld.

### ***Identifying information for AIL and exempt income***

115. Inland Revenue does not receive any information on the recipients of income subject to AIL, so is unable to check that the payment of AIL is appropriate. A person may have elected to have AIL apply to their investment when they are a non-resident for tax purposes and may have forgotten to change back to RWT on their return to New Zealand. Getting AIL information will enable Inland Revenue to check whether other information indicates that a recipient being treated as subject to AIL is actually a New Zealand tax resident.

116. Inland Revenue also receives no information on the recipients of exempt income. This means that Inland Revenue is unable to check that recipients of income that is treated as exempt are actually eligible for this treatment. While other proposals such as providing a certificate of exemption database will help payers of investment income to determine whether recipients are validly being treated as exempt, the provision of recipient information for income that has been treated as exempt will enable Inland Revenue to proactively check compliance in this area and advise payers and recipients if exemptions are being invalidly applied.

### ***Feedback from consultation – IRD numbers/non-declaration rate***

117. The discussion document proposed raising the non-declaration rate in order to encourage the provision of IRD numbers. While some submitters supported this proposal, the majority of submitters were strongly opposed to this. The main points raised by submitters were:

- The costs to implement the changes would be substantial.
- The 45% rate will be too high for the majority of taxpayers who do not have significant social policy entitlements/obligations to justify a 45% rate. For the majority it would be a penal rate that would punish the unsophisticated.
- The non-declaration rate isn't the solution to what is essentially a data matching problem. A better solution would be to require an IRD number to be provided before the investor could use their account.
- The aim of a withholding tax system should be to achieve payment of the recipient's expected income tax liability on an annual basis – no more. Increasing the non-declaration rate seems contrary to the policy behind business transformation as it would result in more taxpayers filing returns at the end of the year to claim back the excess tax.
- Retirement savings PIEs should not be subject to a 45% non-declaration rate as this type of PIE income is not taken into account for social policy purposes. Further, overpaid PIE tax on retirement savings which are subsequently recovered when the individual files a return would be unlikely to be returned to the taxpayer's retirement account.
- This proposal would increase compliance costs for financial institutions as they would be the first port of call for complaints.
- This proposal shifts the costs of policing IRD numbers from investors and Inland Revenue to payers of investment income.
- Wholesale PIEs should be exempt from applying the increased non-declaration rate as it would be unnecessary for them to incur the cost to build it into their system when it is unlikely to ever apply given the type of investors who invest in wholesale PIEs (i.e. superannuation funds and other sophisticated non-individual investors).

- The non-declaration rate should not apply to investors who legitimately do not require IRD numbers, such as non-residents and exempt persons.
- Taxpayers taxed at the non-declaration rate should not be able to receive PIE losses cashed out at 45%.

#### ***Feedback from consultation – date of birth information***

118. The provision of date of birth information to Inland Revenue was supported where payers held that information. There was a consensus that this should be a legislative requirement in order to overcome any privacy concerns.

#### ***Feedback from consultation – joint accounts***

119. Submitters were supportive of providing identifying information of joint account owners where payers of investment income held that information. Payers cautioned that they would be unable to split the income between the joint investors.

#### ***Feedback from consultation – AIL and exempt income***

120. The majority of submitters did not support providing this information for the following reasons:

- System amendments would be required to provide this information.
- AIL information will be provided under the AEOI reporting requirements when these come into effect.
- The information will not be used for auditing non-compliance, rather than prepopulating returns or adjusting social policy payments, so could be provided annually.

#### ***Options in relation to obtaining IRD numbers***

121. Three options have been considered to make changes to the non-declaration rate to increase the provision of IRD numbers to Inland Revenue. The options are:

- Option 1: Status quo.
- Option 2: 45% non-declaration rate for all investment income types.
- Option 3: 45% non-declaration rate just for interest income. For PIEs a taxpayer would need to provide their IRD number before the PIE would allow them to open an account, but a 45% non-declaration rate would not apply. For companies and Maori authorities, the non-declaration rate would remain at 33% (preferred option).

#### ***Option 1 – status quo***

122. Under this option the non-declaration rate would remain unchanged.

### *Assessment against objective and criteria – option 1*

123. The status quo does not meet the main objective as the non-declaration rate is too low to encourage taxpayers to provide their IRD numbers. Where Inland Revenue does not have a taxpayer's IRD number, it is unable to help the taxpayer get it right from the start, for example by prepopulating investment income. The status quo has not been assessed against the criteria as it is the option against which all other options are assessed.

### *Option 2 – 45% non-declaration rate for all types of investment income*

124. Under this option, the non-declaration rate would be increased to 45% for interest, dividends, Māori authority distributions and PIE income.

### *Assessment against objective and criteria – option 2*

- **Main objective:** This option meets the main objective as increasing the non-declaration rate to 45% encourages taxpayers to provide their IRD numbers, which helps Inland Revenue simplify the tax system by prepopulating income and proactively correcting withholding rates and social policy payments.
- **Fairness & equity:** This option represents a significant improvement on the status quo as it treats all taxpayers equally. The status quo could be seen as unfair as a 45% non-declaration rate applies to income from salary and wages, but not to investment income.
- **Compliance & administration:** This option represents a partial improvement on the status quo. A 45% non-declaration rate will reduce Inland Revenue's administrative costs in determining a taxpayer's identity, as more taxpayers will provide their IRD number. However, compliance costs will increase for payers who will need to set their systems up to withhold tax at 45%. This is especially burdensome for companies (whose systems are set up to withhold tax at only one rate as all dividends have tax withheld at 33%) and for Māori authorities (due to administrative and system constraints).
- **Sustainability of the tax system:** This option represents a partial improvement on the status quo. While the tax system is more sustainable where income can be allocated to the correct taxpayer, a 45% rate would overtax people who did not have social policy entitlements or obligations and they would be required to file an annual tax return to ensure the income is taxed at the correct rate. It would also increase the complexity of the tax system as non-declared recipients of PIE income would have to file tax returns in order to get the excess tax back. In addition it would mean that PIE losses could get refunded at 45% whereas recipients could file tax returns to ensure their PIE income was taxed at no more than 33%.

### *Option 3 – 45% non-declaration rate for interest, new account restriction for PIEs (preferred)*

125. Under this option, the non-declaration rate would be increased to 45% for interest income. For PIEs a taxpayer would need to provide their IRD number before the PIE would allow them to open an account, but a 45% non-declaration rate would not apply. There would be exceptions for investors that certify they are non-resident, who provide their tax identification number from the country in which they are resident, and who don't have an IRD number. For companies and Maori authorities, the non-declaration rate would remain at 33%.

126. A 45% non-declaration rate was considered appropriate for interest income as 20% of the recipients of this income have not provided their IRD number. Further, interest is the largest form of investment income. Inland Revenue will work with payers of interest income to identify the IRD numbers of non-declared investors prior to the introduction of the increased non-declaration rate.

127. It was not considered appropriate to impose a 45% non-declaration rate on PIE income because:

- The increased compliance costs for payers would not be justified as only 2% of recipients of PIE income have not provided their IRD number.
- It would create issues for retirement savings and losses as identified in feedback received (see paragraph 117).
- It would be inappropriate for wholesale and locked-in PIEs (see paragraph 117).

128. A 45% non-declaration rate was not considered favourable for companies and Māori authorities due to systems constraints (see analysis on option 2). We have not recommended that the provision of an IRD number is a requirement for all new investments in companies as we are unable to determine the extent of non-declaration problem until we receive detailed recipient information. If future data shows non-declaration to be a problem, then a measure will be considered. This will also provide companies with sufficient time to get used to the proposed increased reporting requirements (which will represent a significant change for companies given they currently do not report taxpayer specific information at all), before additional requirements are imposed.

#### *Assessment against objective and criteria – option 3*

- **Main objective:** This option partially meets the main objective as compliance with the tax system is not encouraged for taxpayers with income not subject to the increased non-declaration rate or rule for new accounts (i.e. dividends and Māori authority distributions).
- **Fairness & equity:** This option represents a partial improvement on the status quo. While it gives preferential treatment to companies and Māori authorities, it does improve non-declaration measures for interest and PIE income.
- **Compliance & administration:** This option represents a significant improvement on the status quo. While there will be transitional compliance costs for interest payers who need to set up their systems to withhold tax at 45%, Inland Revenue's costs associated with determining a taxpayer's identity will reduce. Payers of other types of investment income will not have increased costs under this proposal.
- **Sustainability of the tax system:** This option represents a significant improvement on the status quo as the tax system is more sustainable where income, tax and social policy payments can be allocated to the correct taxpayer and where the withholding tax system, as far as is appropriate, withholds tax at a rate that approximates the taxpayer's final tax liability.

#### *Options on obtaining date of birth information*

129. Three options have been considered for addressing the problem and achieving the main objective. The options are:

- Option 1: Status quo.
- Option 2: Date of birth information to be provided if held by the payer (officials' preferred option).
- Option 3: Date of birth information is requested from the payer if it is needed by Inland Revenue for data matching.
- Option 4: Date of birth information is required to be provided by payers

*Option 1 – status quo*

130. Under this option, the current rules would stay the same – that is, investment income payers would not be required to provide their clients dates of birth, even if they held them.

*Assessment against objective and criteria – option 1*

131. The status quo does not meet the main objective as not receiving date of birth information may hinder Inland Revenue's ability to identify taxpayers – therefore preventing Inland Revenue from helping that taxpayer get their tax affairs correct from the beginning. The status quo has not been assessed against the criteria as it is the option against which all other options are assessed.

*Option 2 – date of birth to be provided if held (preferred)*

132. Under this option, payers of investment income would be required to provide date of birth information provided it was held by the payer of the investment income. In other words, the payer would not need to actively obtain date of birth information from its customers.

*Assessment against objective and criteria – option 2*

- **Main objective:** This option partially meets the main objective as receiving date of birth information for some taxpayers will improve Inland Revenue's ability to identify those taxpayers, and therefore put Inland Revenue in a better position to help customers get their tax affairs right from the start. This option does not fully meet the main objective as date of birth information would not be provided in some circumstances where it was needed (i.e. where Inland Revenue needed it to confirm a taxpayer's identity, but it was not held by the payer).
- **Fairness & equity:** This option represents a significant improvement on the status quo as it improves equity by improving Inland Revenue's ability to identify taxpayers.
- **Compliance & administration:** This represents a significant improvement on the status quo as it reduces administrative costs by making it easier for Inland Revenue to identify taxpayers, and has minimal impact on compliance costs as it only asks investment income payers to provide information they already hold.
- **Sustainability of the tax system:** This option represents a partial improvement on the status quo as while date of birth information is received for some taxpayers, it is not received for all taxpayers that it is needed for. While financial institutions collect date of birth information from customers as part of their Know Your Customer processes (anti money laundering), they may not hold date of birth information for customers that began investing with them before these processes were required. The tax system

is more sustainable where income can be matched to the relevant taxpayer, as otherwise the person could be receiving social policy payments that they are not entitled to, or paying less in social policy obligations than required.

*Option 3 – date of birth to be provided on request if needed*

133. Under this option, payers of investment income would only be required to provide date of birth information (provided it was held by the payer of the investment income) where Inland Revenue identified that it was needed for data matching and made an information request.

*Assessment against objective and criteria – option 3*

- Main objective: This option partially meets the main objective as Inland Revenue could request and would receive date of birth information for some taxpayers. This would improve Inland Revenue's ability to identify those taxpayers, and therefore put Inland Revenue in a better position to help customers get their tax affairs right from the start. This option does not fully meet the main objective as date of birth information would not be provided in some circumstances where it was needed (i.e. where Inland Revenue needed it to confirm a taxpayer's identity, but it was not held by the payer).
- Fairness & equity: This option represents a significant improvement on the status quo as it treats all investment income payers equally.
- Compliance & administration: This option is worse than the status quo as it requires Inland Revenue to go through additional processes to identify situations where the additional date of birth information is required and then prepare information requests (the date of birth information may not just be useful for Inland Revenue data matching but may also assist with cross Government information sharing which could mean the need for the information was not discovered until sometime later). Investment income payers would then have to process the large information requests (with 20% of interest certificates non-declared the requests would be large). These additional processes would give rise to much higher compliance and administrative costs than requesting the information as part of the regular reporting process.
- Sustainability of the tax system: This option represents a partial improvement on the status quo as while date of birth information is received for some taxpayers, it is not received for all taxpayers that it is needed for. The tax system is more sustainable where income can be matched to the relevant taxpayer, as otherwise the person could be receiving social policy payments that they are not entitled to, or paying less in social policy obligations than required.

*Option 4 – date of birth to be provided*

134. Under this option, payers of investment income would be required to provide date of birth information. This would mean that the payer would need to actively try to obtain date of birth information from its customers where the payer does not already hold that information.

#### *Assessment against objective and criteria – option 4*

- Main objective: This option does not meet the main objective as requiring payers to provide date of birth information even when they did not hold it would make it extremely difficult for payers to comply.
- Fairness & equity: This option is about the same as the status quo as it improves equity by improving Inland Revenue’s ability to identify taxpayers but it is unfair as it makes it extremely difficult for payers to be compliant.
- Compliance & administration: This is worse than the status quo as while it reduces administrative costs by making it easier for Inland Revenue to identify taxpayers, it would have a significant impact on compliance costs as it asks investment income payers to provide information they do not hold and that they would be likely to have great difficulty in getting from some customers.
- Sustainability of the tax system: This option is worse than the status quo as while date of birth information is received for some taxpayers, it is not received for all taxpayers that it is needed for and it makes payers non-compliant. The tax system is more sustainable where income can be matched to the relevant taxpayer, as otherwise the person could be receiving social policy payments that they are not entitled to, or paying less in social policy obligations than required. It is also more sustainable where requirements are reasonably able to be complied with as making ordinarily compliant participants in the tax system non-compliant can negatively affect their willingness to constructively engage with the tax system going forwards.

#### *Options in relation to joint accounts*

135. Three options have been considered for allocating income between joint investment owners. The options are:

- Option 1: Status quo.
- Option 2: The investment income payer splits the income and tax among the owners according to their ownership proportions, and passes this information on to Inland Revenue, as well as identifying details for each owner.<sup>13</sup>
- Option 3: The investment income payer informs Inland Revenue that the taxpayers are operating a joint account, and provides details of all account owners. Inland Revenue prepopulates their income based on equal shares (officials’ preferred option).

#### Option 1 – status quo

136. Under this option there would be no changes. This means that income from a joint account would only be allocated to the owner whose IRD number is associated with the account and each owner would need to file a tax return to square this up at the end of the year.

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<sup>13</sup> As was mentioned above Inland Revenue currently only receives one IRD number for a joint account. IRD numbers and contact information would be required for all owners of the account.

*Assessment against objective and criteria – option 1*

137. The status quo does not meet the main objective as it imposes an unnecessary requirement on joint account owners to file a tax return. The status quo has not been assessed against the criteria as it is the option against which all other options are assessed.

*Option 2 – payer splits by ownership proportion*

138. Under this option, the investment income payer would split the income and tax withheld among the owners of the joint investment in accordance with their ownership proportions, and pass this, as well as identifying information for each owner, on to Inland Revenue.

*Assessment against objective and criteria – option 2*

- **Main objective:** This option represents a significant improvement on the status quo as income and tax would be correctly prepopulated provided joint account owners informed their investment payer of their ownership proportions.
- **Fairness & equity:** This option represents a significant improvement on the status quo as the tax system is more equitable where information is pre-populated for taxpayers. This is because taxpayers who are unsophisticated or who cannot afford a tax agent are not disadvantaged.
- **Compliance & administration:** This option is worse than the status quo as it would impose compliance costs on payers to gather the ownership proportions from the investors and would result in expensive and complicated changes to payers' systems to enable the calculation of tax at split rates.
- **Sustainability of the tax system:** This option represents a significant improvement on the status quo as the tax system is more sustainable where income and tax is prepopulated for taxpayers.

*Option 3 – Inland Revenue prepopulates equal shares (preferred)*

139. Under this option, the investment income payer will inform Inland Revenue that the taxpayers are operating a joint account, and provide details of all account owners. Inland Revenue prepopulates their income based on the assumption that the investment is held in equal shares. This would be correct for a significant number of joint accounts. Where this is not the case, the investors will need to inform Inland Revenue of their share of income as part of the annual tax return process. As with the status quo, tax would be withheld at one rate, so a square up would be required where the taxpayers were on different marginal rates.

*Assessment against objective and criteria – option 3*

- **Main objective:** This option partially meets the main objective as the income would be prepopulated correctly where the investment was held in equal proportions (this is the most common ownership proportion). The taxpayers may still have an end of year debt or payment obligation though as tax would still be withheld at one rate.
- **Fairness & equity:** This option represents a significant improvement on the status quo as prepopulating tax returns ensures unsophisticated taxpayers are not disadvantaged.
- **Compliance & administration:** This option represents a partial improvement on the status quo. Compliance costs are reduced relative to the status quo as not all joint investment owners will need to square up at the end of the year. However, owners who do not hold the investment in equal shares or who are on different marginal tax rates will be required to perform a square up.

- **Sustainability of the tax system:** This option represents a partial improvement on the status quo. While the tax system is more sustainable where information is prepopulated, a square up will be required if the investors do not own the investment equally, and if they are on different marginal tax rates.

*Options in relation to contact details of recipients of income subject to AIL or treated as exempt*

*Identifying information for recipients of income subject to AIL and income that is treated as exempt*

140. The following options were considered for obtaining the identity of recipients of exempt income or income subject to AIL.

<b>Options</b>	<b>Analysis against the objective and criteria</b>
Option 1 – Status quo.	Doesn't meet the main objective
Option 2 – Detailed recipient information obtained for exempt income and income subject to AIL.	Meets the main objective Fairness & equity: ✓✓ Compliance and administration: ✓x Sustainability: ✓✓  Overall comment: Significant improvement on status quo
Option 3 – Detailed recipient information obtained for exempt income and income subject to AIL, but carving out any information already provided under AEOI.	Partially meets the main objective Fairness & equity: ✓✓ Compliance and administration: xx Sustainability: ✓x  Overall comment: Improvement on status quo

141. Three options have been considered for obtaining the identity of recipients of exempt income or income subject to AIL. The options are:

- Option 1: Status quo.
- Option 2: The investment income payers provide detailed recipient information for investment income subject to AIL (on New Zealand issued debt) or treated as exempt to Inland Revenue.
- Option 3: Investment income payers to provide detailed recipient information for investment income that is exempt subject to AIL (on New Zealand issued debt), but carving out any information already provided under AEOI.

### Option 1 – status quo

142. Under this option there would be no changes. This means that Inland Revenue would not receive any recipient information in respect of investment income that has been subject to AIL or treated as exempt.

#### *Assessment against objective and criteria – option 1*

143. The status quo does not meet the main objective as recipients of investment income may be subject to an incorrect tax regime which will result in any tax that is being deducted being deducted at too low a tax rate. The recipients would then be required to file tax returns to correct their tax positions.

### Option 2 – payer provides recipient information for investment income subject to AIL or treated as exempt (preferred option)

Under this option, the investment income payer would provide recipient information to Inland Revenue for investment income that was subject to AIL (on New Zealand issued debt) or was treated as exempt. Recipient information would include name and contact detail information, but also the income earned and tax withheld (if any).

#### *Assessment against objective and criteria – option 2 (preferred option)*

- **Main objective:** This option meets the main objective as Inland Revenue would be able to use the information to check that the recipients are validly being treated as subject to the applicable tax regime and could proactively inform the payer and the recipient if they were not.
- **Fairness & equity:** This option represents a significant improvement on the status quo as it treats all taxpayers equally.
- **Compliance & administration:** This option represents a partial improvement on the status quo as while it would reduce administrative costs by improving Inland Revenue's auditing function, it would impose some compliance costs on payers to provide the additional information, however, it would be similar information to the information provided for RWT and NRWT and should be able to be gathered using similar processes.
- **Sustainability of the tax system:** This option represents a significant improvement on the status quo as the tax system is more sustainable where taxpayers are taxed under the right tax regimes and at rates that approximate their actual tax liability. By limiting the AIL information to New Zealand issued debt this also means that investment income payers will not be asked for information that they cannot get or would have significant difficulty providing.

### Option 3 – payer provides recipient information for investment income that is exempt or subject to AIL (but carving out information required to be provided under AEOI)

144. Under this option, the investment income payer would provide recipient information to Inland Revenue for investment income that was subject to AIL (on New Zealand issued debt) or was treated as exempt, however information already provided under AEOI would not need to be provided again. Recipient information would include name and contact detail information, but also the income earned and tax withheld (if any).

*Assessment against objective and criteria – option 3*

- **Main objective:** This option meets the main objective as Inland Revenue would be able to use the information to check that the recipients are validly being treated as subject to the applicable tax regime and could proactively inform the payer and the recipient if they were not.
- **Fairness & equity:** This option represents a significant improvement on the status quo as it treats all taxpayers equally.
- **Compliance & administration:** This option is worse than the status quo. During consultation officials were told that determining the information provided under AEOI and only providing the information not provided would entail higher compliance costs than just providing all AIL information. Officials were also told by financial institutions that they did not want to combine the reporting for FATCA and AEOI with the reporting proposals for investment income. As the information is already held by the investment income payer, it would be easier to provide all the information at once.
- **Sustainability of the tax system:** This option represents a significant improvement on the status quo as the tax system is more sustainable where taxpayers are taxed under the right tax regimes and at rates that approximate their actual tax liability. By limiting the AIL information to New Zealand issued debt this also means that investment income payers will not be asked for information that they cannot get or would have significant difficulty providing.

## APPENDIX B – COMPLIANCE AND ADMINISTRATION COSTS

145. Inland Revenue wants to minimise the costs that taxpayer face complying with the tax system, as well as the costs to the government of administering the tax system. This is a key theme of Business Transformation as was outlined in the Green Paper. In relation to investment income, the following are areas where compliance and administration costs could be reduced:

### *Status quo and problem definition - compliance costs for taxpayers*

#### *Filing tax returns*

146. The current process of filing a tax return is cumbersome as taxpayers are required to gather information about the interest, dividends and Māori authority distributions they have received from payers during the year and include it in their tax return. Taxpayers with multiple investments can end up with dozens of different tax certificates that they need to keep track of to understand their tax position. This is time consuming and, if information is missed out, can result in incorrect returns being filed.

#### *Selecting a withholding rate*

147. Currently, taxpayers need to have an indication of the income they will earn in the tax year in order to select an appropriate withholding rate. Often taxpayers will select a withholding rate and forget to change it as their circumstances change (or they may not realise that their income has reached a threshold that requires a higher tax rate), resulting in under or over taxation. This problem is exacerbated for PIE income as tax on PIE income is final. This means that if a rate higher than the correct rate is selected, the tax cannot be refunded. If a lower rate is selected, the income must be included in the taxpayer's tax return and taxed at their marginal rate, which may be higher than the top PIE rate of 28%. For other income types, a tax return must be filed where an incorrect withholding rate is used.<sup>14</sup> Having to work out the appropriate withholding rate, update it as circumstances change, and file a tax return wherever an incorrect rate is used, entails significant compliance costs for taxpayers.

#### Example

Jack graduated university three years ago. While at university he had a marginal tax rate of 10.5%. This was the rate he used when he set up his bank account and KiwiSaver account. He is now on a 33% marginal rate and has forgotten to update his rate for his bank account and KiwiSaver account (which is a PIE). He must file a tax return to pay the extra tax that should have been withheld from his interest and PIE income. His PIE income will be taxed at 33%, despite the fact that the PIE top rate is only 28%. Depending on the investment income Jack earned, this could result in a sizeable tax bill.

148. Because Inland Revenue does not receive information throughout the year about the investment income of individual taxpayers, it is not able to calculate social policy payments during the year to reflect this income. As a result, a square-up calculation needs to be made at the end of the year when a person's income is finalised. This imposes compliance costs on

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<sup>14</sup> Provided the amount of income taxed at an incorrect rate exceeds \$200.

taxpayers and may also result in hardship for people who have significant amounts to repay, or who received too little during the year when they needed the assistance.

### Example

Will and Eden have 4 children, earn \$50,000 and \$30,000 a year respectively, and both have student loans. During the year they received and invested a sizeable inheritance which returned them \$10,000 income in the income year. As Will and Eden did not include this income in their estimated income for the year they would have an end of year liability of \$3,592, consisting of \$2,392 working for families repayments and \$1,200 in student loan repayments.

### ***Feedback from consultation – compliance costs for taxpayers***

149. Submitters supported in principle the idea to reduce compliance costs for taxpayers by prepopulating returns, proactively advising of withholding rates and adjusting social policy entitlements/obligations. However they noted that a balance should be struck between compliance costs on payers and benefits to taxpayers. Inland Revenue should not strive for a utopia of having every taxpayer’s tax and social assistance obligations perfect every time, all of the time. A “close enough is good enough” approach should be taken.

### ***Status quo and problem definition - Compliance costs for payers of investment income***

#### *End of year tax certificates*

150. Payers of resident withholding income are currently required to provide end-of-year tax certificates to the recipients of the income – such as year-end interest certificates, shareholder dividend statements, PIE investor statements and Māori authority distribution statements. These certificates set out the amount of income earned and tax deducted, which recipients can then include in their tax return. Payers also provide interest and PIE information to Inland Revenue after the end of the tax year. In other words, Inland Revenue receives the same information twice in some instances. This is inefficient. Providing end of year certificates also imposes compliance costs on payers of investment income which would be unnecessary if that information was already held by Inland Revenue and able to be viewed by the taxpayer during the year.

#### *Certificates of exemption*

151. Taxpayers holding certificates of exemption (“COEs”) from RWT are entitled to be paid interest and dividends without having any tax deducted by the payer. The holder of the COE is required to provide a copy to the relevant withholder and must inform the withholder if their COE is cancelled. Cancellations and issues of COEs in the previous quarter are published in the New Zealand Gazette each quarter. Taxpayers exempt under other Acts other than the Income Tax Act 2007 and the Tax Administration Act 1994, for example the Education Act, are entitled to an exemption without needing to obtain a COE.

152. The current exemption process involves compliance costs for payers as they need to:

- receive exemption certificates from taxpayers;
- check the appropriate gazette to see if the taxpayer’s certificate has been cancelled; and

- assess whether the customer can appropriately claim to be exempt under non-tax legislation.

***Feedback from consultation – compliance costs for payers of investment income***

***Feedback from consultation - End of year tax certificates***

153. Feedback was mixed on the proposal to remove the requirement for payers to provide end of year tax certificates to interest recipients who had provided their IRD number. About 40% of submitters supported removing the requirement, and the other 60% felt it should stay.

154. A common view was that the end of year tax certificate was necessary to enable taxpayers to verify the information that Inland Revenue held about them. Taxpayers have an obligation to confirm the correctness of their tax position under our self-assessment tax system, and the end-of-year tax certificate enables taxpayers to do that. Without the end of year tax certificate, taxpayers would have to go back to their bank statements to determine this for themselves, which would be significantly more difficult. Some investment income payers also felt that compliance costs would not decrease from removing this requirement as systems had already been set up to provide the certificates. Even if the requirement were removed, investors may continue to request end of year certificates.

***Feedback from consultation – certificates of exemption***

155. The discussion documents proposed introducing a searchable database of certificates of exemption from withholding tax, to enable payers of investment income to confirm that a customer was entitled to an exemption from RWT. It was also proposed that organisations exempt from RWT under other Acts would be required to apply for a certificate of exemption, and thus would be included on the database.

156. All submitters were in favour of having a certificate of exemption database. Some submitters cautioned that this proposal should not result in the removal of the requirement for investors to send a copy of their certificate of exemption to their investment income provider. Absent this requirement, costs for payers could increase as they would need to check all of their customers against the database to determine whether or not they were entitled to an exemption from RWT. Submitters were also supportive of requiring organisations exempt from RWT under other Acts to apply for a certificate of exemption.

***Options – compliance costs for payers of investment income***

***Options – end of year tax certificates***

157. Three options have been considered to reduce compliance costs for payers of investment income through making changes to the end-of-year tax certificate requirements:

- Option 1: Status quo
- Option 2: Remove the requirement to provide end of year interest certificates.
- Option 3: Remove the requirement to provide end of year interest certificates to customers who have provided their IRD numbers.

***Option 1 – status quo***

158. Under this option, payers of investment income would continue to be required to provide end of year tax certificates to all taxpayers.

*Assessment against objective and criteria – option 1*

159. The status quo does not meet the main objective as it complicates the tax system by requiring the same information to be provided to Inland Revenue twice. The status quo has not been assessed against the criteria as it is the option against which all other options are assessed.

*Option 2 – removal of requirement to provide end of year interest certificates*

160. Under this option, the requirement for payers to provide end of year interest certificates to their customers would be removed. Payers would still need to provide end of year certificates to recipients of PIE income, as well as certificates to recipients of dividends and Maori authority distributions when they were paid, and could continue to provide end of year interest certificates if they wished.

*Assessment against objective and criteria – option 2*

- Main objective: This option meets the main objective as it simplifies the tax system to some extent by removing the provision of duplicated interest income information.
- Fairness & equity: This option represents a partial improvement on the status quo as it treats taxpayers in similar circumstances in similar ways. While this option is inequitable in a sense as payers of dividends, PIE income and Maori authority distributions must continue to provide end of year tax certificates, this is arguably appropriate because the end of year tax certificate acts as a reminder to taxpayers that they have received this income. The regularity of interest income often means the taxpayer is already aware of when they are due to receive the income.
- Compliance & administration: This option represents a significant improvement on the status quo as it reduces compliance and administration costs relative to the status quo as payers of investment income do not need to provide end of year tax certificates to recipients of interest income and Inland Revenue does not receive the same information twice.
- Sustainability of the tax system: This option represents a partial improvement on the status quo. The tax system is more sustainable where costs are reduced, however under this option end of year interest certificates would not be provided to customers who have not provided their IRD number. Providing these certificates is important for these taxpayers as it acts as a reminder to file a return thereby allowing the taxpayer to claim back tax that has been over withheld as a result of the non-declaration rate applying.

*Option 3 – removal of requirement to provide end of year interest certificates to customers who have provided their IRD number (preferred)*

161. Under this option, the requirement for payers to provide end of year interest certificates to their customers would be removed for customers who had provided their IRD number. Payers would still need to provide end of year interest certificates to customers who had not provided their IRD number, in order to remind them to file a tax return (so that they would not be taxed at the non-declaration rate). Payers would still need to provide end of year

certificates for PIE income and would still need to provide certificates to recipients of dividends and Maori authority distributions when they were paid.

#### *Assessment against objective and criteria – option 3*

- **Main objective:** This option meets the main objective as it simplifies the tax system to some extent by removing the provision of duplicated interest income information where the taxpayer has provided their IRD number to the payer.
- **Fairness & equity:** This option represents a partial improvement on the status quo as it treats taxpayers in similar circumstances in similar ways. While this option is inequitable in a sense as payers of dividends, PIE income and Maori authority distributions must continue to provide end of year tax certificates, this is arguably appropriate because the end of year tax certificate acts as a reminder to taxpayers that they have received this income. The regularity of interest income often means the taxpayer is already aware of when they are due to receive the income.
- **Compliance & administration:** This option represents a significant improvement on the status quo as it reduces compliance and administration costs relative to the status quo as payers of investment income do not need to provide end of year tax certificates to recipients of interest income who have provided their IRD numbers, and Inland Revenue does not receive the same information twice.
- **Sustainability of the tax system:** This option represents a partial improvement on the status quo as the tax system is more sustainable where compliance and administrative costs are kept to a minimum.

#### *Options – certificates of exemption*

162. Two options have been considered to reduce compliance costs for payers of investment income by improving the process for checking whether a taxpayer is entitled to be exempt from withholding tax:

- Option 1: Status quo
- Option 2: Certificate of exemption database and require payers exempt under other acts to obtain a certificate of exemption

#### *Option 1 – status quo*

163. Under this option, payers of investment income would continue to be required to check the New Zealand Gazette to determine whether a taxpayer's certificate had been cancelled, and would still have to assess a taxpayer's eligibility to be exempt under non-tax legislation.

#### *Assessment against objective and criteria – option 1*

164. The status quo does not meet the main objective as the current certificate of exemption process is complicated and hard for payers of investment income to comply with. The status quo has not been assessed against the criteria as it is the option against which all other options are assessed.

Option 2 – certificate of exemption database and require payers exempt under other acts to obtain a certificate of exemption (preferred)

165. Under this option, Inland Revenue would establish a searchable database of certificates of exemption. This would enable payers of investment income to confirm the status of a COE holder via a simple search, and could reduce the risk of people incorrectly claiming RWT exempt status. It would also mean that taxpayers would no longer need to provide copies of their certificates to payers; however, they would still need to inform the payer that they are exempt. Taxpayers exempt under other acts would also be required to apply for a certificate of exemption, so that they were included on the database.

*Assessment against objective and criteria – option 2*

- **Main objective:** This option meets this objective as it simplifies the tax system by making it easier for investment income payers to determine whether a taxpayer is eligible for an exemption from withholding tax.
- **Fairness & equity:** This option represents a significant improvement on the status quo as all payers of investment income will be able to use the database, and all taxpayers who are exempt will be included on it.
- **Compliance & administration:** This option represents a partial improvement on the status quo. While it would reduce compliance costs for payers of investment income relative to the status quo, it would increase administrative costs for Inland Revenue who would need to administer the database. This increase in administration costs would be likely to be offset as having a database will result in Inland Revenue spending less on auditing whether recipients that are being treated as exempt are entitled to be treated as exempt.
- **Sustainability of the tax system:** This option represents a significant improvement on the status quo as it helps to increase transparency over who is entitled to be treated as exempt.

*Status quo and problem definition – compliance costs for payers and administrative costs for Inland Revenue*

*Electronic filing*

166. Further, a number of withholding returns are paper based (with no option of electronic filing). For those returns that are able to be filed electronically, there is no electronic filing threshold to require payers of a certain size to file electronically. Paper filing is slower, more expensive in terms of compliance costs for taxpayers and administrative costs for Inland Revenue and more prone to errors.

*Error correction*

167. Currently, payers of investment income are able to correct errors during the tax year that arise from the payer withholding too little tax<sup>15</sup>. This only applies to interest and income subject to NRWT, not to New Zealand dividends. In relation to errors arising from the payer

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<sup>15</sup> Section RA 11 of the Income Tax Act 2007.

withholding too much tax, errors can be corrected during the year for interest, dividends, Maori authority distributions, and income subject to NRWT<sup>16</sup>.

168. Payers are not able to correct errors during the year where the payer does not withhold enough RWT from a dividend. Nor are payers able to correct errors between tax years for any type of investment income. The inability to correct errors between years impacts heavily on PIEs, given PIEs generally only pay tax at the end of the year.

169. The current approach to error correction imposes significant compliance costs and administrative costs on Inland Revenue because instead of correcting the error in the next period by reducing or increasing the amount of the withholding, payers must re-file returns from the previous period. Errors also impose a monetary cost on investment income payers as they bear the cost where they have under-withheld in error from a taxpayer, but will refund the taxpayer the money where they have over-withheld in error. Further, UOMI is payable to Inland Revenue at 8.27% pa on underpayments of tax, but receivable from Inland Revenue at 1.62% on overpayments.

170. Currently, investment income payers report information for each individual period (i.e. interest payers provide summary information to Inland Revenue every month). This makes the correction of errors difficult as an amount needs to be added or subtracted from a subsequent period in the event of an error.

*Feedback from consultation – compliance costs for payers and administrative costs for Inland Revenue*

*Feedback from consultation – electronic filing*

171. The discussion document sought feedback on options to encourage investment income payers to file online.

172. Submitters were of the view that Inland Revenue should consult with the industry in order to determine an appropriate threshold above which investment payers must file electronically. It was suggested that over time, all information should be provided electronically.

*Feedback from consultation – error correction*

173. The discussion document proposed that investment income payers should be able to self-correct errors below the higher of:

- a simple dollar value threshold, or
- a percentage threshold based on the amount of withholding tax paid.

174. Submitters were also asked what they felt would be an appropriate threshold.

175. Submitters were supportive of the approach to use both a simple dollar threshold as well as a percentage threshold for correcting errors. The majority felt that there should be no dollar limit on errors that could be corrected during the tax year.

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<sup>16</sup> Section RA 12 of the Income Tax Act 2007.

## ***Options – compliance costs for payers and administrative costs for Inland Revenue***

### ***Options – electronic filing***

176. Three options have been considered to increase the electronic filing of investment income returns:

- Option 1: Status quo.
- Option 2: Online filing compulsory for all, with the ability to apply to the Commissioner for an exemption.
- Option 3: Online filing compulsory for large payers only.

### ***Option 1 – status quo***

177. Under this option there would be no threshold or mechanism to compel payers of investment income to file electronically.

### ***Assessment against objective and criteria – option 1***

178. The status quo does not meet the main objective as the provision of information via paper channels makes it more difficult for Inland Revenue to prepopulate tax returns and adjust social policy payments.

### ***Option 2 – compulsory for all, with the ability to apply to the Commissioner for an exemption (preferred)***

179. Under this option, it would be compulsory for all investment income payers to file electronically, however there would be the ability to apply to the Commissioner for an exemption, for example, where a payer was not able to access digital services or where the costs of electronic filing would be prohibitive.

### ***Assessment against objective and criteria – option 2***

- **Main objective:** This option meets this objective as electronic filing enables the provision of more frequent information which facilitates pre-population as well as social policy and tax rate adjustments.
- **Fairness & equity:** This option represents a partial improvement on the status quo. While this option is fair in a sense as all investment income payers are treated equally, it could be seen as unfair as it compels small payers to also file online even though they do not have the same resources at their disposal as large payers.
- **Compliance & administration:** This option represents a significant improvement on the status quo. While this option may involve some upfront compliance costs for payers who have not previously filed electronically, it will reduce compliance costs long term because of the efficiencies of online filing when compared to paper filing (for example, recipient information could be pre-populated in the online form for subsequent returns for payers to small numbers of recipients and the information would be able to be submitted at the touch of a button rather than having to post a form to Inland Revenue). Administrative costs for Inland Revenue will also reduce given the amount of paper forms it would have to process would dramatically reduce.

- **Sustainability of the tax system:** This option represents a significant improvement on the status quo as the tax system is more sustainable where information is received in a cheaper, faster and more efficient manner.

*Option 3 – online filing compulsory for large payers only*

180. Under this option, it would be compulsory for investment income payers who withhold above a certain amount of RWT a year (i.e. \$50,000) to file electronically.

*Assessment against objective and criteria – option 3*

- **Main objective:** This option partially meets this objective as electronic filing enables the provision of more frequent information which facilitates pre-population as well as social policy and tax rate adjustments. This option would leave a large number of payers to determine whether they wanted to file electronically or not.
- **Fairness & equity:** This option represents a partial improvement on the status quo as it treats taxpayers in similar circumstances in similar ways. There could be a slight unfairness at the margins of the threshold, but this occurs whenever a threshold is implemented.
- **Compliance & administration:** This option represents a significant improvement on the status quo. This option will result in a reduction of compliance and administration costs when compared to the status quo as it will compel larger payers to file online. However it will not result in as great a reduction as option 2 as there will still be a large number of payers filing one or two certificates.
- **Sustainability of the tax system:** This option represents a partial improvement on the status quo as it ensures more people provide their information to Inland Revenue in a manner that is cheaper, faster and more efficient. The improvement in sustainability is not as great as the improvement under option 2.

*Options – error correction*

181. Two options have been considered to improve error correction mechanisms for payers of investment income.

- Option 1: Status quo.
- Option 2: Unlimited error correction for all investment income types during the tax year, error correction subject to a threshold of the greater of \$2000 or 5% of the annual tax liability for correction between years.

*Option 1 – status quo*

182. Under this option there would be no changes to the error correction mechanisms currently available. In other words, there would be no ability to correct errors between years, but some ability to correct errors during the year.

*Assessment against objective and criteria – option 1*

183. The status quo does not meet the main objective as having to re-file a return in order to correct an error can result in unnecessary complexity. The status quo has not been assessed against the criteria as it is the option against which all other options are assessed.

Option 2 – unlimited error correction during the year, threshold for correction between years (preferred)

184. Under this option, payers of investment income would have no limit on the size of genuine errors that could be corrected in a subsequent period, provided the period in which the error arose and the period in which it was corrected were in the same tax year. Where the error period and the correction period were in different tax years, the error could only be corrected where it was less than \$2000 or 5% of the payer's annual withholding tax liability. Tax payable as a result of a genuine error will be treated as due in the period in which it was corrected. This means that no UOMI or penalties will accrue on the error amount.

*Assessment against objective and criteria – option 2*

- Main objective: This option meets this objective as more flexible error correction makes it easier for payers of investment income to comply with their withholding obligations.
- Fairness & equity: This option represents a significant improvement on the status quo as all payers of investment income will have the same error correction mechanisms available to them.
- Compliance & administration: This option represents a significant improvement on the status quo as more flexible error correction lowers compliance costs for investment income payers as they do not have to re-file previous periods. This also lowers administrative costs for Inland Revenue as Inland Revenue staff no longer need to process the re-filed return.
- Sustainability of the tax system: This option represents a significant improvement on the status quo as the tax system is more sustainable where payers are able to correct genuine errors easily and without penalty.

Options – error correction (period reporting)

185. In order to improve payers ability to correct errors, the following options in regards to reporting requirements were considered:

- Option 1: Status quo.
- Option 2: Year-to-date reporting

Option 1 – status quo (preferred for dividends and Maori authority distributions)

186. Under this option there would be no changes to the reporting method – payers would continue to report information for the period.

*Assessment against objective and criteria – option 1*

187. The status quo does not meet the main objective for income that accumulates over time such as interest or PIE income as filing information for each period makes it more difficult for payers of investment income to correct errors. The status quo does however work well for sporadic payments such dividends and Maori authority distributions. The status quo has not been assessed against the criteria as it is the option against which all other options are assessed.

Option 2 – Year-to-date reporting (preferred for interest and PIE income) (preferred)

188. Under this option, payers of investment income would report their information on a year-to-date basis. This means that, for example, reporting for the month of June would include the total reported for the entire tax year (i.e. April to June), as opposed to just the figures for June. This is most applicable to types of income that accumulate over time such as interest and PIE income

*Assessment against objective and criteria – option 2*

- Main objective: This option meets this objective for interest and PIE income as it facilitates improved error correction, which makes it easier for payers of investment income to comply with their obligations.
- Fairness & equity: This option is about the same as the status quo as payers of investment income in similar circumstances continue to be treated equally.
- Compliance & administration: This option represents a significant improvement on the status quo as compliance costs are reduced for investment income payers where error correction is made easier.
- Sustainability of the tax system: This option represents a significant improvement on the status quo as the tax system is more sustainable where tax compliance is made easier.

# Regulatory Impact Statement

## Demergers

### Agency Disclosure Statement

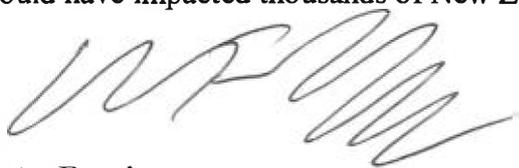
This Regulatory Impact Statement has been prepared by Inland Revenue. It provides an analysis of options to address the problems with the tax treatment of demergers. The current tax treatment does not align with the economic substance of the relevant demerger.

A demerger describes a situation where a corporate group splits off part of itself and distributes that part to its shareholders. The effect of a demerger is that companies which were grouped under a single shareholding are separated into two different shareholdings (initially held by the same shareholders), so they can be dealt with separately. Demergers can have real economic benefits. Generally the full value of the shares in the demerged company is a dividend for the shareholder because (subject to certain exceptions) a dividend includes any transfer of value from a company to a shareholder that is caused by the shareholding.

The current tax treatment of demergers is a problem because a demerger is in substance the division of a corporate group rather than a distribution of income. This issue has been raised by the New Zealand Shareholders Association as an urgent issue which requires a legislative solution. Due to this urgency, the focus of the proposed solution is more narrowly focussed on demergers of Australian listed companies.

A limitation of the analysis is that Inland Revenue has not yet consulted more widely on the detail of the proposed demerger regime. This was to ensure that the amendments sought by the private sector can be enacted as early as possible. However, officials intend to undertake further targeted consultation with the private sector on the detail of the demerger regime. Changes arising from this consultation can be incorporated into the proposals before the introduction of the bill.

A further limitation is that it is not possible to accurately quantify the size of the problem, as the number and size of Australian demergers varies from year to year and Inland Revenue does not record the income returned by New Zealand shareholders on such demergers. However, it is understood that recent high profile demergers of Australian listed companies could have impacted thousands of New Zealand shareholders.



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17 October 2017

## **STATUS QUO AND PROBLEM DEFINITION**

1. A demerger, or spin-off, is where a corporate group splits off part of itself and transfers that part to its shareholders. This can occur by the parent company distributing an existing subsidiary to its shareholders, or by an operating company transferring part of its own business to a new subsidiary, and then distributing that subsidiary to its shareholders.
2. The effect of a demerger is that companies which were grouped under a single shareholding are separated into two different shareholdings (initially held by the same shareholders), so they can be sold separately.
3. A demerger is generally undertaken by a corporate group when it believes its constituent parts would perform better if separated. This can be for a variety of reasons, such as where the group is valued at less than the sum of its parts. Accordingly demergers can have genuine economic benefits.

### **Current tax treatment of demergers**

4. A demerger involves the transfer of value from the company to its shareholders (being the distribution of the shares in the demerged company) that is caused by their shareholdings. Under the Income Tax Act 2007 (the Act) the full value of the shares in the demerged company is generally a dividend for the shareholder. This is because the Act defines a dividend (subject to certain exceptions) as any transfer of value from a company to a shareholder that is caused by the shareholding.
5. Shareholders are therefore liable to pay tax on the full value of the shares in the demerged company when a demerger occurs. This is despite the fact that the value of their two shareholdings should be approximately the same as their previous one shareholding, as the underlying assets are unchanged. Furthermore, the amount of the dividend is usually very large, as it will equal a significant percentage of the corporate group's total market value.
6. A demerger can often be structured to prevent dividend taxation (in whole or part) by arranging a share repurchase or a liquidation.
7. A New Zealand company which intends to demerge could "buy-back" a portion of its shares from shareholders, with the shareholders receiving shares in the demerged company as the consideration. This would not be characterised as a dividend provided the amount was less than the company's paid up share capital (referred to as "available subscribed capital", or ASC, for tax purposes).
8. It is also possible to structure a demerger as a liquidation of the holding company in order to prevent dividend taxation. In this case the holding company would be liquidated and the shareholders would be provided with the holding company's assets – being shares in the two demerged companies. An amount equal to any net capital gains (realised and unrealised) plus the ASC of the distributing company is excluded from being a dividend.
9. Further, a dividend arising from a demerger involving a non-resident company will only be taxable if the shareholder is not subject to the foreign investment fund (FIF) rules. If the New Zealand shareholder is subject to the FIF rules the investment will be taxed under the fair dividend rate (FDR) which is a tax on 5 percent of the value of the investment. As dividends are not separately taxed under the FDR method demergers are also not subject to tax. Generally, a shareholder in a non-resident company is not subject to the FIF rules when

they are a natural person whose total offshore shareholdings (not including shares in Australian listed companies) cost \$50,000 or less.

10. The FIF rules do not apply to most Australian listed companies, which are instead taxed similarly to New Zealand shares. This means that under the current rules, demergers from Australian listed companies will be taxed as a dividend, in the same way that a New Zealand demerger would.

### **Problem definition**

11. The current tax treatment is a problem because a demerger is in substance the division of a corporate group rather than a distribution of income. Following the demerger, the shareholders still have the same proportionate interests in the same underlying assets. Although the demerger is taxed as a dividend, economically there is no distribution of income or underlying assets by the corporate group.

12. This issue has been raised by the New Zealand Shareholders Association (NZSA) as an urgent issue which requires a legislative solution. Officials agree that an urgent solution is desirable so that New Zealand shareholders involved in any upcoming demergers are not faced with an unfair tax bill due to the operation of the current law.

### **Demerger regimes internationally**

13. Australia, the UK, the US and Canada all have regimes which exempt qualifying demergers from dividend taxation. These regimes are generally subject to numerous restrictions to ensure that they only apply to demergers and cannot be used to effect a tax-free distribution of income to shareholders or a sale of the companies. For example, the foreign regimes apply only when active businesses are being divided. They usually also include specific anti-avoidance provisions.

14. Australian demergers are generally excluded from being a dividend either under:

- Australia's specific demerger regime; or
- because the demerger is treated as a return of share capital for Australian tax purposes.

### **Scale of the problem**

15. The current tax treatment raises issues for demergers of both New Zealand and foreign companies. However the problem is particularly acute for demergers by listed Australian companies. This is because:

- New Zealand companies can often structure their demerger so that no dividend arises; and
- shares in other foreign companies are more commonly subject to the FIF rules which ignore dividends.

16. Listed Australian companies, however, often have several thousand New Zealand shareholders that are taxable on any dividends received, but they do not structure their demergers to be efficient for New Zealand tax purposes. For example, approximately 13,000 New Zealand shareholders were affected by the BHP/South 32 demerger in 2015, while about 9,000 New Zealand shareholders were affected by the NAB/Clydsdale demerger in 2016.

Dividend taxation for Australian demergers can seem particularly unfair for New Zealand shareholders, as Australian shareholders are not usually taxable on the demerger.

## OBJECTIVES

17. The **main objective** is to align a demerger's tax treatment with its economic substance. This will improve economic efficiency and ensure that New Zealand shareholders are not inappropriately taxed on the full value of their shares in the demerged company.

18. All options are assessed against the main objective and the following criteria:

- **Economic efficiency** – the proposed changes should align the tax treatment of demergers with their economic substance. This will improve the economic efficiency of the tax system. More particularly, it will ensure that the tax treatment does not incentivise shareholders to sell their shares in a company which is about to demerge (or disincentivise them from acquiring such shares).
- **Integrity of the tax system** – the proposed changes to the demerger regime should not create opportunities for abuse. What is in substance the distribution of income should not be able to be structured as a tax-free demerger.
- **Fairness and equity** – the proposed changes should improve the fairness of the tax system, by ensuring that shareholders are not taxed on a demerger when they have not derived any income in economic substance.

19. In this context, officials consider that the most weight should be given to meeting the objectives of fairness and equity, and the integrity of the tax system. Further, as the scope of the proposed change gets broader, there will be an increase in fairness and equity at the expense of integrity of the tax system. This is because a broader regime could lead to gaps in the law which require the development of provisions that prevent abuse of the regime. Officials consider that the solution should not be so broad as to create opportunities for abuse, and should be targeted at the arrangements which are actually causing problems in practice.

20. The constraint in relation to the proposal is as follows:

- **Timeliness** – it is important to have a legislative solution as soon as practicable. The private sector has asked for an urgent response, and officials have indicated that changes are proposed for the first tax bill of 2017.

## REGULATORY IMPACT ANALYSIS

21. Officials have identified four options to address the problem:

- Option 1 – The status quo
- Option 2 – A full demerger regime, which applies to both New Zealand and foreign companies
- Option 3 – A limited demerger regime, which only applies to Australian listed companies
- Option 4 – A middle ground between the above two options, which would apply to all demergers by foreign listed companies (or potentially a subset of them)

## Option 1

22. Option 1 is the status quo. Shareholders would continue to be taxed on demergers as a dividend.

### *Assessment against criteria – option 1*

23. The status quo does not meet the main objective. Shareholders would be taxed on demergers even though in economic substance they had not received any income.

24. *Economic efficiency.* The status quo does not meet the economic efficiency criterion. Shareholders will be incentivised against owning shares in companies which are in the process of demerging.

25. *Integrity of the tax system.* The status quo meets the integrity criterion. As shareholders are taxed on dividends arising from demergers there is no opportunity to demerge to access a tax free gain that should be taxable.

26. *Fairness and equity.* The status quo does not meet the fairness criterion. Shareholders will have to pay tax even though they have not economically received any income. This will make them worse off than other investors who will not have to pay tax.

## Option 2

27. Option 2 would introduce a full demerger regime, which applies to both New Zealand and foreign companies.

### *Assessment against criteria – option 2*

28. This option is the most conceptually pure approach, as demergers by New Zealand and foreign companies should be taxed the same way from a policy perspective. This option meets the main objective, as it would ensure that genuine demergers are not unfairly taxed as a dividend. This would align the tax treatment of all genuine demergers (whether by a New Zealand or foreign company), with their economic substance.

#### *Economic efficiency*

29. Option 2 is a significant improvement over the status quo, as there would be no tax consequences which arise from holding shares in a demerged company. There would no longer be any incentives against owning shares in a company which is in the process of demerging.

#### *Integrity of the tax system*

30. Option 2 is worse than the status quo. This option would have the greatest integrity risk, as New Zealand companies could attempt to exploit the regime to effect an in-substance distribution of income. For example a company could transfer cash or liquid assets to a subsidiary, and demerge that subsidiary by distributing it to its shareholders. The subsidiary could then be liquidated under the current law, thus providing all of the cash and/or liquid assets to the shareholders tax-free. The foreign demerger regimes referred to above have all included extensive anti-avoidance provisions to prevent such abuse. Therefore it is important

that any comprehensive demerger regime be carefully drafted so that it only applies to demergers that do not effect an in-substance distribution of income to shareholders.

#### *Fairness and equity*

31. Option 2 is a significant improvement over the status quo, as it would ensure that shareholders of demerged companies do not become liable to pay tax on the value of the demerged shares despite there being no in-substance change in their shareholding.

#### *Constraints*

32. A full demerger regime would be complicated and time consuming to develop, particularly concerning the anti-avoidance provisions required to prevent abuse of the regime. Such a regime could definitely not be developed in time for the first omnibus tax bill of 2017, or possibly the second. Consequently officials consider that option 2 is not feasible given the time constraints.

### **Option 3**

33. Option 3 is a limited demerger regime, applying only to Australian listed companies. This option would exclude any demerger by a listed Australian company from dividend taxation provided the demerger was excluded from dividend taxation in Australia under either Australia's demerger regime or its return of share capital rules.

#### *Assessment against criteria – Option 3*

34. While not as conceptually pure as option 2, this is a pragmatic approach that would address the demergers that have been causing issues in practice without needing to be nearly as complex as a full demerger regime. This meets the main objective.

#### *Economic efficiency*

35. This option would improve economic efficiency, by aligning the tax treatment of a qualifying Australian demerger with its economic substance. As demergers by listed Australian companies are the problem for most shareholders, option 3 would address the issues faced by shareholders in practice.

#### *Integrity of the tax system*

36. The Australian demerger regime already has rules designed to prevent it being used to effect a distribution of income. Accordingly, officials are comfortable with excluding any demerger from New Zealand dividend taxation where the Australian demerger regime applies to it.

37. In relation to the return of share capital method, New Zealand already has similar rules to Australia that exclude a return of shareholder capital from being a dividend. However these rules require there to be a repurchase by the company of its own shares, while the Australian rules do not. Consequently New Zealand's dividend exemption often does not apply to an Australian demerger that is structured as a return of share capital (as such demergers often do not involve a repurchase of shares).

38. The requirement to repurchase shares is not a significant policy difference between New Zealand's dividend exemption and the Australian exemption – the more important point is that they both exclude a return of shareholder capital from dividend taxation. Therefore we do not see any integrity issues if the demerger dividend exclusion also applies to a demerger by a listed Australian company that is treated as a non-dividend return of share capital under the Australian tax rules.

39. On this basis, we consider that option 3 is equal to the status quo as it maintains the integrity of the tax system.

#### *Fairness and equity*

40. Based on past history this option would improve fairness and equity for most of the taxpayers who are taxable on demergers, namely shareholders in listed Australian companies. However it would result in shareholders in New Zealand companies and shareholders in other foreign companies who are not subject to the FIF rules remaining potentially taxable on any demerger dividends. Accordingly it would mean that shareholders in some companies were not taxable on a demerger (i.e. shareholders in listed Australian companies) while shareholders in other companies were. Consequently the differential treatment of shareholders under this option does result in some horizontal inequity.

41. However New Zealand companies have in the past been able to structure their demergers so dividend taxation does not arise. In addition, the problem of demerger taxation does not seem to be problematic in practice for shareholders in other foreign companies. Consequently this lack of fairness across shareholders does not seem to be so significant in practice.

#### *Constraints*

42. Option 3 is the least resource intensive of the options, and so it could be implemented the fastest. In particular, the Australian demerger regime already includes anti-avoidance rules designed to prevent abuse. Accordingly the regime could leverage off those rules, by restricting the New Zealand dividend exclusion to demergers by listed Australian companies that are not treated as a dividend under Australian tax legislation. This would significantly simplify the necessary legislation and thus the time required to develop it. This option is the only one which would be able to be included in the first 2017 omnibus tax bill.

43. Accordingly this option best accommodates the current constraints.

#### **Option 4**

44. Option 4 would introduce a limited demerger regime applying to all demergers by foreign listed companies. This regime would be a broader solution to the issue than option 3, as it would also cover (in addition to shareholders in listed Australian companies) New Zealand shareholders that are not subject to the FIF rules (generally natural persons with foreign investments costing less than \$50,000) who invest in foreign companies outside of Australia.

#### *Assessment against criteria – Option 4*

45. This option is not as conceptually pure as option 2, as it would only address demergers of foreign companies. This option is a pragmatic approach that would address the demergers

that can cause issues in practice without needing to be as complex as a full demerger regime which includes New Zealand companies. It would however be a wider approach than option 3, which is targeted at Australian listed companies only. This option can therefore be considered a middle ground between options 2 and 3. This option meets the main objective.

#### *Economic efficiency*

46. This option would increase economic efficiency compared with the status quo due to the broader scope of its dividend exclusion for demergers. This option would be a larger improvement than option 3 but not as large as option 2. However as noted above, it is Australian demergers that are causing the problems in practice. Consequently the increase in economic efficiency and fairness over option 3 does not seem to be significant.

#### *Integrity of the tax system*

47. This option also poses an increased risk to the integrity of the tax system compared with option 3 (but not option 2) due to its broader reach. However foreign-listed companies would not structure their demergers specifically to avoid New Zealand tax. Consequently this increased risk could be largely mitigated with some anti-avoidance provisions.

#### *Fairness and equity*

48. This option is an improvement over the status quo for shareholders in demerged foreign listed companies, as it would prevent dividend taxation in genuine demerger situations. This option could result in shareholders in New Zealand companies remaining potentially taxable on a demerger. However, in practice New Zealand companies usually structure demergers so dividend taxation does not arise. Consequently this lack of fairness across shareholders does not seem to be so significant in practice.

#### *Constraints*

49. Option 4 would be more complex than a regime limited to listed Australian companies (option 3). This is because the regime would need to distinguish between genuine foreign demergers and demergers that are an in-substance distributions of income (which should be taxed in New Zealand) to shareholders. As the regime would apply to demergers by companies in multiple jurisdictions, it could not simply use one country's existing anti-avoidance rules (as can be done for a demerger regime limited to Australian listed companies). Option 4 would therefore be more time consuming to develop than option 3 (although less so than option 2). While this impact on constraints is not fatal to option 4, there is a significant risk of officials being unable to develop legislation for option 4 in time for the first 2017 omnibus tax bill.

#### **Fiscal costs**

50. Option 3 will have a fiscal cost, as New Zealand shareholders will no longer derive income on the demerger of Australian listed companies. This fiscal cost is the lowest out of the three options other than the status quo, as option 3 has the narrowest scope and the lowest integrity risk.

51. It is impossible to accurately estimate the fiscal cost, as the number and size of Australian demergers varies from year to year and Inland Revenue does not record the income

returned by New Zealand shareholders on such demergers. Officials do not anticipate a material impact on tax revenue baselines.

## CONSULTATION

52. The Treasury has been consulted and agree with Inland Revenue's recommendations.

53. Formal consultation has not yet taken place; however the issue was originally raised by the NZSA and the Securities Industry Association. Accordingly officials are aware of the views of the private sector on this issue.

54. The NZSA supports the introduction of a limited demerger regime which excludes all demergers by foreign listed companies from dividend taxation (option 4). However the NZSA focussed on the issues caused by Australian demergers in their correspondence with us, and officials' interactions with the private sector indicate that option 3 would also be well-received given the timeliness of the solution, and the fact that it would address the private sector's primary concern in practice (demergers by listed Australian companies).

55. Inland Revenue has not yet consulted more widely on the proposals. However, officials intend to undertake further targeted consultation with the private sector on the detail of the demerger regime before introduction of the first omnibus taxation bill in 2017. Details to be decided through the consultation process include:

- how the available subscribed capital in the distributing company is to be divided between the original share in the distributing company and the newly held share in the demerged company; and
- how the cost base of the original share in the distributing company is to be divided between the original share in the distributing company and the newly held share in the demerged company.

56. This consultation will include the NZSA, the Securities Industry Association, the Corporate Taxpayers Group, Chartered Accountants Australia and New Zealand, and the New Zealand Law Society. Changes arising from this consultation can be incorporated into the proposals before the introduction of the bill.

## CONCLUSIONS AND RECOMMENDATIONS

57. The following table summarises the consideration of the options from the regulatory analysis section above. Within the overview table the following symbols are used:

- ✓✓ Significantly better than the status quo
- ✓ Better than the status quo
- × No better than the status quo
- ×× Worse than the status quo

Options	Analysis against the objective and criteria
Option 1 – Status quo	Does not meet the main objective
Option 2 – Full demerger regime	Meets the main objective  Economic efficiency ✓✓ Integrity of the tax system ×× Fairness and equity ✓✓  Does not meet constraints
Option 3 – Limited demerger regime applying to Australian listed companies	Meets the main objective  Economic efficiency ✓ Integrity of the tax system × Fairness and equity ✓  Meets constraints
Option 4 – Middle group applying to all demergers by foreign listed companies	Meets the main objective  Economic efficiency ✓ Integrity of the tax system × Fairness and equity ✓  Does not meet constraints

58. Option 2 increases the economic efficiency and fairness of the tax system by the greatest amount. However it is not feasible given the time constraints.

59. Option 3 increases economic efficiency and the fairness of the tax system, but its narrower scope means it does so by less than option 4. Option 3 best meets the criteria of maintaining revenue integrity, although its advantage over option 4 in this regard is not that significant. Accordingly the choice between option 3 and option 4 is essentially a trade-off between increased efficiency and fairness (option 4) versus reduced time for implementation and integrity risk (option 3).

60. Officials consider the reduced time for implementation and integrity risk of option 3 outweighs the increase in economic efficiency and fairness of option 4. In this regard, option 3 would address the demergers that are causing the problems in practice. Accordingly option 4's increased economic efficiency and fairness would not be a significant benefit. It is notable that the private sector has focussed on the problems with the tax treatment of Australian demergers, rather than demergers by foreign companies generally. This shows that the economic and efficiency gains of option 3 are perceived as being sufficient to address the pressing issues with demergers.

61. Option 3 best meets all the criteria given the constraints. Therefore Inland Revenue recommends the introduction of a limited demerger regime. This would exclude demergers by listed Australian companies from giving rise to a dividend for New Zealand tax purposes, provided the demerger is not treated as a dividend for Australian tax purposes (under either Australia's demerger regime or under its return of share capital rules).

## **IMPLEMENTATION**

62. Changes to introduce a limited demerger regime would require amendments to the Income Tax Act 2007. These amendments would be included in the next available omnibus taxation bill, scheduled for introduction in the first quarter of 2017. We propose that the recommended option apply from the beginning of the 2017–18 tax year. This is something we intend to consult on with the private sector however.

63. The detail of the demerger regime will need to specify how the available subscribed capital and the cost base of the original share in the distributing company is to be divided between the original share in the distributing company and the newly held share in the demerged company. It should also provide that the newly held share is held on the same basis as the original share (for example, it should be held on capital account if the original share is held on capital account). These and other details will be finalised following further consultation.

## **MONITORING, EVALUATION AND REVIEW**

64. New Zealand demergers do not in practice lead to unfair tax treatment for shareholders, and shareholder of foreign companies (excluding Australian listed companies) are generally subject to the FIF rules. Therefore the problem is mainly confined to Australian-listed companies and the recommended option is expected to be a permanent solution which resolves this issue in practice. It is not expected that a broader demergers regime will be needed in the future.

65. In general, Inland Revenue's monitoring, evaluation and review of new legislation takes place under the generic tax policy process (GTTP). The GTTP is a multi-stage tax policy process that has been used to design tax policy in New Zealand since 1995.

66. The final stage in the GTTP 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 be prioritised in the context of the current Tax Policy Work Programme, and any proposals would go through the GTTP.



# Regulatory Impact Statement

## Insurance businesses and the controlled foreign company rules

### Agency Disclosure Statement

This Regulatory Impact Statement (RIS) has been prepared by Inland Revenue.

It provides an analysis of options to address the concern raised by tax practitioners in relation to the controlled foreign company (CFC) rules and the ability for insurance companies to qualify for the active income exemption in relation to their offshore insurance businesses.

The concern relates to the inability of new offshore active insurance companies acquired or established by New Zealand resident insurers after 30 June 2009 to pass the active business test in the CFC rules and their preference for specific active business test rules for insurance companies. However, those who expressed concern acknowledged that owing to competing priorities on the Government's tax policy work programme and limited policy resources, a short term fix would be better than the status quo.

The preferred option is that a short term fix should be implemented so that overseas active insurance businesses acquired or established after 30 June 2009 are accorded the same treatment under the CFC rules as those acquired or established before 30 June 2009.

The problem to be addressed is relevant only to a small number of taxpayers, namely, licensed insurers who are required to have financial strength ratings and have interests in active offshore insurance businesses. We are unable to estimate the number of insurers that may set up active insurance businesses in other jurisdictions in the future, so the analysis in this RIS is based on the New Zealand-based insurance companies that are currently attributing income under the CFC rules and the CFC disclosure data indicates that the CFC income relates to an insurance business. This is a very small subset of the number of licensed insurers, but we have discussed this problem with tax practitioners that represent some of these companies.

Owing to time constraints, we did not consult more widely, for example, by way of an officials' issues paper. However, the tax practitioners we did consult represent the majority of those affected.

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



Carmel Peters  
Policy Manager, Policy and Strategy  
Inland Revenue

22 June 2016

## STATUS QUO AND PROBLEM DEFINITION

### Controlled foreign company (CFC) rules

1. New Zealand's international tax rules provide a framework for taxing non-residents who earn New Zealand income and New Zealand residents who earn foreign income. The CFC and foreign investment fund (FIF) regimes apply to New Zealand residents investing in foreign companies; the CFC regime applies when the foreign company is effectively controlled by New Zealand residents, and the FIF regime applies when it is controlled by non-residents. These regimes attribute overseas income arising from CFCs and FIFs back to the New Zealand shareholder, even if no distributions (for example, a payment of a dividend) are made to the shareholder.
2. Before 2009, taxpayers did not have to return attributed income in respect of their interest in a CFC if the CFC was resident in a "grey list" country. The grey list comprised eight countries that were thought to have broadly comparable tax systems to our own. Income earned in a grey list country was exempt and income earned in other countries was subject to tax.
3. Following extensive public consultation, the Government passed legislation to reform the international tax rules in 2009. The main changes to the CFC regime included the repeal of the grey list and the introduction of an "active business test". Under the active business test, if less than 5 percent of the CFC's gross income is passive income, the active business test is passed and no income is attributed to the New Zealand shareholder. If the test is failed, only the passive income (such as, highly mobile income such as interest, rent or royalties) is attributed to the shareholder.
4. The purpose of the active business test is to reduce tax and compliance costs associated with calculating and attributing small amounts of passive income and to ensure that New Zealand businesses that expand offshore by operating subsidiaries in foreign countries can compete on an even footing with foreign competitors operating in the same country. This means, for example, that a New Zealand-owned manufacturing plant in China would generally face the same tax rate as other manufacturers operating in China.
5. Owing to the complexity of the rules, on-going maintenance is required to ensure that they continue to work as intended. Since 2009, the Government has enacted a number of remedial changes to ensure that the policy intent of the reform continues to be met. This regulatory impact statement (RIS) considers the most recent issue that has been raised in discussions between officials and tax practitioners who have experience with both the CFC rules and insurance businesses.
6. In short, the issue concerns the treatment of insurance income as passive income under the CFC rules. While this is a necessary feature to protect the integrity of the CFC rules and the active business test, it means that New Zealand insurance companies with active offshore insurance businesses are required to attribute this income under the CFC rules unless they have applied for and are issued a determination by the Commissioner of Inland Revenue ("the Commissioner") that deems the CFC to have passed the active business test. However, this determination is only available if the CFC was controlled by a New Zealand insurance company and carried out an insurance business in its country of residence before 30 June 2009.

## **Insurance companies**

7. Under the CFC rules, income from insurance is considered to be passive income and therefore must be attributed to the New Zealand shareholder. As a result, New Zealand insurance companies with foreign subsidiaries operating active insurance businesses in foreign markets do not pass the active business test and are required to attribute income back to New Zealand under the CFC rules.

8. Initially, the Government did not intend to introduce special rules for financial institutions (including insurance companies) as it did not believe that there were CFCs that would use them. However, consultation revealed that there were at least some insurance companies that would.

9. Because of a number of constraints, including the complexity of the issues involved in drafting special rules for financial institutions (including insurance companies), it was not possible to do so at the same time the active income exemption was introduced.

10. As a result, a transitional measure was introduced which allows the Commissioner to issue a determination under section 91AAQ of the Tax Administration Act 1994. This measure allows a New Zealand insurance company to pass the active business test in relation to an offshore active insurance business if it can demonstrate that the offshore insurance business is an active business. The determination facility was not made available for other types of financial institutions because the boundary between active and passive income is less apparent.

11. One of the requirements that must be met for the Commissioner to be able to issue a determination is that before 30 June 2009, the offshore insurance business must have been controlled by a New Zealand resident and it must have operated a business of insurance in its country of residence. This date requirement was deemed necessary as the determination facility was only intended to be a transitional measure until further work could be completed on extending the active business test to financial institutions more generally.

12. The financial institution work was due to be taken forward in the second phase of the international tax review, alongside the work on non-portfolio FIFs<sup>1</sup>, and offshore branches. Legislation for the extension of the active income exemption for non-portfolio FIFs was enacted in 2012 and work on the application of the active business test to financial institutions would have followed the work on offshore branches, but other priorities took precedent.

13. The problem with the 30 June 2009 requirement is that as the date becomes more historical, more CFCs that are active insurance businesses are unable to qualify for the active business test determination. It creates an uneven playing field between active offshore insurance businesses that were in existence prior to 30 June 2009 and those established since then. Insurance companies looking to expand offshore face greater tax and compliance costs than those faced by competitors with already-established operations.

14. This runs counter to the purpose of the active business test, which is to reduce tax and compliance costs associated with calculating and attributing passive income and to ensure that New Zealand businesses (in this case insurance businesses) that expand into offshore markets

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<sup>1</sup> A non-portfolio FIF is a FIF where the shareholder's ownership interest is more than 10% but less than 50%.

through foreign subsidiaries can compete on an even footing with competitors (including New Zealand insurers with pre-existing operations) operating in the same country.

### *Scale of the problem*

15. The scale of the problem is very small, as it only affects New Zealand licensed insurance companies that are required to have a current financial strength rating given by an approved rating agency who also happen to have an income interest in an active insurance business overseas. Further, the problem of not being eligible for the active business test determination is relevant only to those with offshore active insurance subsidiaries acquired or established after 30 June 2009.

16. According to public information on the financial strength ratings of licensed insurers from the Reserve Bank of New Zealand, there are approximately 75 licensed insurers that have a current financial strength rating; some of these insurers will be solely focused on the New Zealand market and will not have offshore operations. It is unknown how many of these purely domestic insurance companies will look to expand offshore in the future.

17. We are aware that only a very small number of these licensed insurers with financial strength ratings are currently attributing income under the CFC rules. Of these we estimate that only some of them would be eligible for an active business test determination under section 91AAQ, if it were not for the 30 June 2009 ownership requirement. The reason for this is that not all CFCs owned by New Zealand insurers are active insurance businesses and so income is being attributed in line with the policy intent of the active business test.

18. Overall, the amount of New Zealand tax at stake is also likely to be very small, because under the CFC rules, the taxpayer is provided a foreign tax credit for income tax paid overseas in relation to the CFC income against their New Zealand income tax liability. If the foreign tax credit exceeds or is equal to the New Zealand income tax liability, there is no tax to pay.

19. However, owing to confidentiality concerns we are unable to publicly state the number of insurance companies affected by the problem.

## **OBJECTIVES**

20. The **main objective** is to ensure the CFC rules result in the correct amount of income being attributed to a New Zealand taxpayer who has an income interest in a non-resident company. In particular, this means ensuring that income from an active business is not required to be attributed under the CFC rules. The underlying policy intent of the active business test is to minimise tax and compliance costs associated with attributing income under the CFC rules, so that New Zealand businesses operating in offshore markets through foreign subsidiaries can compete on an even footing with competitors.

21. All options are assessed against the status quo in relation to the main objective and the following criteria:

- (a) **Fairness and equity:** to support fairness in the tax system, options should, to the extent possible, seek to treat similar taxpayers in similar circumstances in a similar way.

(b) **Efficiency of compliance and administration:** the compliance cost impacts on taxpayers and the administrative costs to Inland Revenue should be minimised as far as possible.

22. Although both criteria are important, the fairness and equity criterion is more important than the efficiency of compliance and administration, for small movements in the latter.

23. In addition, the options must be considered against constraints on the time and resources available to the Government. These constraints form part of the trade-offs when evaluating the available options.

## REGULATORY IMPACT ANALYSIS

24. Officials have identified three options to address the problem:

- Option 1: the status quo
- Option 2: remove the 30 June 2009 requirement from the determination provision
- Option 3: introduce rules that extend the active business test to financial institutions, including insurance companies.

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

### Option 1

26. This option would maintain the status quo. CFCs that were controlled by a New Zealand resident and operating an insurance business in their country of residence before 30 June 2009 would continue to be eligible for a determination, but no offshore insurance businesses that commenced or were purchased by a New Zealand resident after this date would be eligible to apply.

#### *Assessment against objective and criteria – option 1*

27. The status quo does not meet the main objective because the CFC rules (and in particular, the active business test) do not apply equally to New Zealand-resident insurance companies with interests in offshore insurance businesses. The active business test does not apply to some insurance businesses solely because of when they were acquired or established rather than whether or not they are actually active businesses. This results in some New Zealand residents with an insurance business CFC having attributed foreign income while others do not.

28. This option is not fair and equitable as it creates an uneven playing field between two otherwise identical insurance businesses where the only difference is when the two businesses were acquired. In the most extreme case, one day could be the difference between being eligible for an active business test determination and being required to calculate, attribute, and pay New Zealand tax on CFC income.

29. This option does not minimise compliance impacts on taxpayers nor administrative costs borne by Inland Revenue. This is because this option imposes significant compliance costs on active insurance businesses simply because they were acquired or established after 30

June 2009, but there are also administrative costs in considering determination applications for those that were acquired or established before 30 June 2009.

## **Option 2**

30. This option would retain the ability for insurance companies to apply for an active business test determination in relation to an offshore active insurance CFC under section 91AAQ, but would remove the requirement that the active insurance business must be owned by a New Zealand resident before 30 June 2009.

### *Assessment against objective and criteria – option 2*

31. This option meets the main objective because the CFC rules would apply equally to New Zealand-resident insurance companies with interests in offshore insurance companies, as long as they meet the requirements for being an active insurance business. This means that active insurance businesses would be able to pass the active business test and would not be required to attribute income under the CFC rules, which conceptually is the correct result under the CFC rules.

32. In terms of fairness and equity, this option is an improvement on the status quo because New Zealand insurers that control offshore active insurance companies would be able to pass the active business test (by applying for a determination) regardless of when those offshore insurance companies were acquired or established. This creates a level playing field in terms of compliance costs and tax costs for New Zealand licensed insurers with active insurance subsidiaries overseas. It also creates a more level playing field for those with active insurance businesses when compared with more generic active businesses.

33. Regarding the efficiency of compliance and administration, this option is an improvement on the status quo because it reduces the compliance costs faced by active insurance businesses. Although there are some additional administrative costs involved in considering an application for an active business test determination, officials consider that these are outweighed by the compliance cost benefits. This is because a determination is able to be issued for more than one income year at a time and Inland Revenue already has the necessary processes in place to issue these determinations, so would be able to capitalise on existing knowledge required to consider applications.

34. Overall, this option represents an improvement on the status quo. Although this option is not necessarily a larger improvement on the status quo than option 3 it is still an improvement over the status quo and can be executed in the light of current resource constraints. Furthermore, implementing option 2 would not prevent option 3 from being considered or implemented at a later date if it is found to be necessary and resource constraints permit.

## **Option 3**

35. This option would introduce specific rules for financial institutions (including insurance companies) to enable them to pass the active business test when their CFCs are engaged in an active business. This option would require the significant use of resources to design effective rules that are able to distinguish between active income and passive income for financial institutions, which is inherently more difficult than for other types of businesses. In addition,

the determination facility in section 91AAQ would no longer be required, so would be removed altogether under this option.

### *Assessment against objective and criteria – option 3*

36. This option meets the main objective because it would enable the CFC rules to correctly attribute income to the New Zealand shareholder when the CFC is an active insurance company or another type of financial institution.

37. This option is a significant improvement on the status quo in terms of fairness and equity. Like option 2, New Zealand insurers with interests in offshore active insurance companies would be able to pass the active business test regardless of when those offshore insurance companies were acquired. This creates a level playing field in terms of compliance costs and tax costs borne between New Zealand licensed insurers with active insurance subsidiaries overseas. Option 3 is also an improvement on the status quo for other types of financial institutions with active offshore businesses, as it would no longer matter what type of business the active business is to determine whether income needs to be attributed under the CFC rules.

38. Regarding the efficiency of compliance and administration, the effect of this option is mixed and overall, it is a slight improvement on the status quo. In terms of administration costs, while it would remove the need for Inland Revenue to issue determinations, designing active business test rules for financial institutions would be a complex undertaking and would require a significant use of resources. Specific active business test rules for financial institutions would naturally be complex, which means that taxpayers would incur compliance costs in complying with them and these compliance costs might not be substantially less than under the status quo.

39. Although overall this option might be an improvement on the status quo, it is not considered desirable at this time. It would meet the main objective and would be an improvement over the status quo in most criteria, but it would also require significant resources to develop a comprehensive package of amendments to accurately identify the boundary between passive and active income in relation to insurance companies and other financial institutions. This option would take much longer to progress than option 2. In addition to option 3 being a very complex undertaking, we believe it would impact very few taxpayers beyond the small number of insurance companies identified for the purposes of option 2. The tax policy work programme is set by the Government with reference to the Government's priorities. Given other work already scheduled on the Government's tax policy work programme and limited policy resources, trade-offs would need to be made to progress option 3.

## **CONSULTATION**

40. The problem analysed in this RIS was independently raised by some tax practitioners. These tax practitioners have experience with the CFC rules and how they apply to insurance companies.

41. In general, these tax practitioners noted that option 3 would be the preferred and more sustainable solution in the longer term, but also agreed that at least in the interim, option 2 would be preferable to the status quo. They understood that competing priorities and limited resources mean option 3 is not a feasible option in the short term in the same way that option 2 is.

42. Owing to time constraints, no wider consultation was undertaken, for example, in the form of an officials' issues paper.

43. Only a very small number of these licensed insurers with financial strength ratings are currently attributing income under the CFC rules and we estimate that only some of these would be eligible for an active business test determination if it were not for the 30 June 2009 ownership requirement. Based on the taxpayers we were able to identify in this exercise, we believe the tax practitioners we consulted represent the majority of those most affected by the problem analysed in this RIS.

## CONCLUSIONS AND RECOMMENDATIONS

44. The table below summarises our analysis of the options. Within this table the following symbols are used:

- ✓✓ Significantly better than the status quo
- ✓ Better than the status quo
- × No better than the status quo
- ×× Worse than the status quo

Options	Analysis against the objective and criteria
Option 1: status quo	<p>Does not meet the main objective</p> <p>Fairness &amp; equity: ×</p> <p>Compliance and administration: ×</p> <p>Overall comment: Does not meet the main objective or criteria</p>
Option 2: remove 30 June 2009 requirement	<p>Meets the main objective</p> <p>Fairness &amp; equity: ✓</p> <p>Compliance and administration: ✓</p> <p>Overall comment: Improvement on the status quo</p>
Option 3: introduce an active business test that is specific to financial institutions	<p>Meets the main objective</p> <p>Fairness &amp; equity: ✓✓</p> <p>Compliance and administration: ✓</p> <p>Overall comment: Improvement on the status quo, but not feasible in the short to medium term owing to limited resources and competing priorities on the Government's tax policy work programme.</p>

45. Inland Revenue prefers option 2 which is to remove the 30 June 2009 ownership requirement from the active business test determination provision for the following reasons:

- It achieves the main objective to make the CFC rules apply on a consistent basis and, in particular, to ensure that active insurance businesses are able to pass the active business test.
- Competing priorities mean that there is insufficient space on the Government's tax policy work programme to implement option 3 at this time. Implementing option 3 would require substantial policy resource and time because of the complexities in determining the boundary between active and passive income in relation to financial institutions. Trade-offs would need to be made to progress option 3. In addition, option 3 would affect a very small number of taxpayers relative to the resources required to implement it.
- The implementation of option 2 would not preclude option 3 from being considered and, if appropriate, implemented at a later date.

## **IMPLEMENTATION**

46. Legislative changes to the Tax Administration Act 1994 would be required to implement option 2. These amendments could be included in the bill which is scheduled to be introduced later this year.

47. No systems changes would be required to implement option 2. However, it would require the use of the Commissioner's resources to consider applications for a determination. There are processes in place to issue determinations for active insurance businesses already, so the implementation of option 2 would just be an extension of these existing processes. As the relevant group affected by the issue is relatively small (licensed insurers in New Zealand that are required to have a current financial strength rating and also have offshore active insurance businesses), the existing processes should be able to be appropriately managed.

48. The implementation of option 2 has the effect of reducing compliance costs for affected parties as they would no longer be required to calculate and attribute income under the CFC rules. Some of these compliance cost benefits would be offset by compliance costs associated with completing an application for a determination under section 91AAQ. However, it is important to note that the determination is able to be issued for more than one income year at a time (currently they tend to be issued for two income years), so this means that determination-related compliance costs would not need to be borne every year.

49. In implementing option 2, Inland Revenue would be required to update forms and communication material to ensure that licensed insurance companies are aware that they may be eligible for a determination that deems them to have passed the active business test in the CFC rules in relation to offshore insurance businesses.

## **MONITORING, EVALUATION AND REVIEW**

50. Inland Revenue would monitor the effectiveness of the proposed changes in the first 12 months of operation. In general, Inland Revenue monitoring, evaluation and review of tax changes takes place under the generic tax policy process (GTPP). The GTPP is a multi-stage policy process that has been used to design tax policy (and subsequently social policy administered by Inland Revenue) in New Zealand since 1995. The final step in the process is the implementation and review stage, which involves post-implementation review of legislation and the identification of remedial issues. Opportunities for external consultation

are built into this stage. In practice, any changes identified as necessary following enactment would be added to the tax policy work programme, and proposals would go through the GTPP.

# Regulatory Impact Statement

## Lloyd's of London – tax simplification

### Agency Disclosure Statement

This Regulatory Impact Statement (RIS) has been prepared by Inland Revenue.

It provides an analysis of options to simplify tax compliance for Lloyd's of London in connection with income earned from its proposed New Zealand term-life insurance business. Term-life insurance is directed at life risk only and does not contain provisions for policyholder savings.

The Income Tax Act 2007 contains rules that require non-resident life insurers to file and pay tax in relation to their New Zealand business. As Lloyd's trades as syndicates, these rules result in each Member of Lloyd's that does business in New Zealand having to apply for an Inland Revenue number and file annual tax returns. This would impose considerable compliance costs on Lloyd's in terms of calculating taxable income and paying tax at the Member's correct marginal tax rate. Inland Revenue would also face increased administration costs as the requirements of the Income Tax Act would generate over time a significant increase in the volume of life insurer returns that are processed and audited for tax compliance. These outcomes give rise to efficiency concerns.

The analysis in this RIS is constrained by the fact that the problem and preferred solution is limited to Lloyd's and its authorised New Zealand agents. There are wider issues concerning the treatment of life insurance sold by life insurers, including reinsurance. Given current priorities on the Government's tax policy work programme, these wider issues have not been considered in depth.

Taxpayer confidentiality provisions prevent Inland Revenue from disclosing the expected value of Lloyd's life insurance business in New Zealand. In terms of scale, the current law as it applies to Lloyd's syndicates produces compliance costs and costs on Inland Revenue that are out of proportion to the tax revenue at issue.

As the proposal affects life insurers only, consultation was limited to the Financial Services Council, the representative body for New Zealand life insurers. Inland Revenue considers that level of consultation fairly reflected the nature of the issue under consideration and those affected.



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Inland Revenue

17 October 2016

## STATUS QUO AND PROBLEM DEFINITION

1. Lloyd's of London (Lloyd's) has regulatory approval to write term-life insurance business in New Zealand. While taxpayer confidentiality provisions prevent Inland Revenue from disclosing the expected value of Lloyd's life insurance business in New Zealand, it is a minute fraction of total life insurance premium income sold in New Zealand.<sup>1</sup> This business is expected to add capacity rather than substituting existing life insurance policies sold by New Zealand life insurers.

2. Lloyd's is an insurance market, not an insurance company. It is an institution where Members of the Society of Lloyd's, both corporate and individual, join together in syndicates to insure risk. These syndicates have different market specialisations and risk profiles. Over time the underwriting activity attracted capital from outsiders in a subscription market, signifying that a series of underwriters would assume shares of risk. Members are required to be United Kingdom tax residents under Lloyd's governance rules.

3. Lloyd's unique structure means that any amount of business in New Zealand would require each Member of a syndicate to obtain Inland Revenue numbers and file tax returns in New Zealand with material compliance and administration implications. The problem arises because the Income Tax Act rules for non-resident life insurers are designed with companies in mind rather than the syndicate approach used by Lloyd's. Lloyd's advises that its life syndicates in 2015 had 282 members, including 125 companies, 66 individuals and 91 partnerships. By way of comparison, Inland Revenue currently processes 58 returns from 34 life insurers.

4. The current law would generate a significant increase in the number of complex life insurance tax returns received by Inland Revenue for what would be very small amounts of tax relating to each return.

5. Under current law, non-resident life insurers are required to complete tax returns for income (less allowable deductions and losses) for life insurance policies that are:

- offered in New Zealand; or
- offered or entered into in New Zealand.

6. Non-resident life insurers can apply to Inland Revenue to file and pay tax as if they were New Zealand tax residents to the extent of their New Zealand business. Compliance by non-residents with these rules is generally excellent.

7. A different set of rules apply to non-resident general insurers (non-life insurers). Income from general insurance business that is attributed to New Zealand is deemed to be 10 percent of the gross premium. No deductions are allowed and responsibility for returning the tax falls on a hierarchy of New Zealand persons (typically the insurer's agent or the insured's broker). There are well-established practices in the general insurance industry to ensure compliance with New Zealand's tax obligations.

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<sup>1</sup> There are 34 established life insurers operating in New Zealand, with the five largest comprising 75 percent of the life market. Total premium income is close to \$2.6 billion (2015).

8. Lloyd's has requested a legislative change that would allow income from New Zealand term-life insurance business sold by Lloyd's to be treated in a similar manner to general insurance premiums. The effect of the requested change shifts the tax compliance obligations from Lloyd's syndicates to Lloyd's New Zealand authorised agents. Lloyd's have established practices that ensure its New Zealand authorised agents comply with the obligations required by the Income Tax Act and Tax Administration Act 1994.

9. The purpose of the requested legislative change is not to provide a tax concession but improve the efficiency of tax system by significantly reducing compliance and administration costs.

10. Inland Revenue has considered whether there is a good case for changing the way that tax is calculated for life insurance sold by Lloyd's. The current legislative settings for offshore life insurers require the calculation of taxable income after adjusting for allowable deductions and losses. The rules ensure accuracy and the tax paid reflects the economic activity that has a connection with New Zealand. The trade-off is the cost of compliance on taxpayers and, for Inland Revenue, the increased volume of returns that could result.

11. There are also additional tax compliance complexities created by the way that profit is recognised by Lloyd's for each syndicate. Typically, the profits from insurance business are not fully recognised until the end of a three-year reporting cycle based originally on the period of time it took a 17<sup>th</sup> century ship to sail around the world. Consider the description below. While this reporting cycle is supported by annual interim reporting, this pattern of financial reporting does not translate well into income year concepts used in tax law and the administrative and compliance systems that hinge off that concept (such as audit, disputes and collections).

#### **Description of Lloyd's three-year reporting cycle**

Member X underwrites on syndicate 123 for the 2014 year-of-account. In November 2014, the syndicate's managing agent gives a 12-month binding authority to a Lloyd's authorised agent in country Z. Premium and claims relating to that binding authority might be processed in 2014, 2015 and 2016 but all are allocated for 3-year accounting to the 2014 year-of-account.

The managing agent maintains the premiums trust fund into which all premium is received and for which claims and other expenses are paid. No profit or loss is struck for the 2014 year-of-account at the end of 2014 (or at the end of 2015). Instead, the balance of the fund is carried forward until the end of 2016 (the 36-month point for that syndicate for that year of account). This allows time for claims to arise and liabilities to be quantified.

The profit or loss for the year-of-account is struck at the 36-month point. The syndicate "declares" the result of the 2014 year of account in 2017 and "distributes" the profits of that syndicate to its Members at that time in proportion to their participation on the syndicate. A loss will result in a cash-call to Members to make up the deficit.

## OBJECTIVES

12. The **main** objective is to simplify the way tax is collected on term-life insurance business carried on by Lloyd's in New Zealand in order to improve the overall efficiency of the tax system.

13. All options are assessed against the status quo in relation to the main objective and the following criteria:

- Efficiency of compliance – the options should minimise compliance costs on Lloyd's of London.
- Efficiency of administration – the options should minimise administration costs for Inland Revenue and the government.
- Sustainability – the options should maintain the integrity of the income tax base and perceptions of fairness.

14. This RIS is solely concerned with Lloyd's and there is no intention to review the tax treatment of non-resident life insurers generally. The reason for considering a specific set of rules for Lloyd's syndicates recognises its unique governance and the need for the tax system to work efficiently within current tax policy settings.

15. There are constraints on what is practically achievable by Inland Revenue and Lloyd's. These constraints create trade-offs when considering the available options. For example, there is a trade-off between sustainability and efficiency. Sustainability considers perceptions of fairness and the integrity of the tax system. The accuracy of each option is therefore an important policy consideration in terms of a taxpayer's tax liability should bear a close relationship to profitability. The life insurance industry is no exception to this.

## REGULATORY IMPACT ANALYSIS

16. Four options are considered in this RIS. They are:

- Option 1 (status quo) – Lloyd's Members return tax on their New Zealand life insurance business.
- Option 2 (treat Lloyd's syndicates as a single taxpayer) – Treat all Lloyd's syndicates that carry on life insurance business in New Zealand as one taxpayer.
- Option 3 (special presumptive tax rule) – Establish a special tax rule that imposes tax on the gross premiums of Lloyd's term-life insurance products.

17. The impact of each option is discussed below. None of the options have social, cultural or environmental impacts. All of the options considered are expected to be largely fiscally neutral relative to the status quo.

### Option 1 – Status quo

18. This option would maintain the status quo. Lloyd's Members would be required to obtain Inland Revenue numbers and meet their obligations under the Inland Revenue Acts.

### *Efficiency of compliance*

19. Lloyd's Members who carry on life insurance business in New Zealand would be required to obtain Inland Revenue numbers and file annual tax returns. It is estimated that compliance with the current law could over time create the need to produce a significant number of reasonably complex annual tax returns.<sup>2</sup> Each return would be for a very small sum of revenue. For Lloyd's, the current treatment of non-resident life insurers would impose considerable practical difficulties and compliance costs and act as a barrier to enter the New Zealand life insurance market.

### *Efficiency of administration*

20. Inland Revenue currently processes 58 tax returns from 34 established life insurers operating in New Zealand. Faced with a significant increase in the volume of tax returns from Lloyd's syndicate Members, Inland Revenue would need to divert resource and time to manage the associated increase in return volume.

21. Inland Revenue is also concerned that the interaction of the Inland Revenue Acts and Lloyd's three-year financial reporting cycle gives rise to practical difficulties. The four-year time bar, which prevents Inland Revenue from increasing tax assessments (except in the case of tax avoidance), would make it difficult to maintain adequate audit and control across all of Lloyd's syndicate Member's profits (or losses) from business emerging over the three-year business cycle.

### *Sustainability*

22. Given the estimated value of New Zealand business that Lloyd's expects to sell, the amount of income tax for each Member's return is expected to be low. Tax would be payable on the basis of the Member's marginal tax rate (for companies 28% and individuals between the range of 10.5% to 33%). This option ensures, however, that both resident and non-resident life insurers face the same rules and preserves perceptions about the fairness of the tax system.

23. The status quo, however, is arguably inefficient as it creates compliance and administration costs that are likely to exceed the value of any tax payable from the sale of Lloyd's term-life insurance in New Zealand. The efficiency of the tax system is therefore a concern.

### **Option 2 – Treat Lloyd's syndicates as a single taxpayer**

24. This option would involve a legislative change that would treat Lloyd's syndicates as a single taxpayer for the purposes of the non-resident life insurance rules. Tax would be calculated on the basis of income less allowable deductions and losses, and would require the completion of an annual return. In this respect, tax liabilities would be correlated to profits from Lloyd's syndicates' life insurance business in New Zealand.

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<sup>2</sup> Lloyd's has 2,100 underwriting Members, including 325 individuals, over 700 partnerships and over 1,000 companies. The figure above assumes the potential for all Members (not just those described in paragraph 3) underwriting life risk in New Zealand.

### *Efficiency of compliance*

25. This option removes the need for Lloyd's Members to individually obtain Inland Revenue numbers and file annual tax returns. Instead, one annual tax return would be prepared for Lloyd's business activity in New Zealand. Preparation of the tax return and associated compliance would be undertaken in the United Kingdom. This would involve compilation of syndicate activities and associate consolidation of information to meet New Zealand's tax laws. While this option offers some cost efficiencies for Lloyd's, it is still compliance intensive due to the need to consolidate information across multiple syndicates.

### *Efficiency of administration*

26. This option reduces the number of returns that Inland Revenue would be required to process. Practical concerns remain, however. The return would be an amalgam of syndicate activity and would be complex to audit and verify the correctness of any tax position in those returns. The problem with Lloyd's three-yearly financial reporting and its interaction with the four-year time bar and tax administration system generally is not addressed.

### *Sustainability*

27. This option ensures that both non-resident and resident life insurers face the same rules. In this regard, the option protects the integrity of the tax base and perceptions about its fairness.

### **Option 3 – Special presumptive tax rule**

28. This option involves a legislative change that would change the calculation of tax payable from the sale of Lloyd's life insurance products in New Zealand.

29. Instead of calculating tax using the approach described in options 1 and 2, a presumptive tax would be applied to the gross premiums earned by Lloyd's for any term-life product sold in New Zealand. The tax rate applicable to this income would be 28%, consistent with the current rate of company tax. The presumptive tax would be calculated on the basis of 10 percent of gross premiums. This approach is used for the taxation of general insurance sold by non-resident insurers to the New Zealand market. Tax would be calculated and paid by Lloyd's handful of New Zealand authorised agents.

### *Efficiency of compliance*

30. This option would change the way that tax is calculated and returned by Lloyd's syndicates that carry on business in New Zealand. It shifts the cost of compliance from Lloyd's Members to Lloyd's New Zealand-resident agents. Lloyd's advises that their agents would be suitably prepared to comply with the proposed legislation under this option.

31. Part of the cost savings for Lloyd's is a result of the simplified calculation of tax and shifting tax compliance obligations to Lloyd's authorised agents. For this latter group, the cost of compliance is not anticipated to be significant as option 3 is effectively an extension of its tax compliance in connection with Lloyd's general insurance products. There would be a need for Lloyd's authorised agents to maintain records regarding the split between sales of life and non-life insurance.

### *Efficiency of administration*

32. This option would not significantly increase the number of returns that Inland Revenue is required to process. The option would be consistent with income-year concepts used by the tax system, and Inland Revenue's audit and control systems.

### *Sustainability*

33. Option 3 is a pragmatic response to the problem and protects the integrity of the income tax base.

34. It, however, raises a question of fairness if the option produces a tax advantage to Lloyd's that is not available to other life insurers.

35. To ensure the integrity of the tax system and perceptions of fairness, Inland Revenue considers that the deemed rate of taxable income should be reviewed periodically. This is discussed in more detail under the heading "Monitoring, evaluation and review".

36. This option is not as accurate as options 1 and 2 for calculating tax that should be paid by Lloyd's in connection with its New Zealand term-life insurance business. There is a risk that treating 10 percent of gross premiums as reflecting Lloyd's profit from New Zealand would either overstate or understate taxable income. At least initially, it is likely that tax paid on Lloyd's business activity in New Zealand would be higher than what would otherwise be payable under the status quo or option 2. This is a trade-off for simplifying Lloyd's tax compliance.

37. It is relatively uncommon to have specific rules in the Income Tax Act for a specified group of taxpayers. In this particular case, the use of a syndicate structure for insurance does not fit within the conventional taxation rules for life insurance business. Tax and regulatory authorities in New Zealand, Australia and elsewhere recognise that Lloyd's does not fit within normal frameworks or rules. There are several examples of special rules and administrative arrangements to ensure proper compliance with regulators and the payment of taxes.<sup>3</sup>

## CONSULTATION

38. Inland Revenue wrote to the Financial Services Council (FSC) seeking its views on option 3. The FSC is the industry representative group for most insurers operating in New Zealand.

39. Private sector consultation was limited to the FSC as the matters discussed in this RIS solely concern a new life insurer entering the New Zealand market. No other private sector groups with an interest in this issue were identified. The scale of the issue did not warrant extensive consultation using the generic tax policy process.

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<sup>3</sup> For example, provisions in the Insurance (Prudential Supervision) Act 2010 and the Financial Markets Conduct Act 2013 and the Financial Services Providers (Exemption) Regulations 2010. In a New Zealand tax context, there were specific provisions that were largely directed at Lloyd's underwriters – former sections 210 and 210A of the Income Tax Act 1976. In Australia, provisions concerning Lloyd's are found with the Income Tax Assessment Act 1936 the Corporations Act 2001 and the Australian Prudential Regulation Authority Act 1998 and the Financial Institutions Supervisory Levies Collection Act 1998.

40. The FSC's comments on option 3 and Inland Revenue's response are set out below:

- Option 3 could provide a competitive advantage to a new entrant. The FSC noted that the current rules require all life insurers whether New Zealand resident or not to comply with the same rules to ensure that a tax concession is not available to a particular life insurer.

Inland Revenue is reasonably confident that the proposed presumptive tax provides a reasonable proxy of profitability and, given the niche markets that Lloyd's syndicates' intend to operate, the risk that option 3 provides Lloyd's with an unfair competitive advantage is considered to be low. This will be the subject of regular monitoring.

- Whether option 3 should apply to all non-resident life insurers including reinsurers. The proposal for Lloyd's raises broader questions relating to the basis on which life insurance business by, and with, non-resident life insurers are taxed.

Inland Revenue agrees that the proposal raises the possibility for wider consideration of the treatment of life insurance and life risk sold by life insurers, but notes a potential for fiscal risk. The priority of any future work on these matters would be considered as part of the tax policy work programme.

- There are a number of technical issues with option 3, particularly relating to its detail. These issues relate to who bears the liability for tax, the type of life insurance product the option would apply to, and the frequency of any review of the deemed rate of taxable income on which option 3 is based.

The technical matters raised in submissions confirmed the need to confine option 3 to the sale of term-life insurance policies and that the deemed amount of taxable income of 10 percent be reviewed. As discussed, the obligation to calculate and pay tax would fall on Lloyd's New Zealand authorised agents.

41. The overall message from consultation was an acknowledgement a compliance problem exists and we infer that the FSC reluctantly accepts option 3. The FSC did not express any outright opposition to option 3.

42. Lloyd's was also consulted and supports option 3.

43. Inland Revenue also sought comment from the Treasury and the Reserve Bank. Both note that the costs imposed by the current law (status quo) are disproportionate to the tax revenue at issue.

## CONCLUSIONS AND RECOMMENDATIONS

44. The table "summary of options and analysis" below summarises the assessment of each option described in this RIS. The following symbols are used to describe if the option improves on or is worse than the status quo.

- ✓✓ Significantly better than the status quo
- ✓ Better than the status quo
- × No better than the status quo
- ×× Worse than the status quo

**Table 1: summary of options and analysis**

Options	Analysis against the objective and criteria
Option 1 – Status quo	Does not meet the main objective
Option 2 – Treat Lloyd’s syndicates as a single taxpayer	Meets the main objective in part. Efficiency of compliance ✓ Efficiency of administration ✗ Sustainable ✗
Option 3 – special presumptive rule	Meets the main objective Efficiency of compliance ✓✓ Efficiency of administration ✓✓ Sustainable ✗

45. Inland Revenue supports option 3. This is because out of all the options, it represents the greatest improvement over the status quo.

46. Option 3 may not be fiscally neutral when contrasted against the status quo or option 2. It is possible that option 3 could over or underestimate the amount tax that would be payable. This is a trade-off for the expected compliance and administration cost savings that do not arise under the other options.

### IMPLEMENTATION

47. Legislative change to the Income Tax Act and possibly the Tax Administration Act are necessary to implement option 3. These amendments would be included in the first omnibus taxation bill for 2017.

48. The changes would apply to term-life insurance sold by Lloyd’s syndicates on and after 1 April 2017 to align with Lloyd’s proposed entry into the New Zealand life insurance market.

49. When introduced into Parliament, a *Commentary* on the bill will be released explaining the amendments. Further explanation about their effect will be contained in Inland Revenue’s *Tax Information Bulletin* series, which would be released shortly after the bill receives Royal assent.

50. Inland Revenue would administer the proposed legislative changes. Enforcement of the changes would be managed by Inland Revenue as business as usual.

51. The proposed change aligns with Inland Revenue’s existing technology and business systems. Additional information may be sought from affected Lloyd’s authorised New

Zealand agents as to the breakdown of premiums from Lloyd's life and non-life insurance products.

52. Lloyd's will work with affected New Zealand authorised agents to ensure they are informed about the practical day-to-day impact of the changes. Lloyd's advises that its New Zealand authorised agents are generally familiar with the rules that apply to the sale of Lloyd's non-life insurance products and the proposed legislative change is an extension of those rules. Lloyd's authorised agents would be expected to prepare the same IR4 returns as currently required.

### **MONITORING, EVALUATION AND REVIEW**

53. In general, post-implementation reviews are a feature of the generic tax policy process (GTPP). The GTPP is a multi-stage policy process that has been used to design tax policy (and subsequently social policy administered by Inland Revenue) in New Zealand since 1995.

54. 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 built into this stage. In practice, any changes identified as necessary would be added to the tax policy work programme, and proposals would go through the GTPP.

55. If the Government adopts option 3, Inland Revenue recommends that the presumptive tax be reviewed in 2020 to assess its on-going suitability and whether it broadly reflects Lloyd's syndicates' profit based on financial reporting evidence for the period 2017-2019 and projected future profitability. Notwithstanding accuracy matters, if the compliance and administration savings are sufficiently material, unders and overs in tax payable are likely to be tolerated. Compliance cost implications for Lloyd's authorised agents would also be considered as part of the review in 2020.

# REGULATORY IMPACT STATEMENT

## Proposed changes to PAYE and GST

### Agency disclosure statement

This Regulatory Impact Statement (RIS) has been prepared by Inland Revenue. It provides an analysis of options to improve the administration of PAYE and GST.

The options considered are intended to reduce compliance costs for businesses and administrative costs for Government, while improving the administration of PAYE and social policy and ensuring the rules are robust. The options were developed in the context of the wider tax policy framework of a clear and coherent broad-base, low-rate tax system.

It is challenging to accurately forecast some of the costs (including compliance, and administrative costs) for the options due to information not being available or difficulty in estimating likely behavioural changes. Equally, it is difficult to determine the number of taxpayers who may be impacted by the proposals as various factors may influence the decision to adopt a proposal. Instead, indications of the direction and order of magnitude have been provided where appropriate.

None of the policy options restrict market competition, impair property rights, reduce incentives for small businesses to operate, or override fundamental common law principles.



Mike Nutsford  
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2 June 2016



## Contents

Agency disclosure statement.....	1
Reader’s guide to this RIS .....	5
STATUS QUO AND PROBLEM DEFINITION .....	6
Inland Revenue’s transformation programme.....	6
Problems with PAYE and GST and their magnitude .....	7
OBJECTIVES .....	8
REGULATORY ANALYSIS.....	9
A. Using Digital services to integrate tax requirements into business processes .....	10
B. Getting it right from the start.....	18
C. Making the PAYE rules work better .....	19
CONCLUSION.....	20
CONSULTATION.....	21
IMPLEMENTATION .....	22
MONITORING EVALUATION AND REVIEW.....	23
APPENDIX A - USING DIGITAL SERVICES TO INTEGRATE TAX REQUIREMENTS INTO BUSINESS PROCESSES.....	24
1. PAYE information at the time of the business process.....	26
Recommendations.....	30
2. Facilitating provision of PAYE information through payroll software .....	30
Recommendations.....	33
3. Remit PAYE and related deductions on payday .....	33
Recommendations.....	37
4. PAYE – encouraging the take-up of digital services and targeting support .....	37
Recommendations.....	41
5. PAYE Thresholds .....	41
Recommendations.....	48
6. GST –Introducing a framework for setting an electronic filing threshold for GST returns .....	48
Recommendations.....	51
APPENDIX B - GETTING IT RIGHT FROM THE START.....	52
1. Provision of date of birth information and contact details from all new employees.....	52
Recommendations.....	55
APPENDIX C - Making the PAYE rules work better .....	56
1. Tax treatment of holiday pay .....	56

Recommendation ..... 58

2. Application of legislated rate changes ..... 59

Recommendation ..... 62

## **Reader's guide to this RIS**

This document covers 9 discrete proposals which have been grouped into three themes. To manage this large number of topics we have shifted the detailed analysis of each theme, and the component proposals within that theme, out of the Regulatory Analysis section and into a set of three appendices.

The body of the RIS still contains an overview of the options considered but the detailed analysis of the costs, benefits, impacts and recommendations is contained in the corresponding appendix. Within the overview tables the following symbols are used:

- ✓✓ Significantly better than the status quo
- ✓ Better than the status quo
- × No better than the status quo
- ×× Worse than the status quo

The consultation section of the RIS provides a summary of our consultation approach with the feedback received on each proposal set out in corresponding appendix.

## STATUS QUO AND PROBLEM DEFINITION

### Inland Revenue's transformation programme

1. The Government's objective for the revenue system is for it to be as fair and efficient as possible in raising the revenue required to meet the Government's needs. For taxpayers the tax system should be simple to comply with, making it easy to get right and difficult to get wrong. It should serve the needs of all New Zealanders, put customers at the centre and help them from the start, rather than when things go wrong.
2. The shift to digital and greater globalisation has reshaped how businesses and individuals interact and connect, and their expectations of government.
3. Businesses are increasingly using software packages to automate processes and reduce their compliance burden. Businesses have consistently ranked tax as their highest compliance priority, and it often contributes the most to their overall compliance burden. Compliance costs could be reduced by making better use of businesses' everyday processes and systems to meet tax obligations. Enabling businesses to spend less time on tax and more time on running their business will support Government's wider goals of building a more competitive economy and delivering better public services.
4. The ways in which individuals work has changed with different types of employment and working arrangements. The New Zealand workforce has become more casualised as permanent employment has become less common, and temporary, casual and contract work has become more prominent. Other trends include part-time and temporary workers increasingly holding multiple jobs, and more self-employment and small businesses. Many of the current tax policies and administrative processes were designed for an era when New Zealand's workforce was more strongly characterised by salary and wage earners in permanent full-time employment arrangements.
5. To protect the Government's ability to collect sufficient revenue to keep providing services, it is important that New Zealand's revenue system keeps pace with change and is as efficient as possible. The fiscal challenges associated with an ageing population and associated demand for high quality healthcare and other services will add impetus to the need for a highly efficient and responsive revenue system. To meet these challenges, Inland Revenue requires a fundamental shift in the way it thinks, designs, and operates.
6. The Government has agreed to change the revenue system through business process and technology change. A digitally-based revenue system, simplified policies, and better use of data and intelligence to better understand customers will simplify how services are delivered and change how customers interact with the revenue system.
7. Having a good overall revenue system means having both good policies and good administration. While the policy framework is fundamentally sound, there is an opportunity to review current policy and legislative settings as levers to help modernise the revenue system and ensure it is responsive to global changes.
8. There is no doubt that Inland Revenue's computer systems (known as FIRST) need replacement to improve resilience and agility. They have reached the end of their life and are

not sustainable in the medium to long term. The FIRST systems are aging, extremely complex, very difficult and costly to maintain, and inflexible. Since FIRST was implemented, a number of income-related social policies have been added to the platform. Implementing social policies within a platform designed for tax administration has added layers of complexity and risk to Inland Revenue's business processes and technology infrastructure. This in turn limits the department's ability to respond to government policy priorities.

9. However, Business Transformation is far more than just updating a computer system. It is a long-term programme to modernise New Zealand's revenue system, and will re-shape the way Inland Revenue works with customers, including improvements to policy and legislative settings and enabling more timely policy changes. A new operating model and new systems will be the catalysts for these changes.

10. PAYE and GST are key components of the New Zealand tax system. This regulatory impact statement outlines options made possible by modernisation of the New Zealand revenue system, for improving the administration of PAYE and GST.

### **Problems with PAYE and GST and their magnitude**

11. PAYE raises 37% of tax revenue. In addition PAYE processes are used for the payment of the ACC earners' levy, some child support obligations, student loan repayments, employer's superannuation contribution tax (ESCT), payroll giving and KiwiSaver contributions (of both employers and employees).

12. PAYE income information is used to assess entitlements for tax credits, to determine child support obligations and to determine whether benefit entitlements from the Ministry of Social Development (MSD) and compensation entitlements from the Accident Compensation Corporation (ACC) have been overpaid.

#### *Compliance costs*

13. PAYE imposes compliance costs on more than 194,000 New Zealand employers. Because of the absence of economies of scale it is generally accepted that PAYE imposes higher per employee compliance costs on small employers than on larger ones. If this is considered to be unfair thresholds and subsidies are mechanisms which can be used to differentiate obligations or offset costs. On the other hand such subsidies and thresholds impose costs on society in general and taxpayers specifically. From a dynamic perspective they can be seen as encouraging the growth of small business relative to other investments, although in this context it is appropriate to note that employers are not necessarily businesses. Non-profit organisations, individuals, clubs and societies can all have obligations as an employer. The role for thresholds and subsidies is considered further in many of the options canvassed in this regulatory impact statement.

14. For the smallest employers (1 – 5 employees) the most recent compliance cost survey (2013) identified the median hours spend on PAYE as 12 hours a year. The PAYE legislation is prescriptively written. It requires PAYE information to be provided on a monthly basis which prevents employers and the government benefiting from using business software to integrate PAYE obligations into normal business processes, such as paying staff.

Estimates made for Inland Revenue's Business Transformation business case suggest that using modern digital services could reduce PAYE compliance costs on small employers (1-5 employees) by between 15% and 40%.

15. PAYE information is currently required monthly, by the 5<sup>th</sup> of the following month for the largest employers and by the 20<sup>th</sup> of the following month for all other employers. Although PAYE information is provided for each employee it is aggregated across the pay periods in the month to provide monthly totals.

#### *Impact on individual employees*

16. The aggregated and delayed nature of current PAYE information enables errors to perpetuate across multiple pay periods and limits Inland Revenue's ability to identify and work with employers to rapidly correct them. In turn this affects individual employees who can have PAYE over or under-withheld or can incur additional student loan deductions or child support or Working for Families' debt. As an example almost 19,000 student loan borrowers were required to make additional deductions in the year to June 2015 because they were on the wrong tax code.

17. The aggregated and delayed nature of current PAYE information also limits opportunities to improve the future operation of social policy for example by reducing the period over which social policies such as Working for Families are assessed. A shorter assessment period could allow assistance to better match periods of need.

#### *PAYE rules*

18. The existing tax treatment of holiday pay paid in advance has a tendency to result in over-withholding of PAYE, which gives rise to fairness concerns.

19. Different types of PAYE income payments and PAYE-related social policy products currently have different rules on what is to be done when there is a legislated rate (or threshold) change during a pay period or if there is rate (or threshold) change between the date the payment is made and the pay period to which the payment relates. This creates complexity and confusion for employers, which adds to compliance costs.

#### *GST*

20. GST raised 36% of tax revenue in the year to June 2015. Around 640,000 persons and businesses are registered for GST. The time and costs they incur in complying with their GST obligations and the cost of administering GST could be reduced and efficiency improved if more use was made of electronic services in interaction with Inland Revenue.

## **OBJECTIVES**

21. The Government is committed to making positive changes to reduce the time and costs to employers of meeting their tax obligations, it also seeks more useful and timely PAYE information to improve the administration of social policy and support wider

improvements to public services. The criteria against which the options have been assessed are:

- a. *Fairness and equity*: to support fairness in the tax system, options should, to the extent possible, seek to treat similar taxpayers in similar circumstances in a similar way.
- b. *Efficiency of compliance and administration*: the compliance impacts on taxpayers and the administrative costs to Inland Revenue should be minimised as far as possible.
- c. *Sustainability of tax and income-related social policy system*: options should collect the revenue required in a transparent, coherent and timely manner while not leading to tax driven outcomes and should enable more timely policy changes.
- d. *Basis for improved social policy and other government services*: options should support the more effective use of income information in the delivery of social policy and improved information sharing between government agencies to deliver better public services.

22. These criteria are weighted equally. It is acknowledged however that judgements are affected by the weight given to different aspects for example '*Fairness and equity*' involves consideration of both the employers who may benefit from a subsidy or incentive and of taxpayers who must pay for it.

23. Impacts on employees are considered, from a systems perspective under '*Sustainability of the tax and income-related social policy system*' and under '*Basis for improved social policy and other government services*'. This later criterion is only used in respect of PAYE information.

24. Fiscal impacts are identified where relevant. There are no social, environmental or cultural impacts from these recommended changes.

## **REGULATORY ANALYSIS**

25. Officials have developed options to address the above issues. These options have been grouped into the following three key themes:

- A. Using digital services to integrate tax requirements into business processes
- B. Getting it right from the start (additional PAYE information)
- C. Making the PAYE rules work better.

26. Each of these themes and the options under them are summarised below. Further detail on the issues and options under each theme is contained in the appendices.

27. Within the overview tables the following symbols are used.

- ✓✓ Significantly better than the status quo
- ✓ Better than the status quo
- × No better than the status quo
- ×× Worse than the status quo

## **A. Using Digital services to integrate tax requirements into business processes**

28. Currently businesses and other employers need to manage their PAYE obligations as separate processes which stand-alone from the management of business as usual. Elsewhere businesses, organisations and individuals are increasingly harnessing the power of software to automate, integrate and facilitate processes.

29. Maintaining the current PAYE processes would deny employers the opportunity to take advantage of modern digital services to reduce compliance costs by integrating PAYE requirements into business processes. Integrating tax requirements into business processes, such as providing PAYE information at the time employees are paid, would also reduce administrative costs and lay the basis for improved service provision to employees from Inland Revenue and wider government.

30. Using digital services to reduce compliance and administrative costs and improve the quality of government services is crucially dependent on the nature and quality of the PAYE-related services offered in payroll software and options are considered to ensure payroll software facilitates the provision of PAYE information at the time of the business process.

31. To maximise available compliance and administrative savings and reflect the fact that PAYE and related deductions belong to employees and then the Crown, PAYE and related deductions should also be remitted on payday. Options for changing when remittance of PAYE and related deductions are due are considered.

32. Options for encouraging and targeting the uptake of digital services are also considered in this section as is the use of thresholds to differentiate obligations between larger and smaller employers.

33. The final proposal in this section examines options for reducing the costs associated with filing GST returns.

### **Options and Analysis**

34. The proposals to address the issues identified are:
- PAYE information at the time of the business process
  - Provision of PAYE information through payroll software
  - Remit PAYE and related deductions on payday
  - PAYE - encouraging the take-up of digital services and targeting assistance
  - PAYE thresholds

- GST – Introducing a framework for setting an electronic filing threshold for GST returns

*PAYE Information provision at time of business process*

35. To improve processes for the provision of PAYE information officials have considered a number of options. These options centre on whether or not employers are required to provide information at the time of the business process, for example providing information about income and deductions on payday<sup>1</sup>. The options are summarised below and are outlined further in appendix A -1.

Options	Comparison to status quo
1. Retain the status quo – where the legislation requires PAYE information on a monthly basis regardless of the employers pay cycle.	
2. Voluntary provision of PAYE information at time of business process	Fairness and equity ✓ Compliance and administration ✓ Sustainability ✗ Basis for improved social policy ✗
3. Require PAYE information on payday <sup>2</sup> and other PAYE information <sup>3</sup> no later than payday. For employers below a threshold and not using payroll software the due date would allow for returns to be posted.	Fairness and equity ✗ Compliance and administrative costs ✓ Sustainability ✓✓ Basis for improved social policy ✓✓
4. Require pay period PAYE information on payday <sup>4</sup> and other PAYE information <sup>5</sup> no later than payday above a threshold and at month end for those below the threshold or exempt, the due date for this category would allow time to post a return.	Fairness and equity ✓✓ Compliance and administrative costs ✓ Sustainability ✓ Basis for improved social policy ✓

<sup>1</sup> There would be a minimum period of a week; employers who pay daily would not be required to provide information more than weekly.

<sup>2</sup> Due date would be day after payday.

<sup>3</sup> About new and departing employees

<sup>4</sup> Due date would be the day after payday

<sup>5</sup> About new and departing employees

*Recommendation*

36. Option three, requiring PAYE information on payday from all employers would represent a significant improvement on the status quo and rates highest on the criteria related to the sustainability of the tax and income-related social policy system and the extent to which it creates a foundation for future improvements to social policy. It reflects the proposition that this information is available at this point in time as a result of the employer paying staff and could therefore be provided to Inland Revenue at little additional cost.

37. Officials however recommend option 4. Option 4 would require pay-period PAYE information to be provided on payday above a threshold and at month end from those below the threshold and from those with an exemption because they are unable to access digital services. This option balances the interests of employers with small payrolls who may not derive the benefits associated with the use of payroll software against the wider system benefits that are available from payday filing of PAYE information.

*Facilitating provision of PAYE information through software*

38. The Commissioner can prescribe the content and format for electronic forms. The options considered below centre on whether or not payroll software should:

- only be able to be used to provide PAYE information on payday<sup>6</sup>, even in circumstances where the employer is below a payday filing threshold and could chose to file with a later due date, and
- be required to offer services which employers can chose to use to advise of new and departing employees when they are added to or removed from the payroll.

39. The options are summarised below and are outlined further in appendix A -2.

Options	Comparison to status quo
<p>1. Status Quo – leave it to the market to decide whether</p> <ul style="list-style-type: none"> <li>- Payroll software can be used to file with a later due date (by small employers)</li> <li>- Software offers the opportunity for employers to advise Inland Revenue of new and departing employers at the time they are added to or removed from the payroll.</li> </ul>	
<p>2. Require payroll software to:</p> <ul style="list-style-type: none"> <li>- Only offer payday filing of PAYE income and deduction information.</li> <li>- Offer services which employers can choose to use to report new and departing employee information at the time they arrive or leave.</li> </ul>	<p>Fairness and equity ✓                      Compliance and administrative costs ✓✓                      Sustainability ✓                      Basis for improved social policy ✓✓</p>

<sup>6</sup> The payroll software will not automatically provide the information, all transmissions must be authorised by the employer’s representative.

*Recommendation*

40. Officials recommend option 2 which requires payroll software providers to only offer payday filing and to offer a service to notify IR when new employees are added or removed from the payroll. This option best supports the objectives of reduced compliance and administrative costs and provides the best basis for subsequent improvements to social policy.

Remit PAYE and related deductions on payday

41. Officials have considered three options to address opportunities in relation to PAYE remittance and its integration into business processes and the use of digital services. These options focus on whether the timing and process of remitting PAYE should be required to be aligned with:

- the business process of paying employees, and
- the timing and process of providing PAYE information to Inland Revenue.

42. It is noted that those employers who are not required to align PAYE remittance with the process of paying their employees under the below options will be able to remit PAYE on payday on a voluntary basis should they wish to take advantage of integrating all PAYE obligations with their business processes.

43. These options are summarised below and are outlined further in appendix A-3.

Options	Comparison to status quo
1. Retain the status quo – employers are allowed to hold PAYE and related deductions until they are required to remit them to Inland Revenue either once or twice a month.	
2. Align the remittance of PAYE with the business process of paying staff for <b>all employers</b> .	Fairness and equity: ✕✕ Compliance and administration: ✓ Sustainability: ✓✓
3. Align the remittance of PAYE with the business process of paying staff for employers above a <b>threshold</b> and payroll intermediaries, and retain delayed PAYE remittance for employers below the threshold.	Fairness and equity: ✕ Compliance and administration: ✓✓ Sustainability: ✓✓

*Recommendation*

44. Officials recommend option 3 as it balances the benefits of aligning PAYE (and related deductions) remittance with the business process of paying employees and the consideration of the impact payday remittance may have particularly on small businesses and not-for-profit organisations. Officials acknowledge that retaining the status quo while allowing employers who chose to do so, to remit on payday, would avoid the negative impacts that requiring payday remittance could have.

PAYE encouraging the uptake of digital services and targeting support

45. Government has identified a major role for digital technology in making tax simpler and a key focus will be working with the software industry to ensure the deployment of high quality user friendly services. A payroll subsidy currently exists to encourage small businesses to outsource their PAYE obligations. Officials have considered options to encourage digital uptake and target support. The options are summarised below and are outlined further in appendix A-4.

Options	Comparison to status quo
1. Retain the status quo – leave the payroll subsidy threshold where it is.	
2. Reduce the payroll subsidy threshold to better target the subsidy.	Fairness and equity ✓✓ Compliance and administrative costs × Sustainability ✓ Foundation for improved social policy ×
3. Repeal the payroll subsidy	Fairness and Equity ✓ Compliance and administrative costs ×× Sustainability ✓✓ Foundation for improved social policy ××

*Recommendation*

46. Option 3 addresses the concerns about eliminating distortions and weights fairness to the tax payer higher than option 2.

47. Officials recommend option 2 to reduce the payroll subsidy threshold to better target the subsidy and reduce the potential for it to distort decisions about whether or not to use a listed payroll intermediary (eligible for the subsidy) or to purchase payroll software or other services (ineligible).

PAYE thresholds

48. Because of the absence of economies of scale PAYE obligations impose higher per employee compliance costs on small employers than on larger ones. Although not without costs of their own thresholds are a mechanism through which obligations and entitlements can be differentiated to mitigate the higher compliance costs and to target support.

49. Officials have considered four options for a PAYE threshold to apply to the following obligations and entitlements:

- The obligation to file PAYE information electronically
- The obligation to file PAYE information on payday
- The obligation to remit PAYE and related deductions on payday
- Eligibility for the payroll subsidy

50. These options are summarised below and are outlined further in appendix A-5

Options	Comparison to status quo
<p>1. Status quo thresholds which relate to the above obligations and entitlements as follows:</p> <p>\$100,000pa of PAYE and ESCT<sup>7</sup> for electronic filing- but no payday filing obligation.</p> <p>\$500,000pa of PAYE and ESCT threshold for twice monthly remittance of PAYE and for PAYE information by 5<sup>th</sup> of following month.</p> <p>\$500,000pa of PAYE and ESCT as the threshold for the payroll subsidy.</p> <p>Change to threshold requires legislative amendment.</p>	
<p>2. One PAYE threshold for all obligations and entitlements at \$100,000pa of PAYE and ESCT.</p> <p>Threshold able to be changed by Order-in-Council following consultation</p>	<p>Fairness and equity ✓</p> <p>Compliance and administrative costs ✓✓</p> <p>Sustainability ✓✓</p> <p>Foundation for improved social policy ✓</p>
<p>3. One PAYE threshold for all obligations and entitlements at \$50,000pa of PAYE and ESCT.</p> <p>Threshold able to be changed by Order-in-Council following consultation</p>	<p>Fairness and equity ×</p> <p>Compliance and administrative costs ✓</p> <p>Sustainability ✓✓</p> <p>Foundation for improved social policy ✓✓</p>
<p>4. Status quo: \$500,000pa of PAYE and ESCT threshold for frequency of twice monthly remittance.</p> <p>\$50,000pa of PAYE and ESCT for electronic filing.</p> <p>All employers to submit PAYE information on payday.</p> <p>No payroll subsidy.</p> <p>Threshold able to be changed by Order-in-Council following consultation.</p>	<p>Fairness and equity ×</p> <p>Compliance and administrative costs ✓</p> <p>Sustainability ✓✓</p> <p>Foundation for improved social policy ✓✓</p>

<sup>7</sup> Employer's superannuation contribution tax.

*Recommendation*

51. The analysis of the options depends on the importance ascribed to the various obligations, particularly the importance of payday information compared to the value put on payday remittance of PAYE.

52. Because it balances the objective of receiving PAYE information earlier against small businesses' concerns about the cash flow impact of earlier remittance officials recommend option 2 to introduce a single threshold at \$100,000 a year of PAYE and ESCT to determine the following obligations and entitlements:

- The obligation to file PAYE information electronically
- The obligation to file PAYE information on payday
- The obligation to remit PAYE and related deductions on payday
- Eligibility for the payroll subsidy
- The threshold able to be changed in future by Order in Council following consultation:

*GST – Introducing a framework for setting an electronic filing threshold for GST returns*

53. Currently there is no electronic filing threshold for the filing of GST returns. To address uptake of electronic services for GST in the future and its benefits officials have considered two options.

54. These options are summarised below and are outlined further in appendix A-6.

<b>Options</b>	<b>Comparison to status quo</b>
1. Retain the status quo – All taxpayers can choose to file their GST returns electronically or on paper.	
2. Introduce a framework for the setting of an electronic filing threshold for GST returns.	Fairness and equity: ✕ Compliance and administration: ✓✓ Sustainability: ✓
3. Introduce a non-electronic filing penalty set at \$250 as part of the framework under option 2.	Fairness and equity: ✓ Compliance and administration: ✓✓ Sustainability: ✓

*Recommendation*

55. Officials recommend options 2 and 3 to introduce a framework for setting an electronic filing threshold for the filing of GST returns by Order-in-Council in the future and a non-electronic filing penalty set at \$250 as part of this framework.

56. Combined option 2 and 3 recognise the benefits of reduced compliance and administrative costs and reduced transcription errors that can be realised through electronic filing. The option acknowledges the relatively high level of uptake of electronic filing for GST returns under current Inland Revenue services and provides a mechanism to introduce a threshold if electronic filing does not continue to increase.

## B. Getting it right from the start

### Provision of date of birth information and contact details for all new employees

57. Because new employees are not always set up correctly from the start, or as near as possible to the start of their employment PAYE compliance and administrative costs are higher than they need to be and employees can incur social policy debt and be subject to incorrect PAYE withholding.

58. The recommended requirement that payroll software should offer employers the opportunity to forward new employee details as soon as they are added to the payroll and before they are first paid will contribute to reducing these problems. Current tax processes are however out of step with modern approaches to identity confirmation in not seeking date of birth information and in not taking the opportunity to update contact details at the time employment changes. The options also consider whether employers should be able to pass on information such as contact details already gathered from the employee.

59. Officials have considered two options which are summarised below and set out in more detail in Appendix B-1.

Options	Comparison to status quo
<p><b>1. Retain the status quo:</b> No date of birth information and contact details only from those in or eligible for KiwiSaver and no ability for employer to pass on information already gathered from an employee.</p>	
<p><b>2. Require date of birth and contact detail information</b> for all new employees and enable employers to pass on information already gathered.</p>	<p>Fairness and equity ✓ Compliance and administrative costs ✗ Sustainability ✓✓ Foundation for improved social policy ✓✓</p>

### *Recommendation*

60. Officials recommend option 2 to require date of birth and contact information for all new employers while allowing employers to pass on information already gathered from an employee for their own purposes.

## C. Making the PAYE rules work better

### Tax treatment of holiday pay

61. The tax treatment of holiday pay differs depending on whether it is paid as a lump sum (in which case it is treated as an extra pay), or whether it is included in an employee's regular pay or paid in substitution for an employee's ordinary salary or wages when annual paid holidays are taken (in which case it is treated as salary or wages).

62. Holiday pay paid in advance as a lump sum is currently taxed as an extra pay. This has a tendency to result in over-withholding of PAYE. Anecdotally, it is common for employees in some industries to work longer hours in the lead up to Christmas, which can exacerbate the over-withholding caused by using the extra pay formula. This, combined with receiving no income during the following weeks when the holiday is taken, may make things difficult for the employee financially.

63. While employees are able to obtain a refund for any over-withheld tax following the end of the tax year, the fact that it can adversely affect employees' adequacy of income around the period the holiday is taken gives rise to fairness concerns.

64. Officials have considered a number of options, which are summarised below and outlined in more detail in Appendix C-1.

Options	Comparison to status quo
1. Retain the status quo	
2. Require employers to deduct PAYE from holiday pay paid in advance as if the lump sum payment was paid over the pay periods to which the leave relates	Fairness and equity ✓✓ Compliance and administrative costs ×× Sustainability ×
3. Retain the ability for employers to tax holiday pay paid in advance as an extra pay, but allow employers the option of deducting PAYE as if the lump sum payment was paid over the pay periods to which the leave relates	Fairness and equity ✓ Compliance and administrative costs ×× Sustainability ✓

### *Recommendation*

65. Officials recommend option 3, as it strikes the best balance between fairness and compliance cost considerations, and it is the most sustainable option.

Application of legislated rate changes

66. Different types of PAYE income payments and PAYE-related social policy products have different rules on what is to be done when there is a legislated rate (or threshold) change during a pay period or if there is rate (or threshold) change between the date the payment is made and the pay period to which the payment relates. The rates (or thresholds) that apply are sometimes based on the pay date, sometimes pay period end-date or pay period start-date, while sometimes apportionment applies. This creates complexity and confusion for employers when there is a rate (or threshold) change, which adds to compliance costs.

67. Officials have considered a number of options, which are summarised below and outlined in more detail in Appendix C-2.

Options	Comparison to status quo
1. Retain the status quo	
2. Alignment based on pay date	Fairness and equity ✓ Compliance and administrative costs ✓✓ Sustainability ✓
3. Alignment based on pay period end-date	Fairness and equity xx Compliance and administrative costs ✓ Sustainability ✓
4. Alignment based on pay period start-date	Fairness and equity xx Compliance and administrative costs ✓ Sustainability ✓
5. Alignment based on apportionment	Fairness and equity ✓ Compliance and administrative costs xx Sustainability ✓

*Recommendation*

68. Officials recommend option 2 because it would simplify the transitional process the most for employers when a legislated rate or threshold change occurs (thus resulting in the largest reduction in compliance costs), and it would be the most sustainable option.

**CONCLUSION**

69. The recommended options under the above themes enable material compliance and administrative cost savings, enable improved service delivery to individuals and lay a foundation for subsequent improvements to social policy and wider government services. They do this while recognising that ‘one size cannot fit all’ and while maintaining New Zealand’s broad base low rate tax framework.

## CONSULTATION

70. Several forms of consultation have been undertaken in developing the options outlined in this statement.

71. In June 2014, Inland Revenue, the Treasury and Victoria University hosted a conference entitled *Tax administration for the 21<sup>st</sup> Century*. The conference explored options for making tax easier through reducing both compliance and administration costs, while balancing increased voluntary compliance against the core tax policy objectives of raising sufficient revenue and ensuring fairness and efficiency. The main points made by attendees were to give people the ability to self-manage their tax affairs through improved services and more flexible legislative frameworks, the importance of involving businesses and others in the design of the rules and processes, the need to ensure that there is an overall net benefit to society of the changes not just a cost shift from Inland Revenue to businesses, and to ensure the continued maintenance of the current tax system whilst the reforms occur.

72. Following this conference the Government issued *Making Tax Simpler – a Government green paper on tax administration* which outlined the scope and direction of the review of the tax administration, and sought feedback on the problems taxpayers face with the current system. At the same time the Government released *Making Tax Simpler – Better Digital Services a Government discussion document* which identified the key role envisaged for digital services in the modernised tax administration system.

73. Feedback on these two documents informed *Making Tax Simpler – Better administration of PAYE and GST: a Government discussion document* which was released for public consultation in early November 2015. In addition to the discussion document an on-line forum was established and employers and GST registered persons were notified of the consultation and encouraged to provide feedback. Over 1,000 comments were made to the online forum and more than eighty written submissions were received. This public feedback has informed the development of the options presented in this statement.

74. Submissions from representative bodies, large employers and employers already using payroll software noted one-off compliance costs to upgrade software, but were generally supportive of further integration of PAYE processes into payroll software. Submissions from employers not using payroll software and from smaller employers were largely opposed to providing PAYE information at the time of the business process as they did not want to have to adopt software and/or were concerned about the potential for higher compliance costs from more frequent filing.

75. Submissions on the proposed changes for GST supported allowing GST registered persons to file directly from their accounting software, a change that does not require legislative amendment but were generally opposed to the proposal that there be a threshold above which GST registered persons would have to file electronically.

76. Further details on the response to consultation are provided for each measure set out in the appendices.

## **IMPLEMENTATION**

77. The discussion document consulted on three implementation options for the potential obligation to report PAYE information at the time of the business process:

- a voluntary-first approach with the potential for subsequent compulsion after a critical mass had adopted the new way of submitting PAYE information;
- a review approach that would establish a timetable for a review but would not establish new obligations until after the new digital PAYE services were in operation and had been reviewed; or
- a legislated approach where the initial legislation would establish a lead-in period by the end of which employers would be required to provide information at the time of the business process.

78. The majority of submissions on the implementation approach supported the voluntary-first approach with some support for the review approach. Feedback in response to other questions and discussions with some software providers suggests however, that in the absence of a legal requirement for employers to provide PAYE information at the time of the business process, it will be difficult to ensure that software providers update their systems and services.

79. The voluntary-first and review approaches would also postpone the realisation of benefits and potentially delay the timeframe for the introduction of the changes to social policy which depend on disaggregated and more timely PAYE information.

80. Accordingly a legislated approach to implementing a timeframe for the changes to PAYE is proposed. The approach will initially be permissive and allow employers to adopt the new ways of providing PAYE information and remitting PAYE and related deductions, but the legislation will include a timeframe by the end of which employers will be required to provide pay-period PAYE information. Employers at, or above, the threshold will be required to provide the information electronically.

81. Having regard to the timetable for the introduction of Inland Revenue's new START system, and taking into account feedback from large employers about their requirement for 1 to 3 years to plan, schedule and implement the changes, it is proposed that the recommended options will be included in a bill to be introduced later in 2016 and enacted before Parliament rises for the general election in 2017. The recommended options will apply as set out below:

- 1 April 2018 is the date from which it will be permissible for employers to submit PAYE information and remit PAYE and related deductions on payday.
- 1 April 2018 is the effective date for the proposed changes to the PAYE rules.
- 1 April 2018 is the date at which the eligibility threshold for the payroll subsidy would change.
- 1 April 2019 is the date from which employers with an obligation to do so, will be required to submit pay-period PAYE information on payday.
- 1 April 2019 is also the date from which any employers required to do so would remit PAYE and related deductions on payday.

## **MONITORING EVALUATION AND REVIEW**

82. Inland Revenue will monitor the outcomes pursuant to the Generic Tax Policy Process ("GTTP") to confirm that they match the policy objectives. The GTTP is a multi-stage policy process that has been used to design tax policy in New Zealand since 1995.

83. 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. Post-implementation review is expected to occur around 12 months after implementation. Opportunities for external consultation are 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.

84. Also, as part of Inland Revenue's business transformation programme a benefit management strategy has been developed and endorsed. The programme costs and benefit estimation approach is outlined in Appendix G of the November 2015 Programme Update and Detailed Business Case. The benefit management strategy provides the framework for managing benefits within the programme, and:

- defines benefit components;
- details how programme benefits will be quantified and measured;
- documents how progress will be tracked; and
- describes what governance arrangements will be in place.

85. Inland Revenue has commissioned a regular survey of compliance costs. This survey is being redeveloped in the context of Inland Revenue's business transformation programme and will survey SMEs, individuals and larger employers with a specific focus on the impact of change.

86. Both internal and external stakeholders will be actively involved in the on-going assessment of timeframes, benefits identification and benefits realisation for each stage of the transformation programme.

## APPENDIX A - USING DIGITAL SERVICES TO INTEGRATE TAX REQUIREMENTS INTO BUSINESS PROCESSES

### Status Quo and problem definition

There are just over 194,000 employers in New Zealand with PAYE obligations.

- Thirty seven percent of total tax revenue comes from PAYE (\$25,760 million)<sup>8</sup>
- PAYE system is also used to collect:
  - Student loan repayments \$795 million<sup>9</sup>
  - Child Support payments \$286.5 million<sup>10</sup>
  - KiwiSaver employee contributions \$3,214 million<sup>11</sup>
  - KiwiSaver employer contributions \$2,017 million<sup>12</sup>
  - Payroll giving \$2.1 million<sup>13</sup>

Currently businesses and other organisations employing staff including not for profit organisations, central and local government<sup>14</sup> agencies, clubs, societies and individuals, need to attend to their PAYE obligations on timetables set by the Income Tax Act 2007 and the Tax Administration Act 1994. Filing returns and making payments are separate stand-alone processes.

Employers must deduct PAYE and related deductions from an employee's salary or wages each payday and provide aggregated information<sup>15</sup> for each employee about income paid and deductions made to Inland Revenue once a month. PAYE information is due on the 5<sup>th</sup> of following month for the largest employers (those with over \$500,000 a year of PAYE and employers superannuation contribution tax (ESCT)) and on the 20<sup>th</sup> of the following month for all other employers.

Employers must pay (remit) the PAYE and other deductions to Inland Revenue. The largest employers remit twice monthly on the 20<sup>th</sup> for deductions made between the 1<sup>st</sup> and the 15<sup>th</sup> and on the 5<sup>th</sup> of the following month deductions made between the 16<sup>th</sup> and month end. All other employers remit their PAYE and other deductions with their PAYE information on the 20<sup>th</sup> of the following month.

Employers with more than \$100,000 a year of PAYE and ESCT must file their PAYE information<sup>16</sup> electronically. Despite this a significant number of Inland Revenue's PAYE processes and requirements involve paper forms, or electronic forms which cannot be directly populated from a payroll software system but must be manually completed.

<sup>8</sup> Year to March 2016

<sup>9</sup> Year to June 2015

<sup>10</sup> Year to June 2015

<sup>11</sup> Year to March 2016

<sup>12</sup> Year to March 2016

<sup>13</sup> Year to March 2015

<sup>14</sup> In addition to their obligations as an employer the Ministry of Social Development, ACC and Inland Revenue also have PAYE obligations when they pay taxable benefits and entitlements.

<sup>15</sup> For each employee the information is aggregated across the pay-periods in the month to provide monthly totals.

<sup>16</sup> The IR 348 EMS and the IR 345 EDF

PAYE imposes compliance costs on employers. It is generally accepted that per employee compliance costs are highest for small employers. Inland Revenue's 2013 survey of small and medium enterprise (SME) compliance costs identified median PAYE including KiwiSaver, compliance costs for micro employers (1-5 staff) of \$827 per annum and \$1,350 per annum for small employers with between 6 – 19 staff.

If these costs are extrapolated across the all employers in these segments PAYE compliance costs for micro and small employers amount to over \$171 million per annum. Data limitations and sample size suggest however that the figures should be regarded as indicative and ranged  $\pm 30\%$  (\$120 million to \$223 million).

Administrative costs for PAYE are comparatively low at an estimated \$0.25 per \$100 of PAYE. There is however potential for reduction in administrative costs as a significant number of Inland Revenue staff are currently engaged in error correction and other remedial work.

The status quo also imposes costs on employees. PAYE information about income and deductions is currently aggregated across a month and is not received until the month following. This means that Inland Revenue is unable to ensure that deductions are correctly set up from the start of employment and limits its ability to subsequently intervene if things start to go wrong. As a result employees can end up paying additional student loan deductions or incur child support, or Working for Families' tax credit, debt.

The aggregated and delayed nature of current PAYE information also limits opportunities to improve the future operation of social policy, for example by reducing the period over which social policies such as Working for Families are assessed. A shorter period of assessment could allow assistance to better meet periods of need. In March 2015 the Government released *Making Tax Simpler: A Government green paper on tax administration* which set out these ideas. A consultation document on social policy which will set out how these changes might work is scheduled for release in 2017.

In addition, the delayed remittance of PAYE and related deductions denies individuals the timely application of their student loan repayments and KiwiSaver contributions and delays the onward passage of child support payments.

### Options

The proposals to address these issues are:

1. Require PAYE information to be provided at the time of the business process
2. Facilitating the provision of PAYE information through software
3. Remitting PAYE at time of the business process
4. PAYE – encouraging the take-up of digital services and targeting support
5. Use of thresholds to vary obligations
6. GST – Introducing a framework for setting an electronic filing threshold for GST returns

## 1. PAYE information at the time of the business process

Businesses are increasingly using software packages to automate and integrate processes. Digital systems provide the opportunity to eliminate calculation and transcription errors and to seamlessly transmit data from the customer to Inland Revenue at the time of the business process. This could improve accuracy and timeliness, reduce compliance and administrative costs and create opportunities for improved social policy.

### *New and departing employee information*

Under the status quo information is not received about new employees until the month following when they are first paid and processing time with Inland Revenue's current system means that it is often more than 6 weeks after a new employee is first paid that Inland Revenue may identify a problem with their deductions and get back to the employer.

These delays may require the employer to make adjustments, which incurs compliance costs, and may impose debt or additional payments, such as higher student loan repayments, on the employee. For example in the year ended 2015 more than 18,700 student loan borrowers incurred additional student loan deductions which could have been avoided if they had been on the correct tax code. These additional deductions generally lifted the repayment rate from 12% of salary to 17%.

If employers provided information about new employees when they were first added to the payroll and before they were first paid, it would allow Inland Revenue to respond in near real-time to assist the employer to set the new employee up correctly from the outset.

However in small businesses the process of adding employees to the payroll does not necessarily occur as a discrete process prior to staff being paid. New staff details are added as part of completing the first pay. New staff in large organisations can also be added to the payroll immediately prior to payment and while there might in theory be time for an employer to send information to Inland Revenue and action a near-real time response from Inland Revenue, in reality the payroll staff will often have other priorities.

### *Pay period information*

Integrating the provision of PAYE information relating to income and deductions with the process of paying staff would improve timeliness and by eliminating transcription and reducing calculation errors, should improve the quality of the information.

Integrating PAYE obligations to report income and deductions with the payday process would provide Inland Revenue with pay period information on<sup>17</sup>, or close to, payday. At present employers must calculate PAYE income and deductions for each payday but are then required to aggregate it for each employee into monthly totals. Disaggregated (pay period) information provided sooner would enable Inland Revenue to intervene more quickly to improve the accuracy of PAYE withholding, for example by suggesting a special tax code to someone at risk of being overtaxed because their secondary tax code has taken them into a higher tax bracket.

It would also enable Inland Revenue to better monitor the income assessments made by employees for social policy entitlements such as Working for Families and to intervene with

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<sup>17</sup> Some employers pay staff daily; in all options for change, a minimum period of a week is proposed.

more confidence when it appears that customers are at risk of being underpaid or of incurring year-end debt. In the year to June 2014 52,000 families were either over or under paid by more than \$500 and while some of this will reflect changes in family arrangements rather than changes in income, the redevelopment of systems to support Working for Families customers requires accurate, timely PAYE information.

Pay period PAYE information provided sooner would provide the opportunity for Inland Revenue to reduce the square up period for Working for Families from a year to a shorter period which could enable assistance to better match periods of need.

Pay-period information provided sooner would also improve the effectiveness of information sharing with Ministry of Social Development and the Accident Compensation Corporation to identify fraud and overpayment. Finally if pay period information on income and deductions was available to other Government agencies in near real-time it could lay a foundation for further service improvements.

### *Consultation*

Feedback from employers on providing PAYE income and deduction information on payday was mixed. Large employers and representative bodies generally support the further integration of PAYE requirements with payroll software, agreeing that after the one off cost of change there should be compliance costs savings. Similarly a number of smaller employers currently using payroll software were supportive of the proposed changes. Most respondents found it hard to estimate the magnitude of the savings although they were usually assessed as relatively modest. Submitters who supported further integration of PAYE with payroll software wanted a simple method for correcting payroll errors.

Other submitters considered that an updated means of filing through Inland Revenue's website would make electronic and/or payday filing more attractive to small employers.

However many submitters who responded on the on-line forum opposed the change either because they did not use payroll software or because they were concerned that the changes would increase compliance costs because of the requirement for more frequent filing.

### *Options*

Several options to integrate PAYE information with business processes were considered.

A voluntary-first approach would amend the legislation to allow employers to choose to file on payday if it suited them. If a significant number of employers demand the service software providers could be expected to update their payroll systems to offer it and payday filing might subsequently be required from all employers. Feedback from large employers identified however that unless changes are required by legislation their often overseas based software providers may not update their systems. Limited consultation with software providers servicing small employers in the New Zealand market reinforced these concerns.

Requiring all employers to provide pay period information on payday would maximise the benefits available from earlier PAYE information and would lay the best foundation for subsequent improvements to social policy. This option would not require employers to calculate additional information as the PAYE information is required to calculate the pay. The option would however require the information to be provided more often (each payday). Under this option it is proposed that the due date for those above a threshold would be the

day after payday and for those below the threshold and not using payroll software, it would be set allowing time for the receipt of posted returns.

The option of requiring pay-period PAYE information to be provided on payday<sup>18</sup> by employers above a threshold, with other employers required to provide the same information but able to choose to do so, on a monthly basis, reflects the fact that employers filing PAYE information on paper could incur additional compliance costs from payday filing. This option would allow larger employers and other users of software to benefit from the proposals to integrate the provision of PAYE information with the process of paying staff while not imposing more frequent filing on small employers.

Bringing the date for monthly filing forward from the 20<sup>th</sup> to a date after month end which allows for the receipt of posted returns is designed to minimise delay while recognising that it will take time for employers, who chose to continue to file using paper, or who can't access digital services, to complete their month end processes and mail the information to Inland Revenue.

In all options other than the status quo it is intended that simple payroll errors would be able to be self-corrected in a subsequent period.

Officials' analysis of the options is set out on the next page. None of the options have fiscal impacts.

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<sup>18</sup> Due date the day after payday.

Options	Fairness and equity	Efficiency of compliance and administration	Sustainability of tax and income related social policy system	Basis for improved social and other government services
1. Retain status quo: the legislation requires PAYE information on a monthly basis regardless of the employers pay cycle.	The status quo denies opportunity to employers who want to benefit from integration of tax and business processes.	Overall compliance and administrative costs higher than they would be under other options.	PAYE information underpins much of the income-related social policy system - the status quo is inflexible and limits policy options.	PAYE information would still be aggregated and received from employers in the following month.
2. Voluntary provision of PAYE information at time of business process	Better than status quo  Would enable employers to decide although if payroll software providers do not upgrade the choice is illusory.	Better than status quo  Employers whose software providers have updated their systems could benefit. The administration may have to cater for both approaches over a long period.	No better than the status quo  The system will have to cater for those who chose the status quo as so will remain inflexible.	No better than status quo  Redesign of social policy cannot assume that PAYE information will be available on a pay period and more timely basis.
3. Require pay period PAYE information to be filed on payday and other PAYE information <sup>19</sup> no later than payday from all employers.  For employers below a threshold, not using payroll software, the due date is proposed as a date which allows for the receipt of posted returns. For others the due date is the day after payday. <sup>20</sup>	No better than status quo  The payday filing obligation is imposed on all employers.  Those using manual systems could incur increased costs which will raise fairness concerns.	Better than status quo  Compliance costs for many employers should reduce although costs on small employers not filing electronically could increase due to payday filing requirement.  Administration costs will decrease.	Significantly better than status quo  All employers providing pay period information and filing on payday will improve the flexibility of the tax and income related social policy system	Significantly better than status quo  Pay period information on payday from all employers would provide significant improvements over the status quo in the management and future improvement of social policy delivery.
4. Require pay period PAYE information on payday and other PAYE information no later than payday above a threshold and at month end for those below threshold or exempt. <sup>21</sup> The due date for those below the thresholds and not using software would allow for the receipt of posted returns.	Significantly better than status quo  Permits employers to choose options which should reduce compliance costs without imposing pay period filing on small employers.	Better than status quo  Following a one off compliance cost to upgrade software, compliance and administrative costs lower than status quo.	Better than status quo  All employers providing pay period information will improve the flexibility of the system but not as much as option 3.	Better than the status quo  An improvement over the status quo. Does not provide payday information near payday for all employees but is a stepping stone towards that objective.

<sup>19</sup> About new and departing employees.

<sup>20</sup> Employees who are required to provide their own PAYE information because their employer has not deducted PAYE (including IR56 taxpayers) would be required to provide PAYE information after the end of the month in which they receive the payment(s). The due date would allow for postage of a return.

<sup>21</sup> Employees who are required to provide their own PAYE information because their employer has not deducted PAYE (including IR56 taxpayers) would be required to provide PAYE information after the month in which they receive the payment(s). The due date would allow for postage of a return.

## Recommendations

Officials recommend option 4 – require the provision of pay period PAYE information on payday and other PAYE information no later than payday above a threshold, and require the same information from those below the threshold and from those unable to access digital services, but allow them to choose whether to provide it on payday or at month end, allowing time for posting a return. This option balances the interests of small employers, with regard to compliance costs, against the wider system benefits available from universal payday filing

The status quo must change if employers who are using payroll software or an updated IR website are to benefit from being able to provide information as part of their business process. The current requirement is that regardless of when an employer pays employees the PAYE information must be provided on a monthly basis.

The option of leaving it to employers to choose whether to provide PAYE information on payday or on the current basis would not ensure that payroll software providers update their packages and services to support payday filing, which would undermine the benefits.

Option 3, requiring PAYE information from all employers at the time of the business process is also a substantial improvement on the status quo. It would maximise the benefits available from earlier PAYE information but may impose additional compliance costs on employers who do not use payroll software.

For a discussion of threshold levels under option 4, number of employers affected and mechanisms to change the threshold see the discussion of thresholds in section A-5 (page 40).

## 2. Facilitating provision of PAYE information through payroll software

Provision of PAYE information through payroll software would maximise compliance and administrative cost savings and by facilitating payday reporting would maximise the opportunities for improved service provision<sup>22</sup> to employees.

### *Consultation*

The option of requiring employers to use payroll software was however discounted before consultation. This judgment was informed by the sheer number of very small employers and by the significant opposition to the prospect of being required to use software from those who responded to consultation on *Making Tax Simpler: Better digital services a Government discussion document* which identified the major role proposed for digital technology in making tax simpler. Many of those who responded on the online forum, to the *Making Tax Simpler - Better administration of PAYE and GST* similarly indicated that they considered that they were ‘just too small’ to justify the cost<sup>23</sup> of payroll software.

<sup>22</sup> Both in terms of accurate PAYE withholding and management of social policy obligations and entitlements such as student loan deductions, child support, Working for Families Tax credits.

<sup>23</sup> In financial terms and in the psychological cost of change.

*PAYE income and deduction information*

At present if payroll software is used to populate electronic versions of the PAYE information return (the employer monthly schedule) the software must meet a prescribed format. The material that can be prescribed covers content and format but not due dates<sup>24</sup>.

If all employers, or employers above a threshold, are required to provide PAYE information about income and deductions on payday, payroll providers will need to update their software to remain compliant. The approaches to payday filing set out above do however leave grey areas around software being used by employers which are under the electronic filing threshold for whom the due date would allow time to post a return.

In the absence of a specific requirement that payroll software must be used to file income and deduction information on payday, payroll providers may experience pressure from employers under the relevant threshold, to take advantage of the later due date available to small employers. For the reasons set out in the previous section, provision of PAYE information at the time of the business process should provide compliance cost savings to users of payroll software and there will be administrative cost and social policy benefits if all payroll software is used to submit PAYE information about income and deductions on payday.

*Provision of employee information at the time they are added to or removed from the payroll*

As set out in the previous analysis feedback to consultation identified that it would not always be practicable to require employers to provide information about new employees before they were first paid and about departing employees when they are removed from the payroll. For this reason officials have recommended that the obligation is to provide such information no later than the next return of PAYE income and deduction details. Despite it not being practicable to legislate for, there was considerable support from employers for the option of sending new employee details to Inland Revenue before they are first paid and getting confirmation or otherwise, back in near-real time.

There was also support for the proposal that the employer could use their payroll software to notify Inland Revenue of a departing employee mid pay period enabling Inland Revenue to automatically de-link the employee from the employer. Due to the current delays in the provision and processing of PAYE information de-linking can take months which can result in employers being contacted repeatedly about employees who have ceased employment.

The options considered below include leaving it to the market to decide whether:

- employers can use their payroll software to advise Inland Revenue of new and departing employees at the time they are added to or removed from the payroll;
- employers can source payroll software which allows small employers to take advantage of a later due date for filing PAYE information.

The alternative option would require all payroll software to:

- offer the capability of advising Inland Revenue when employees are added or removed from the payroll;
- only offer payday filing of PAYE income and deduction information (no later filing date option regardless of the size of the employer).

Neither of the options has fiscal implications.

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<sup>24</sup> The due dates for PAYE returns are set out in the legislation Sections RD 22 (2); RD 22(2B) and RD22 (3) of the Income Tax Act 2007.

Options	Fairness and equity	Efficiency of compliance and administration	Sustainability of tax and income related social policy system	Basis for improved social and other government services
<p>1. Status Quo – leave it to the market to decide whether:</p> <ul style="list-style-type: none"> <li>- Payroll software can be used to file with a later due date (by small employers)</li> <li>- Software offers the opportunity for employers to advise Inland Revenue of new and departing employers at the time they are added to or removed from the payroll.</li> </ul>	<p>Employers below the relevant threshold using payroll software may be able to take advantage of a due date which allows time to post a return.</p> <p>Employers could choose whether to use software which can advise Inland Revenue of new and departing employees at the time of the business process.</p> <p>The constraint would be whether an employer can source the feature they want in the software they use.</p>	<p>Compliance and administrative costs may be higher/slower to reduce than under option 2.</p>		<p>Outcome dependent on the choices that software providers and employers make.</p> <p>To the extent that fewer employers report PAYE information at the time of the business process (on payday and when employees are added to and removed from the payroll) the quality of services provided to individuals may be reduced.</p>
<p>2. Require payroll software to:</p> <ul style="list-style-type: none"> <li>- Only offer payday filing of PAYE income and deduction information.</li> <li>- Offer services which employers can choose to use to report new and departing employee information at the time employees are added to or removed from the payroll.</li> </ul>	<p>Better than the status quo</p> <p>Employers can have confidence that software offering digital services which integrate with business processes will be available. However employers below the threshold using software who wish to file PAYE information with a later due date are denied the option. All employers using payroll software would be provided with the option of providing details of new and departing employees at the time of the business process.</p>	<p>Significantly better than the status quo</p> <p>Compliance and administrative costs lower than under the status quo because more employees will be set up correctly from the start or near start of employment.</p>	<p>Better than the status quo</p> <p>Option 2 will obtain pay period information on payday for more employees which improves the flexibility of the system compared to the status quo.</p>	<p>Significantly better than the status quo</p> <p>If all employers who use payroll software are filing income and deduction information on payday it will improve the services that can be offered to their employees. Similarly, if all employers using software can choose to inform Inland Revenue of employee details at the time of the business process then the services offered to their employees should improve.</p>

## Recommendations

Officials recommend option 2 – Require payroll software to:

- Only offer payday filing of PAYE income and deduction information.
- Offer services which employers can choose to use to report new and departing employee information at the time employees are added to or removed from the payroll

While the status quo, leaving it to the market, would theoretically maximise the choices available to employers it may require employers to change their processes on more than one occasion and would reduce the likelihood that all new employers choosing payroll software would chose a service or product which should minimise their compliance costs.

In addition the status quo is likely to be more costly to administer, due to slower identification of errors and as a result, would mean less accurate withholding and less effective administration of social policy.

### 3. Remit PAYE and related deductions on payday

Employers deduct PAYE (and related deductions, such as child support, student loan and KiwiSaver) from their employees' salary or wages each payday. The employer holds the withheld amount in trust for the Crown until it is passed on to Inland Revenue, once or twice a month, to meet the employee's tax (and some other) liabilities. Large employers and software intermediaries pass on withheld amounts twice monthly on the 20<sup>th</sup> of the month and the 5<sup>th</sup> of the following month. Employers who have below \$500,000 of PAYE and ESCT a year remit PAYE once a month on the 20<sup>th</sup> of the month following the PAYE source payment to the employee.

The delayed remittance results in a separate PAYE payment and reconciliation process for employers which adds to their PAYE compliance costs. However, employers get the benefit of any interest on the withheld amounts until they pass them on to Inland Revenue.<sup>25</sup> Some other amounts that are part of the employer monthly schedule system (for example KiwiSaver employer contributions) are passed on in the delayed remittance process. In addition, the delayed remittance results in employers that are in financial difficulties and default on their PAYE remittance obligations only being able to be identified and provided with support on a delayed timeframe.

Integrating PAYE remittance as well as PAYE information with the employer's business process of paying their employees would realise a number of benefits. It could reduce compliance costs in particular for employers using payroll software and reduce administrative costs. It would also reflect the fact that the deducted amounts do not belong to the employer, but are passed on to Inland Revenue to meet the employees' tax (and some other) liabilities. It could also reduce employer defaults.

However, these benefits have to be weighed against the disadvantages of aligning PAYE remittance with the business process of paying employees. In particular employers using

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<sup>25</sup> For many small employers the retention of these deductions is used as working capital.

manual or paper systems may have increased compliance costs because of an increased frequency in PAYE payments to Inland Revenue. Employers would lose the advantage of reducing interest on borrowings they use to fund their business they would otherwise incur or earning interest on the PAYE deductions they hold for a while before passing them on. In particular small businesses' cash flow may be adversely impacted. Assessments of the magnitude of this impact range from a one off \$2.85 million additional interest cost on employers<sup>26</sup> to \$175 million<sup>27</sup>.

Payroll intermediaries have been identified as a particular case where there could be adverse impact from a requirement for payday remittance. Legislation currently provides that employees using payroll intermediaries must pass on PAYE and related deductions to the intermediary on payday. This enables the intermediaries to earn interest on those deductions until payment to Inland Revenue is due. Officials have been advised that interest earned in this way is a significant part of payroll intermediaries' revenue stream (one payroll intermediary advised it is about 40%) and in its absence the over 23,000 employers who use them may experience higher fees.

### *Consultation*

The majority of those who responded to consultation were opposed to requiring employers to align the remittance of PAYE with the business process of paying employees and the process of providing PAYE information provision. The main concern was that they saw it negatively affecting businesses' cash flow and the ability to offset some of the cost of employers' PAYE obligations would be lost. Additionally, there were concerns that more frequent payment could increase compliance costs and there would be reduced time for error correction. A few submitters supported aligning the process of paying employees with employers' PAYE obligations (PAYE remittance and provision of PAYE information) because they expect this to reduce compliance costs and to have the potential to help reduce PAYE payment default.

### *Options*

Officials have considered three options in relation to PAYE remittance:

- Option 1: Retain the status quo with delayed remittance of PAYE once or twice monthly.
- Option 2: Require **all employers** to remit PAYE and related deductions to Inland Revenue at the time they pay their employees.
- Option 3: **Require employers above a threshold** and payroll intermediaries to remit PAYE and related deductions at the time they pay their employees and employers below the threshold retain the delayed remittance of PAYE.

Officials' analysis of the options is set out in the table on the next page.

It is noted that employers who are not required to remit PAYE when they pay their employees under any of the below options will still be able to do so on a voluntary basis

<sup>26</sup> Assuming a once only cost and a \$100,000pa of PAYE and ESCT threshold.

<sup>27</sup> This estimate was made in response to consultation and is assumed to not involve a threshold and to assume employers borrow to fund every PAYE payment.

should they wish to take advantage of integrating all PAYE obligations with their business processes.

Some employers pay their employees daily. Officials considered whether PAYE deducted on daily payments should be required to be remitted on a payday basis. However, on balance this was discounted. It is considered that a minimum frequency of a week should apply to PAYE remittance. This means that employers who pay their employees daily and may be required to remit PAYE on a payday basis can aggregate the withheld PAYE on daily payments to employees to remit them to Inland Revenue on a weekly basis.

Under options 2 and 3, employees who are responsible for providing their own PAYE information and remitting their own PAYE and related deductions because they receive gross payments from their employer(s) (including IR56 taxpayers) would have to remit their PAYE and related deductions on a monthly basis by the same due date as for the provision of PAYE information.

Options	Fairness and equity	Efficiency of compliance and administration	Sustainability of tax and income related social policy system	Fiscal
1. Retain the status quo allowing delayed remittance of PAYE once or twice monthly.		Depending on the option chosen for the provision of PAYE information, this option may result in additional PAYE remittance due dates separate from the due date for PAYE information for some or all employers, which may increase compliance costs and risk.	The possibility of timely assistance for employers in risk of defaulting on PAYE (and related deductions) is limited.	No impact.
2. Require all employers to remit PAYE and related deductions to Inland Revenue at the time they pay their employees.	<p>Worse than status quo</p> <p>Could impose additional compliance costs specifically on small employers who already incur higher PAYE costs per employee.</p> <p>In particular some small businesses and small not-for profit organisations may experience cash flow difficulties.</p>	<p>Better than status quo</p> <p>Realises compliance cost reduction if aligned with business and PAYE information provision processes for employers using business software.</p> <p>Increases compliance costs for businesses using manual or paper processes (likely very small businesses).</p>	<p>Significantly better than status quo</p> <p>Employers that have difficulties with meeting PAYE remittance obligations are identified faster and support can be provided faster.</p>	<p>No revenue impact. No fiscal impact.</p> <p>Cash-flow benefit for the Crown of \$1,040 million in the first year and \$55 in the following.</p>
3. Require employers above a threshold and payroll intermediaries to remit PAYE and related deductions at the time they pay their employees and employers below the threshold to remit PAYE when they provide PAYE information in the following month.	<p>No better than status quo</p> <p>Takes into consideration cash flow impacts on small employers. The cash flow impact on those above the threshold will depend on the threshold (see threshold section)</p> <p>Small employers which may be adversely affected by the impact on payroll intermediaries are entitled to the payroll subsidy.</p>	<p>Significantly better than status quo</p> <p>Realises compliance cost reduction if aligned with business and PAYE information provision processes for employers using business software, but allows small businesses who are more likely to use manual or paper processes to remit PAYE once a month.</p>	<p>Significantly better than status quo</p> <p>Employers that have difficulties with meeting PAYE remittance obligations are identified faster and support can be provided faster.</p>	<p>No revenue impact. No fiscal impact</p> <p>Cash impact for the Crown depends on the level of the threshold (see section on thresholds)</p>

## Recommendations

Officials recommend option 3 – Require all employers with yearly PAYE and ESCT at or above a threshold to remit PAYE on payday and employers below the threshold to remit PAYE in the following month when they provide PAYE information. This will reduce compliance costs for employers and administrative costs for Inland Revenue while considering cash flow implications for small businesses and other small organisations.

Officials acknowledge however that retaining the status quo while allowing those employers who wish to, to remit PAYE on a payday basis, could avoid some of the negative impacts associated with option 3.

For a discussion of threshold levels and number of employers affected see the section on thresholds in A-5 on page 40.

## 4. PAYE – encouraging the take-up of digital services and targeting support

Government has identified a major role for digital technology in making tax simpler. The development and delivery of high quality digital services which are user friendly and intuitive will play a key role in encouraging the uptake of digital services and in the realisation of the associated benefits.

### *Consultation*

A significant number of those who responded to consultation suggested that to encourage digital uptake Inland Revenue should make payroll software freely available. Others suggested that some form of subsidy should be provided to offset the cost of switching or updating software and still others commented favourably on the existing payroll subsidy with some suggesting that the value should be increased.

### *Inland Revenue provided tools*

In a world of rapidly changing technology the option of Inland Revenue developing its own basic payroll software and making it freely available has been discounted. Even basic payroll software is complex and does much more than calculate tax and related obligations. To become a provider of payroll software would be a distraction from Inland Revenue's core focus on tax and social policy. In addition employers who begin by using a basic package often subsequently seek additional services; these employers would be better served by starting with an upgradable product or service.

Instead Inland Revenue will update and modernise the tax and social policy focused calculators on its website and will modernise the electronic services that allow for the filing of PAYE information through its website. These changes do not require legislative change and are not further analysed below.

## *Subsidy*

The option of offering a subsidy or tax credit to encourage small employers to adopt payroll software has been discounted. As noted earlier the possibility of requiring all employers to adopt payroll software has also been discounted. In a market where a significant number of free trials are already available a subsidy may reduce the incentives on software providers to use price or free offerings as a way of stimulating demand.

### *Payroll subsidy*

A 'payroll subsidy' has existed since 2006. The subsidy pays \$2 per employee for each pay-run for a maximum of 5 employees. The payroll subsidy was introduced to encourage small businesses to outsource their PAYE compliance obligations to approved third parties (listed payroll intermediaries). The subsidy is only available to employers who use listed payroll intermediaries. The payroll subsidy has the objectives of making tax compliance easier for small business to give them more time to run their business and to improve the overall operation of the PAYE system. To reduce administrative costs the subsidy is paid to the payroll intermediary rather than to the employer. There are currently 20 listed payroll intermediaries some of whom make free payroll services available to small employers and not for profit organisations.

While not primarily designed to encourage an employer to adopt digital services the subsidy has the effect of increasing electronic filing because although employers using payroll intermediaries may be below the electronic filing threshold payroll intermediaries are required to file PAYE information electronically. Almost 90% of the approximately 23,200 employers who currently use the payroll subsidy are under the existing electronic filing threshold of \$100,000 of PAYE and employers superannuation contribution tax (ESCT).

The case for the payroll subsidy is strongest for small employers who bear higher PAYE compliance costs per employee and where there is less likely to be a division of duties or any specialist knowledge of payroll. In 2009 the payroll subsidy threshold was however lifted from \$100,000 a year of PAYE and ESCT to \$500,000 a year of PAYE and ESCT. The threshold for eligibility for the payroll subsidy was lifted because it was linked to the threshold for twice monthly remittance of PAYE and related deductions and this threshold was lifted to reduce cash flow pressure on business in the context of the global financial crisis. At the \$500,000 a year threshold almost 98% of employers are eligible for the payroll subsidy. Given its objectives the threshold for the payroll subsidy is currently too high and is unfair to the taxpayers who fund it.

Payroll is about much more than meeting tax compliance obligations and the market for payroll products and services has many available offerings at a variety of price points. In this context there is concern that the subsidy may be offsetting core costs of doing business and that it might distort employers' decisions about whether to use a listed payroll intermediary or purchase payroll software products or services.

Officials have considered the following options

- Options 1: retain the status quo and make no change to eligibility for the payroll subsidy.
- Option 2: reduce the threshold for eligibility to the payroll subsidy.
- Option 3: repeal the payroll subsidy.

Officials' analysis of the options is set out on the next page. For a discussion of possible thresholds see section A-5 (page 40).

Options	Fairness and equity	Efficiency of compliance and administration	Sustainability of tax and income related social policy system	Basis for improved social and other government services	Fiscal impact
<p>1. Status quo – no change to payroll subsidy</p>	<p>The subsidy was originally designed to help small businesses, which incurs higher PAYE compliance costs per employee than large business. The current threshold makes almost 98% of employers eligible so does not target assistance to small business</p> <p>Considered in the context of incentivising electronic filing the payroll subsidy is not equitable because it only subsidises one form of electronic filing – use of a listed payroll intermediary.</p>	<p>At the current threshold the subsidy is available to offset compliance costs for the majority of employers.</p> <p>To the extent that it is easier for Inland Revenue to deal with listed payroll intermediaries (professional managers of payroll) than it would be to deal with the employers individually the current threshold reduces Inland Revenue’s administration costs.</p>	<p>The subsidy only supports one type of payroll product or services and could therefore lead to tax driven choices between digital payroll products and services.</p>	<p>The payroll subsidy indirectly incentivises business to file digitally and using a payroll intermediary means no option of a later due date. Digital pay period filing provides the best basis for improved administration of PAYE and social policy because it provides information in the nearest to real-time.</p>	
<p>2. Reduced threshold for eligibility to payroll subsidy</p>	<p>Significantly better than the status quo</p> <p>A reduced threshold would reinstate the original intent and target assistance to small employers who bear relatively higher costs.</p> <p>This change would also reinstate a measure of fairness for the taxpayers who are providing the subsidy.</p>	<p>No better than the status quo</p> <p>While a lower threshold would exclude larger employers they could reasonably be expected to have staff that have knowledge of payroll.</p> <p>To the extent that those excluded from the subsidy have payroll knowledge Inland Revenue’s administrative costs are unlikely to be affected.</p>	<p>Better than the status quo</p> <p>While it would apply to fewer employers than under the status quo the subsidy still only supports one type of payroll product or service and could therefore lead to tax driven choices between payroll products and services.</p>	<p>No better than the status quo</p> <p>Employers above the proposed thresholds who would lose the subsidy would not have the option of returning to paper filing so there should not be material impact on the date of filing.</p>	<p>Positive</p> <p>Reduced threshold reduces expenditure estimated at between \$3.1m and \$6.3m over four years from 2016/17, depending on the threshold.</p>
<p>3. Repeal payroll subsidy</p>	<p>Better than the status quo</p> <p>The payroll subsidy is currently available to a very wide range of employers which is unfair to taxpayers who fund it.</p> <p>The subsidy only benefits employers who choose to outsource their payroll obligations to a listed payroll intermediary.</p>	<p>Worse than the status quo</p> <p>The repeal of the subsidy could increase compliance costs for employers on whose behalf it is currently paid.</p> <p>If small employers lacking knowledge begin to manage their own payroll administration costs may increase.</p>	<p>Significantly better than the status quo</p> <p>The tax system will no longer incentivise one type of payroll service over another.</p>	<p>Worse than the status quo.</p> <p>In the absence of the subsidy some current users of listed payroll intermediaries may cease to use them. This may reduce the amount of PAYE information received on, or the day after payday.</p>	<p>Positive</p> <p>Reduction in expenditure of \$8.1 million over 4 years from 2106/17.</p>

## Recommendations

While the option of repealing the payroll subsidy would remove a potentially distortionary intervention from the payroll market officials recommend option 2 – reduce the threshold for the payroll subsidy. This recommendation reinstates the original policy intent to target assistance to small business (employers) and reduces the likelihood that the subsidy could distort decisions between using listed payroll intermediary or purchasing payroll software or a payroll service.

### 5. PAYE Thresholds

Because of the absence of economies of scale PAYE obligations impose higher costs on small employers.

Thresholds are a mechanism through which obligations can be differentiated to mitigate the higher relative compliance costs and to target support. However thresholds are not costless. In the case of PAYE thresholds will generally result in higher administration costs<sup>28</sup> and may limit, or at least slow down, the services that could otherwise be delivered to individual employees.

Thresholds have been considered for the following PAYE obligations. Where relevant the existing threshold is noted on the right.

Obligation	Existing threshold
<ul style="list-style-type: none"> <li>file PAYE information electronically</li> </ul>	Employers with \$100,000pa of PAYE and ESCT or more and payroll intermediaries.
<ul style="list-style-type: none"> <li>file PAYE information on payday</li> </ul>	Payday filing would be a new obligation.
<ul style="list-style-type: none"> <li>remit PAYE and related deductions on pay day</li> </ul>	Employers that withhold less than \$500,000pa of PAYE and ESCT <sup>29</sup> currently submit information and remit PAYE on the 20 <sup>th</sup> of the following month. Employers that withhold \$500,000pa or more of PAYE and ESCT <sup>30</sup> submit information by the 5 <sup>th</sup> of the following month and remit PAYE twice monthly on the 20 <sup>th</sup> and the 5 <sup>th</sup> of the following month.
<ul style="list-style-type: none"> <li>eligibility for the payroll subsidy</li> </ul>	Employers that withhold less than \$500,000pa of PAYE and ESCT are eligible for the payroll subsidy.

Prior to 2009 a single threshold (\$100,000pa of PAYE and ESCT) existed for the following obligations and entitlements:

<sup>28</sup> Than would exist if the obligation fell on all employers.

<sup>29</sup> And payroll intermediaries.

<sup>30</sup> And payroll intermediaries.

- electronic filing of PAYE information;
- the due date for PAYE information;
- the obligation to remit PAYE and related deductions twice monthly;
- those below the threshold were entitled to the payroll subsidy

A return to a single threshold for PAYE obligations would reduce complexity for employers and simplify administration. In addition many of the recommended obligations are interconnected and a consistent approach would maximise the available compliance cost and administrative benefits. For example if information reporting and payment of PAYE and related deductions both occurred on payday and were derived from the same data, without the need for it to be aggregated over a month, or split between twice monthly payments, the task of reconciliation should be simplified and the current common problem of a mismatch between the PAYE payment and the PAYE information should reduce.

### *Consultation*

Feedback was sought on the proposal that the existing electronic filing threshold should be reduced to \$50,000 a year of PAYE and ESCT. Feedback from the online consultation was generally opposed to a reduction in the threshold while written submissions expressed mixed views.

### *Options*

A number of options have been considered. An option that was discounted was basing the threshold on staff numbers. Although this might appear easier for employers to understand it would be hard to operationalise. Many businesses employ part-time or casual staff and, if an employee number threshold was based on numbers at a point in time, it could add complexity as obligations would come and go as employee numbers fluctuated around the threshold. If instead the obligation was based on average numbers of employees over a year, or on full time equivalents, it would be no easier for an employer with variable staffing to estimate than a threshold based on dollar value of PAYE and ESCT. Inland Revenue currently notifies employers when they have crossed the existing threshold.

All of the options, other than the status quo, provide that the threshold could in future be reduced by Order-in-Council following consultation with affected parties. This would allow the threshold to be changed to reflect changed business practice, for example further increases in the use of digital channels. The threshold could also be reviewed if changes elsewhere in the public service increased the benefits that would derive from receiving pay period information digitally on payday.

Officials have considered the following options.

**Option 1** – the status quo which has no threshold for payday filing but provides:

- A threshold of \$100,000 a year of PAYE and ESCT for electronic filing
- A threshold of \$500,000 a year of PAYE and ESCT for provision of PAYE information by the 5<sup>th</sup> of the following month, all other employers have until the 20<sup>th</sup> of the following month.
- A threshold of \$500,000 a year of PAYE and ESCT for twice monthly remittance of PAYE and related deductions, other employers have until the 20<sup>th</sup> of the following month.
- Employers with less than \$500,000 a year of PAYE and ESCT are eligible for the payroll subsidy.

These thresholds are established in legislation and can only be changed by amending legislation.

**Option 2** – a threshold of \$100,000 a year of PAYE and ESCT to determine:

- The obligation to file PAYE information electronically
- The obligation to file PAYE information on payday
- The obligation to remit PAYE and related deductions on payday
- Eligibility for the payroll subsidy

The level of the thresholds to be subject to future change by Order-in-Council following consultation with affected parties.

**Option 3** – a threshold of \$50,000 a year of PAYE and ESCT to determine:

- The obligation to file PAYE information electronically
- The obligation to file PAYE information on payday
- The obligation to remit PAYE and related deductions on payday
- Eligibility for the payroll subsidy

The level of the thresholds to be subject to future change by Order-in-Council following consultation with affected parties.

**Option 4** – status quo for remittance and a lowered threshold for electronic filing with all employers having to submit PAYE information on payday and:

- A threshold of \$500,000 a year of PAYE and ESCT for twice monthly remittance of PAYE and related deductions, other employers have until the 20<sup>th</sup> of the following month
- A threshold of \$50,000 a year of PAYE and ESCT to determine the obligation to file PAYE information electronically
- The \$50,000 a year threshold will also set a later due date for PAYE information on payday, which allows time after payday for a return to be posted by below the threshold not using payroll software

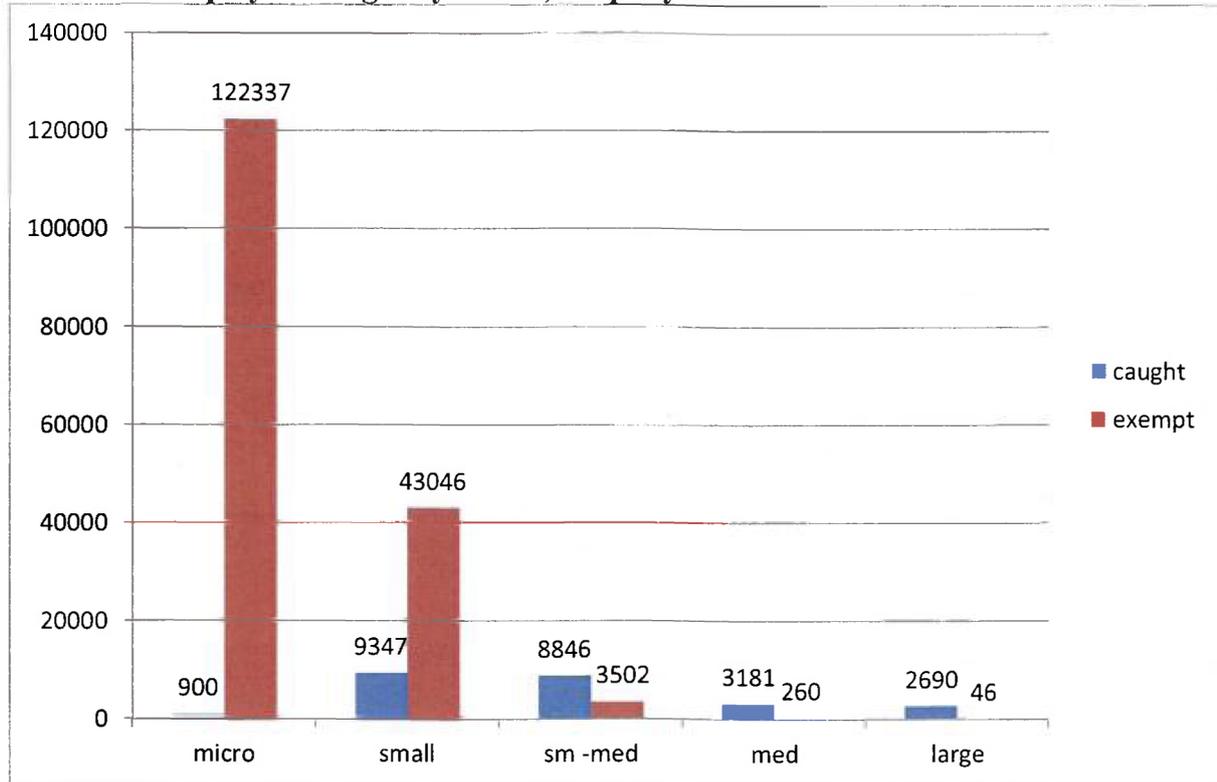
The level of the thresholds to be subject to future change by Order-in-Council following consultation with affected parties.

### *Options compared*

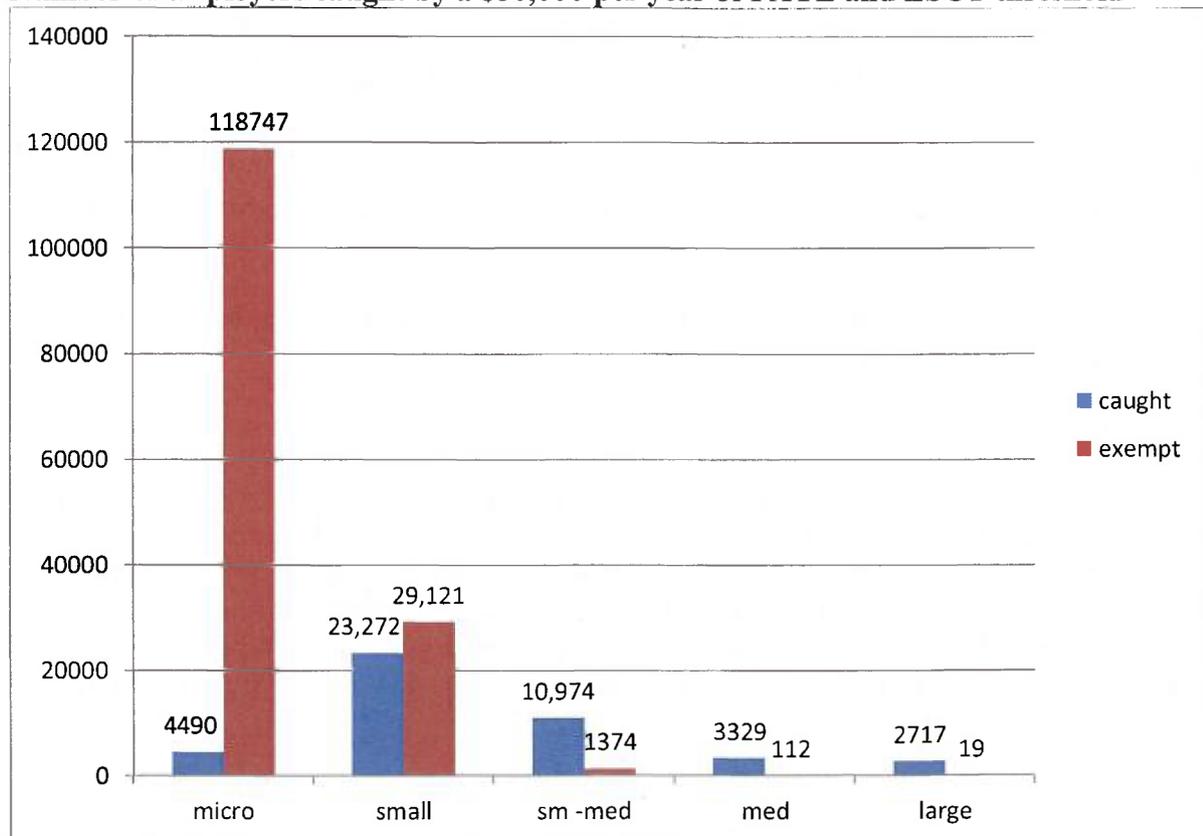
The graphs on the next page present the \$50,000pa and \$100,000pa of ESCT and PAYE thresholds visually showing how the dollar based thresholds map to employer size. The employer size categorisation has been used by Ministry of Business, Innovation and Employment<sup>31</sup> and is defined as follows: micro (1-5 employees); small (6-19); small-medium (20-49); medium (50 -99) and large (100+). The graphs are based on the maximum employee numbers included in 2015 employer monthly schedules. Wage increases would be expected to increase the numbers over each threshold by the proposed effective date of 2019.

<sup>31</sup> *The Small Business Sector Report 2014*, Ministry of Business, Innovation and Employment.

**Number of employers caught by a \$100,000 per year of PAYE and ESCT threshold**



**Number of employers caught by a \$50,000 per year of PAYE and ESCT threshold**



The numbers of employers and in some cases employees, affected by each option is presented in the following table. The options set out above, are then considered against the criteria.

<b>Numbers impacted by different thresholds for PAYE related obligations</b>				
	<b>Option 1.</b> Status Quo: \$500,000pa of PAYE and ESCT for twice monthly remittance, employers below the threshold entitled to payroll subsidy. \$100,000pa for electronic filing; No obligation for payday filing of information.	<b>Option 2.</b> PAYE threshold at \$100,000pa of PAYE and ESCT for: <ul style="list-style-type: none"> <li>• Payday filing of information</li> <li>• Payday remittance</li> <li>• Electronic filing</li> <li>• Those below eligible for payroll subsidy.</li> </ul>	<b>Option 3.</b> PAYE threshold at \$50,000pa of PAYE and ESCT. <ul style="list-style-type: none"> <li>• Payday filing of information</li> <li>• Payday remittance</li> <li>• Electronic filing</li> <li>• Those below eligible for payroll subsidy.</li> </ul>	<b>Option 4.</b> Status quo \$500,000pa of PAYE and ESCT for twice monthly remittance All employers provide PAYE information on payday \$50,000pa of PAYE and ESCT for electronic filing. No payroll subsidy.
<b>Provision of PAYE information</b>	5,400 employers provide PAYE information by 5 <sup>th</sup> of following month. 188,800 employers have until the 20 <sup>th</sup> of following month.	25,000 employers (12.9%) would be required to provide PAYE info on payday by the threshold; plus 46,200 below the threshold who use payroll software = 71,200 employers (36.6%) employing 86% of employees.	44,800 employers (23.1%) would be required by the threshold to provide PAYE on payday, plus 36,400 below the threshold using payroll software = 81,200 employers employing almost 90% of employees.	194,200 employers (100%) would be required to file PAYE information on payday, representing 100% of employees.
<b>Remittance of PAYE</b>	5,400 employers required to remit twice monthly.	25,000 employers required to remit on payday.	44,800 employers required to remit on payday.	5,400 employers required to remit twice monthly.
<b>Electronic filing of PAYE information</b>	25,000 employers required to file electronically (a total of 130,000 currently file electronically many of them below the threshold).	25,000 employers required to file electronically.	44,800 required to file electronically. All but approximately 6,000 already file electronically.	44,800 required to file electronically, this would require 6,000 more employers to adopt electronic filing.
<b>Eligibility for payroll subsidy</b>	188,800 employers eligible for payroll subsidy.	169,200 employers eligible for the payroll subsidy. 2,400 employers currently receiving the subsidy would lose	149,400 employers eligible for payroll subsidy. 4,900 employers receiving the subsidy would lose it.	No employers eligible for payroll subsidy. 23,200 employers lose entitlement to the subsidy.

Options	Fairness and equity	Efficiency of compliance and administration	Sustainability of the tax and income-related social policy system	Basis for improved social and other government services	Fiscal
<p>1. Status quo</p>	<p>Only the largest employers are required to remit PAYE more often than monthly and all but the largest are eligible for the payroll subsidy.</p> <p>All employers provide PAYE information in the following month.</p>	<p>Multiple thresholds can impose higher compliance costs as obligations change progressively.</p> <p>Multiple thresholds impose higher administrative costs than a single threshold would.</p>	<p>The need for legislative amendment to change the threshold reduces the flexibility of the tax and social policy system.</p>	<p>Delayed provision of PAYE information does not provide a basis for improved social and other services.</p>	
<p>2. One PAYE threshold \$100,000pa of PAYE and ESCT</p>	<p>Better than the status quo</p> <p>This option supports payday filing and remittance which should reduce costs for those using software. The threshold exempts the majority of micro and small employers from payday filing and remittance requirements but allows them the choice of whether to use the new systems.</p>	<p>Significantly better than the status quo</p> <p>All but 2.7% of employers over this threshold are already using payroll software and should experience a decrease in overall compliance costs compared with the status quo. Administration costs should reduce.</p>	<p>Significantly better than the status quo</p> <p>Threshold would see pay period information reported on payday for majority of employees. Order-in-Council to change the threshold allows for more flexibility.</p>	<p>Better than the status quo</p> <p>PAYE information received on payday is the best basis for improved services. This option is better than the status quo and although it does not <i>require</i> as many employers to file PAYE information on payday as options 3 or 4 does it would result in payday filing for 87% of employees.</p>	<p>Greater targeting of the payroll subsidy would save \$3.1 million over four years from 2016/17.</p>

Options	Fairness and equity	Efficiency of compliance and administration	Sustainability of the tax and income-related social policy system	Basis for improved social and other government services	Fiscal
<p>3. One PAYE threshold \$50,000pa of PAYE and ESCT</p>	<p>No better than the status quo</p> <p>This threshold would require 44% of small employers (5 -19 staff) to remit PAYE on payday. This requirement may impact negatively on fairness</p>	<p>Better than the status quo</p> <p>While significant compliance cost savings should be available to the employers from using payroll software the one off costs and cash flow impacts may adversely impact on small employers. Inland Revenue should benefit from administrative savings.</p>	<p>Significantly better than the status quo</p> <p>As above</p>	<p>Significantly better than the status quo</p> <p>This option would require PAYE information on payday from employers employing almost 90% of employees.</p>	<p>Greater targeting of the payroll subsidy saves \$6.3 million over 4 years.</p>
<p>4. \$500,000pa of PAYE and ESCT for frequency of remittance</p> <p>\$50,000pa of PAYE and ESCT threshold for electronic filing, all employers required to file PAYE information on payday.</p> <p>Payroll subsidy repealed.</p>	<p>No better than the status quo.</p> <p>Does not require payday remittance.</p> <p>The lower threshold for electronic filing would impact on approximately 6,000 employers; many others below this threshold are already filing electronically.</p> <p>The requirement for payday submission of information may negatively impact on fairness for small employers using manual systems</p>	<p>Better than the status quo</p> <p>Compliance costs savings should be available to all employers who can access digital services. While this potential exists there will be costs to upgrade and some employers will continue to use manual systems and will incur increased compliance costs as a result.</p> <p>Administrative costs should reduce compared to the status quo but they may be higher than under option 2 because of the receipt of more paper schedules.</p>	<p>Significantly better than the status quo</p> <p>As above</p>	<p>Significantly better than the status quo</p> <p>This option would require PAYE information to be submitted on payday for 100% of staff.</p>	<p>Saving of \$8.1 million over four years from 2016/17.</p>

## Recommendations

Officials recommend option 2 – The PAYE threshold is set at \$100,000 and applies to:

- The obligation to file PAYE information electronically
- The obligation to file PAYE information on payday
- The obligation to remit PAYE and related deductions on payday; and
- Eligibility for the payroll subsidy

The level of the threshold to be subject to future change by Order-in-Council following consultation with affected parties.

This recommendation balances the Government's interest in earlier PAYE information against small employers' concerns about cash flow and one-off compliance costs.

Other options balance these objectives differently. Option four does not change the status quo on remittance which recognises the concern expressed by employers on this matter, but places greater emphasis on earlier receipt of PAYE information by requiring payday submission of PAYE information by all employers.

## 6. GST –Introducing a framework for setting an electronic filing threshold for GST returns

GST registered persons and businesses are required to file GST returns based on their self-assessment with Inland Revenue. The filing frequency is according to the taxable period, which can be one, two or six months depending on the amount of taxable supplies made in any 12-month period or in some cases on the period elected.<sup>32</sup>

At present GST returns can be filed electronically and on paper. There is no electronic filing threshold for the filing of GST returns. Nevertheless electronic filing uptake for GST returns has been increasing steadily over the last years and is expected to continue to increase. 65% of all GST returns were filed electronically in 2015, with the highest uptake of 82% for large businesses (annual turnover above \$24,000,000).

Digital technology plays a major role in making tax simpler. Effective, timely and accurate GST administration can best be achieved through electronic transfer of information. Electronic filing is faster, cheaper in terms of compliance costs for taxpayers and administrative costs for Inland Revenue and less prone to errors, in particular if filed directly from business software.

As part of Business Transformation the tax system will be transitioned from the current system to the new START platform in different stages. GST is the first tax type to be moved to START in

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<sup>32</sup> Under the new GST rules for non-resident suppliers of remote services, suppliers of these services that are subject to GST will have quarterly taxable periods from 1 April 2017.

stage 1 (expected transition date for GST into the new START system is in the first half of 2017). It is expected that electronic services offerings under START will change and improve. This will likely influence uptake for electronic GST return filing in the near future. For example, feedback on a pilot Inland Revenue undertook trialling the filing of GST returns directly from customers' accounting software indicates that this new service is meeting taxpayers' needs. Officials consider it appropriate to monitor uptake of electronic filing for GST returns under the services in START and develop a threshold meaningful for GST return filing under the new platform. In developing the below options officials have therefore discounted the setting of an electronic filing threshold at this stage.

## **Options**

Officials have considered the following options:

- Option 1: Retain the status quo.
- Option 2: Introduce a framework that allows for an electronic filing threshold to be set for the filing of GST returns by Order in Council. A limited exemption is available for taxpayers for which electronic filing would cause undue compliance costs.
- Option 3: Introduce a non-electronic filing penalty of \$250 as part of the framework under option 2.

Officials' analysis of the options is set out in the table on the next page.

Options	Fairness and equity	Efficiency of compliance and administration	Sustainability of tax system	Fiscal
1. Status quo with no threshold above which taxpayers are required to file GST returns electronically.	All GST registered persons and businesses can choose whether to file GST returns electronically or on paper.	Compliance and administrative costs depend on the level of uptake of voluntary electronic GST return filing within the new START system.		
2. Introduce a framework that allows for an electronic filing threshold to be set for the filing of GST returns by order-in-council.	No better than status quo.  Fairness and equity will be considered when the level of the threshold is set.	Significantly better than the status quo.  Compliance and administrative costs are lower than under the status quo.	Better than the status quo.  Electronic GST returns are processed faster.	No impact.
3. Introduce a non-electronic filing penalty of \$250 as part of the framework under option 2.	Better than the status quo  The level of penalty is consistent with existing thresholds for larger businesses such as the late filing penalty for GST returns and the existing minimum non-electronic filing penalty in relation to PAYE.	Significantly better than the status quo.  Encourages taxpayers to file electronically when required and recovers the additional costs of administering paper returns.	Better than the status quo.  Encourages taxpayers to file electronically when required which enables faster processing of GST returns.	No impact at this stage – may have impact when a threshold is set and implemented in the future.

## Recommendations

Officials recommend option 2 and 3 – introduce a framework that allows for an electronic filing threshold to be set for the filing of GST returns in the future and for a non-electronic filing penalty set at \$250 as part of this framework. This option acknowledges the benefits that can be realised through electronic filing and the relatively high uptake of electronic filing for GST returns under current Inland Revenue services. It provides a mechanism however that allows for the introduction of a threshold by Order-in-Council should uptake of electronic services need to be further encouraged.

## APPENDIX B - GETTING IT RIGHT FROM THE START

### 1. Provision of date of birth information and contact details from all new employees

#### *Status quo and problem definition*

All new employees complete an IR330 declaration with their name, IRD number, tax code and declaration of eligibility to work in New Zealand. All new employees who are KiwiSaver members or eligible for KiwiSaver enrolment must also complete a KS2 which similarly requires details of name and IRD number and in addition, their KiwiSaver status and contact details (physical address, phone number(s) and email). Many of these employees will already have provided some of this information to their employer as part of the employee induction process.

Employers complain that PAYE compliance involves too many pieces of paper and large employers report that they can spend considerable time assisting employees when Inland Revenue has been unable to confirm an individual's identity.

Inland Revenue lacks current contact details for a significant number of individual tax payers and receives PAYE deductions for thousands of individuals where there is an incorrect IRD number. Despite attempts to resolve these situations if the individual does not respond to a request made via their employer, to contact IRD, the confusion can persist.

Sorting out instances where identity has been confused imposes considerable compliance costs on employers and on Inland Revenue. If in future, as was suggested in *Making Tax Simpler a Government green paper on tax administration*, all individuals have to interact at some level with Inland Revenue the importance of certainty about identity will increase.

One option to improve the operation of the tax and social policy system is to require that when individuals start new employment date of birth information is provided to Inland Revenue and that contact details are provided for all employees<sup>33</sup>. Date of birth information would help Inland Revenue confirm identity where an error had been made with the IRD number, where names were the same or where a different form of a name was being used. Updated contact details would assist Inland Revenue to stay in touch with individual customers.

Many employers already collect date of birth information for their own purposes. It is for example required if an employer is to auto enrol a young employee in KiwiSaver and is also required if the employer intends to cease making employer contributions to KiwiSaver when the employee turns 65. Date of birth information can be a sensitive topic; it is however widely used in health care, by utility companies and financial institutions to help verify

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<sup>33</sup> At present contact details are provided by those who are KiwiSaver members or are eligible for KiwiSaver membership. This is the overwhelming majority of employees.

identity. Although provision of date of birth information via the employer was not universally supported in consultation it received majority support. There was also considerable support for enabling employers to provide details of new and departing employees from their payroll systems.

An option which was discounted because of the compliance costs involved was requiring employers to verify date of birth and contact details for example by sighting a drivers licence or passport (for date of birth) and utility bills (for address).

Another option that has been discounted is relying on the individuals to contact Inland Revenue directly with date of birth information. Where Inland Revenue detects a mismatch between an employee name and IRD number the individual is requested, via the employer, to contact Inland Revenue but often this does not happen.

The options that have been considered to modernise the PAYE system include allowing employers to provide contact details and date of birth information to Inland Revenue which they have collected for their own purposes and not requiring that tax specific information such as an IRD number, tax code, KiwiSaver status and declaration of entitlement to work in NZ is provided on a particular form. It is however intended that the employer must be able to demonstrate that the information was sourced from the employee.

It is intended that for those who prefer to use paper, Inland Revenue forms will still exist, if possible combining the IR33 (tax code declaration form) and KS2 (KiwiSaver deduction form).

Officials' analysis of the following options is set out below:

#### Option 1

- Status quo – employers not required to collect/provide date of birth information for new employees nor are they required to provide contact details for all new employees.

#### Option 2

- In addition to existing information employers required to collect/provide date of birth information and contact details to Inland Revenue for all new employees.
- Employers are able to pass on contact detail and date of birth information which they collect for their own purposes but must be able to demonstrate that they have collected their employee's IRD number, tax code and declaration of entitlement to work in New Zealand from the employee.

Neither option has fiscal implications.

Options	Fairness and equity	Efficiency of compliance and administration	Sustainability of the tax and income-related social policy system	Basis for improved social and other government policy
<p><b>1. Retain the status quo:</b> No date of birth information, contact details only from those in or eligible for KiwiSaver and no ability for employer to pass on information already gathered from an employee.</p>		<p>Employers are required to act as the middleman between Inland Revenue and an employee when identity cannot be confirmed and this imposes considerable compliance costs.</p> <p>The current rules require employers to collect multiple forms from new employers for IRD and in some cases employers have to transcribe them and pass the information on to Inland Revenue.</p> <p>Incorrect IRD numbers and out of date contact details impose considerable administrative costs.</p>	<p>The quality of contact and identity information currently held in the tax system for employees is not sufficient to support modernisation.</p>	<p>To the extent that identity or contact information is incorrect Inland Revenue and other agencies will be unable to contact taxpayers to offer improved services.</p>
<p><b>2. Require date of birth and contact detail information</b> for all new employees and enable employers to pass on information already gathered.</p>	<p>Better than the status quo</p>	<p>Better than the status quo</p> <p>Option 2 requires the employer to source and/or pass on additional information however for employers using payroll software the compliance costs should be outweighed by being able to send the information already gathered for their own purposes from the payroll system and/or from reduced rework.</p> <p>Administrative costs will be reduced by better identity and contact information.</p>	<p>Significantly better than the status quo</p> <p>Obtaining date of birth information for new employees and contact details for all new employees will contribute to the sustainability of the tax system.</p>	<p>Significantly better than the status quo.</p> <p>Delivery of improved services is dependent on sound identity and contact information for individual taxpayers and this option should deliver improvements.</p>

## Recommendations

Officials recommend option 2 – that date of birth information and contact information is provided for all new employees, with employers having the ability to pass on to Inland Revenue information they have already collected for their own purposes.

Option 2 best supports improved delivery of social policy and is consistent with modern approaches to identity verification. With the recommended simplification of forms the proposals should not impose significant additional compliance costs even on employers using paper based systems. Employers using payroll software should experience a reduction in compliance costs.

## APPENDIX C - Making the PAYE rules work better

### 1. Tax treatment of holiday pay

#### *Status quo and problem definition*

The tax treatment of holiday pay differs depending on whether it is paid as a lump sum (in which case it is treated as an extra pay), or whether it is included in an employee's regular pay or paid in substitution for an employee's ordinary salary or wages when annual paid holidays are taken (in which case it is treated as salary or wages).

When holiday pay is paid in advance as a lump sum (for example, where an employee takes four weeks' annual leave and receives a lump sum payment of holiday pay covering the four weeks in advance), it is currently taxed as an extra pay. This tends to result in PAYE being over-withheld, as it tends to essentially over-tax the leave payment by using the employee's marginal rate, and under-tax the payments made in each of the subsequent periods that have only part of the earnings. Anecdotally, it is common for employees in some industries to work longer hours in the lead up to Christmas, which can exacerbate the over-withholding caused by using the extra pay formula. This, combined with receiving no income during the following weeks when the holiday is taken, may make things difficult for the employee financially.

While employees are able to obtain a refund for any over-withheld tax following the end of the tax year, the fact that it can adversely affect employees' adequacy of income around the period the holiday is taken gives rise to fairness concerns.

#### *Options*

We have considered the following options:

- Option 1: Retain the status quo.
- Option 2: Require employers to deduct PAYE from holiday pay paid in advance as if the lump sum payment was paid over the pay periods to which the leave relates.
- Option 3: Retain the ability for employers to tax holiday pay paid in advance as an extra pay, but allow employers the option of deducting PAYE as if the lump sum payment was paid over the pay periods to which the leave relates.

Under options 2 and 3, similar treatment would also be extended to salary or wages paid in advance.<sup>34</sup> This would ensure consistent tax treatment for conceptually analogous situations.

Our analysis of the options is set out on the next page.

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<sup>34</sup> Under current law, salary or wages paid in advance are an extra pay under the PAYE rules.

Options	Fairness and equity	Efficiency of compliance and administration	Sustainability of tax system	Fiscal
1. Retain the status quo	<p>Extra pay tax treatment tends to result in PAYE being over-withheld when holiday pay is paid in advance, which can adversely affect employees' adequacy of income around the period the holiday is taken, giving rise to fairness concerns.</p> <p>The existing law should ensure that employees in similar situations receive consistent treatment, but this is undermined by the reportedly common practice of employers applying an alternative tax treatment.</p>	<p>Treating holiday pay paid in advance as an extra pay is simpler for employers doing their payroll manually, thus minimising their compliance costs.</p>	<p>It is reportedly common practice to apply the alternative approach of deducting PAYE as if the lump sum payment was paid over the pay periods to which the leave relates for end of (calendar) year holiday pay paid as a lump sum. This indicates a lack of buy-in to the appropriateness of extra pay tax treatment, which suggests that the status quo is not sustainable.</p>	No impact
2. Require employers to deduct PAYE from holiday pay paid in advance as if the lump sum payment was paid over the pay periods to which the leave relates	<p>Significantly better than the status quo</p> <p>This option would give rise to greater withholding accuracy than extra pay tax treatment, with the same amount of PAYE being withheld as if the employee had received their leave payment and their normal salary or wages payment in their normal pay cycle.</p>	<p>Worse than the status quo</p> <p>More complicated for employers to apply than treating the payment as an extra pay, due to the need, when future payments are made in the pay periods to which the leave relates, to calculate PAYE based on all earnings for the pay period less PAYE already collected for the pay period. This will occur for pay periods that are not taken entirely on leave, but partially taken on leave and partially worked in. In our view, this makes the alternative method too complex to be suitable for employers who do their payroll manually to be required to use.</p>	<p>No better than the status quo</p> <p>Due to the high compliance costs this option would impose on employers who do their payroll manually, non-compliance from these employers would likely be a significant issue. This would undermine the integrity of the tax system and would not be sustainable.</p>	No impact
3. Retain the ability for employers to tax holiday pay paid in advance as an extra pay, but allow employers the option of deducting PAYE as if the lump sum payment was paid over the pay periods to which the leave relates	<p>Better than the status quo</p> <p>This option would give rise to greater withholding accuracy than extra pay tax treatment for employees of employers who chose to use the new method, with the same amount of PAYE being withheld as if the employee had received their leave payment and their normal salary or wages payment in their normal pay cycle.</p> <p>However, optionality would mean there would be inequities between employees in similar situations as a consequence of their employers using different methods.</p>	<p>Worse than the status quo</p> <p>Employers still have the option to use the simpler extra pay tax method. However, optionality could introduce additional complexity and confusion for employers.</p>	<p>Better than the status quo</p> <p>This option would be sustainable as it would not force the use of the new (more complicated) method on employers who consider that the compliance costs are too high, while allowing those employers who are already using the alternative method (or who wish to do so) because they consider that extra pay tax treatment is unfair on their employees to lawfully do so.</p>	No impact

### Consultation

Feedback from payroll software providers on the tax treatment of holiday pay in the *Making Tax Simpler – Better administration of PAYE and GST* consultation was that extra pay tax treatment in the case of holiday pay paid in advance (for example, where an employee takes four weeks' annual leave and receives a lump sum payment of holiday pay covering the four weeks in advance) results in over-withholding. Their argument is that this tax treatment essentially over-taxes the leave payment by using the employee's marginal rate, and under-taxes the payments made in each of the subsequent periods that have only part of the earnings. They argue that more accurate withholding outcomes are achieved if PAYE is deducted as if the lump sum payment was paid over the pay periods to which the leave relates.

A few other submitters suggested it was common practice to apply this alternative approach for end of (calendar) year holiday pay paid as a lump sum. According to one submission, it is common for employees in some industries to work longer hours in the lead up to Christmas, which can exacerbate the over-withholding if the extra pay formula is used.

The majority of submitters commenting on the PAYE rules, more generally, were of the view that if, in a post-Business Transformation world, everyone will be required to under-take an annual income tax square-up, withholding accuracy should become less important and simplicity of the PAYE rules more important.<sup>35</sup>

### Recommendation

We recommend retaining the ability for employers to tax holiday pay paid in advance as an extra pay, but allowing employers the option of deducting PAYE as if the lump sum payment was paid over the pay periods to which the leave relates (option 3).

While the status quo minimises employers' compliance costs, it is unfair due to the tendency of extra pay tax treatment of holiday pay paid in advance to result in over-withholding. It could be argued that, if any over-withholding is to be squared-up at the end of the tax year, simplicity for employers should trump withholding accuracy. However, we consider that over-withholding on holiday pay paid in advance is something that nevertheless warrants addressing, given that there are particular concerns about employees being financially disadvantaged over the Christmas holiday period.

The alternative method (option 2) has policy merit in that it does produce more accurate withholding outcomes, so would improve fairness. However, in our view, the additional compliance costs it would impose on employers who do their payroll manually make the alternative method unsuitable for them.

While there may be concerns that the optionality afforded by option 3 could introduce additional complexity and confusion, as well as equity concerns around some employees being disadvantaged relative to other employees as a consequence of their employers using different methods, we do not consider that these concerns are large enough for us to support the retention of the status quo. We consider that the status quo is not sustainable going

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<sup>35</sup> *Making Tax Simpler – a Government green paper on tax administration* set out the Government's idea of potentially requiring all individuals to undertake an annual square-up of income tax.

forward due to a lack of buy-in to the appropriateness of extra pay tax treatment for holiday pay paid in advance.

## 2. Application of legislated rate changes

### *Status quo and problem definition*

Different types of PAYE income payments and PAYE-related social policy products<sup>36</sup> have different rules on what is to be done when there is a legislated rate (or threshold) change during a pay period or if there is rate (or threshold) change between the date the payment is made and the pay period to which the payment relates. The rates (or thresholds) that apply are sometimes based on the pay date, sometimes pay period end-date or pay period start-date, while sometimes apportionment applies. This creates complexity and confusion for employers when there is a rate (or threshold) change, which adds to compliance costs.

### *Options*

We have considered the following options:

- Option 1: Retain the status quo.
- Option 2: Align the rules about how legislated rate or threshold changes are applied across the different types of PAYE income payments and PAYE-related social policy products, such that the rates and thresholds to be applied are those in force on the date the payment is made.
- Option 3: Align the rules about how legislated rate or threshold changes are applied across the different types of PAYE income payments and PAYE-related social policy products, such that the rates and thresholds to be applied are those in force on the pay period end-date (for those payments that relate to a specific pay period).
- Option 4: Align the rules about how legislated rate or threshold changes are applied across the different types of PAYE income payments and PAYE-related social policy products, such that the rates and thresholds to be applied are those in force on the pay period start-date (for those payments that relate to a specific pay period).
- Option 5: Align the rules about how legislated rate or threshold changes are applied across the different types of PAYE income payments and PAYE-related social policy products, such that the rates and thresholds to be applied are based on apportioning the payment between the old and new rates and thresholds. This would only apply to those payments that relate to a specific pay period and are made during the pay period. Payments not related to a specific pay period would have the rates and thresholds that are in force on the date the payment is made applied. Payments made

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<sup>36</sup> PAYE-related social policy products include the ACC earners' levy, student loan deductions, the minimum employee KiwiSaver contribution and the compulsory employer KiwiSaver contribution.

after a date on which a rate or threshold change comes into force that relate to a pay period that ended before the change would have the previous rate or threshold applied.

Our analysis of the options is set out on the next page.

Options	Fairness and equity	Efficiency of compliance and administration	Sustainability of tax system	Fiscal
1. Retain the status quo	The accuracy of PAYE withholding depends on the circumstances.	Having different rules for different types of PAYE income payments and PAYE-related social policy products creates complexity and confusion for employers when a legislated rate or threshold change is made.	Having different rules for different types of PAYE income payments and PAYE-related social policy products means there is a lack of coherence and makes it likely that employers will get things wrong, which is not conducive to sustainability.	No impact
2. Alignment based on pay date	Better than the status quo  PAYE withholding accuracy would be increased in most circumstances but reduced in some circumstances due to the removal of apportionment.	Significantly better than the status quo  This option would simplify the transitional process the most for employers when a legislated rate or threshold change occurs, thus it would result in the largest reduction in compliance costs.	Significantly better than the status quo  This option would improve coherence and make it more likely that employers will get things right, both of which are conducive to sustainability.	No impact
3. Alignment based on pay period end-date	Worse than the status quo  PAYE withholding accuracy would be reduced in some circumstances due to the removal of apportionment.	Better than the status quo  This option would simplify the transitional process for employers relative to the status quo, but the different rules for payments that do not relate to a specific pay period would likely mean some confusion would remain amongst employers.	Better than the status quo  This option would bring about some improvement in coherence but the continued misalignment with employer reporting of income and the tax year in which it is assessable in for the employee, both of which are based on pay date, would not be conducive to sustainability.	No impact
4. Alignment based on pay period start-date	Worse than the status quo  PAYE withholding accuracy would be reduced in most circumstances.	Better than the status quo  This option would simplify the transitional process for employers relative to the status quo, but the different rules for payments that do not relate to a specific pay period would likely mean some confusion would remain amongst employers.	Better than the status quo  This option would bring about some improvement in coherence but the continued misalignment with employer reporting of income and the tax year in which it is assessable in for the employee, both of which are based on pay date, would not be conducive to sustainability.	No impact
5. Alignment based on apportionment	Better than the status quo  Apportionment would produce the most accurate PAYE withholding outcomes in some circumstances but it would produce less accurate withholding outcomes than a pay date-based approach in others.	Worse than the status quo  Apportionment is the most complicated option and would increase compliance costs for employers doing their payroll manually.	Better than the status quo  This option would improve coherence but its relative complexity would likely mean that employers will get things wrong.	No impact

### *Consultation*

Responses to the *Making Tax Simpler – Better administration of PAYE and GST* consultation strongly supported alignment. The majority of submitters favoured a pay date-based approach.

### **Recommendation**

We recommend that the rules in the Inland Revenue Acts about how legislated rate or threshold changes are applied be aligned across the different types of PAYE income payments and PAYE-related social policy products, such that the rates and thresholds to be applied are those in force on the date the payment is made (option 2). Aligning the rules would simplify the transitional process for employers when a legislated rate (or threshold) change occurs, thus reducing compliance costs.

We consider that an approach based on pay date is the preferable option for alignment, for the following reasons:

- not all payments relate to a specific pay period;
- the pay date determines in which reporting period PAYE-related information is submitted to Inland Revenue; and
- it will improve PAYE withholding accuracy for pay periods spanning two tax years, and pay periods ending in one tax year for which payment is not received until the next tax year, when there is a change in tax rates or thresholds, because employment income is treated as derived by an employee when it is received.

While there is a trade-off in that option 2 will reduce PAYE withholding accuracy in some circumstances (for example, when there is a legislated tax rate change mid-tax year part way through a pay period longer than a month), it will improve it in other more common circumstances.

# Regulatory Impact Statement

## Requiring non-resident IRD number applicants to have a New Zealand bank account

### Agency Disclosure Statement

This Regulatory Impact Statement (RIS) has been prepared by Inland Revenue. It provides an analysis of options on whether to continue with the requirement for offshore persons to open a New Zealand bank account before they are issued with an IRD number.

Officials have been provided evidence from a range of stakeholders that the bank account requirement is making it difficult in a number of cases for people to comply with their New Zealand tax obligations. We have anecdotal evidence of the impact of this restriction but are unable to determine the full extent of its impact on the New Zealand tax system and wider economy.

Targeted consultation was undertaken with Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, New Zealand Bankers' Association and the New Zealand Law Society, who represent the majority of those affected by the requirement. All respondents have welcomed the review. There was no support for the status quo and all submitters supported reform. Evidence of further examples where the bank account requirement is causing difficulties has been provided.



Peter Frawley  
Policy Manager, Policy and Strategy  
Inland Revenue

30 November 2016

## **STATUS QUO AND PROBLEM DEFINITION**

### **Introduction of the bank account requirement**

1. A law change effective from 1 October 2015 requires all offshore persons to provide evidence of a current New Zealand bank account before an IRD number can be issued to them. This requirement was brought in as part of a suite of initiatives announced in Budget 2015 related to property transactions and to assist Inland Revenue in enforcing compliance with these rules.
2. The Budget 2015 property changes included:
  - Requiring all parties to a property transaction to provide an IRD number to Land Information New Zealand as part of the transaction process (unless subject to an exemption)
  - Requiring all offshore persons to provide evidence of a functioning New Zealand bank account before obtaining an IRD number
  - The two year bright-line test for sales of residential property
  - Residential land withholding tax
3. The bank account requirement has proved to be difficult to comply with for a number of offshore persons. As these offshore persons find it difficult or impossible to comply with the requirement, they are unable to get an IRD number, and in many cases to account for their New Zealand tax liability.
4. The bank account requirement can also affect sales of New Zealand property owned by offshore persons. Land Information New Zealand requires an IRD number to be provided for all property transfers, unless the transfer is subject to an exemption. This is one of the Budget 2015 property changes noted above.
5. A number of offshore persons may require an IRD number to be processed urgently or without delays, in order to meet their New Zealand tax obligations on time.

### **An “offshore person”**

6. For the purposes of the bank account requirement an “offshore person” includes both individuals and non-individuals.
7. An individual is an offshore person if they are:
  - not a New Zealand citizen and do not hold a residence class visa granted under the Immigration Act 2009; or
  - a New Zealand citizen who is outside New Zealand and has not been in New Zealand within the last 3 years; or
  - a holder of a residence class visa granted under the Immigration Act 2009, who is outside New Zealand and has not been in New Zealand within the last 12 months.
8. A non-individual, such as a company or a trust, is an offshore person if they are 25% or more controlled or owned by an offshore person.

## **Identity verification**

9. At the time the bank account requirement was introduced, the Government considered that requiring offshore persons to have a New Zealand bank account would provide Inland Revenue with confidence that it knew who it was dealing with by requiring the identity verification rules in the Anti-Money Laundering and Countering Financing of Terrorism Act 2009 (“AML Act”) to apply to all offshore persons applying for an IRD number, whether for the reason of transactions involving New Zealand property or any other reason.

10. Currently when a non-resident or offshore individual (form IR742) or non-individual (form IR744) applies for an IRD number, they must provide the Commissioner with the following information:

- Their names
- Date of birth for individuals
- Type of organisation for non-individuals
- Photographic identification for individuals
- Proof of their current address, or the most recent previous address
- Contact details
- Proof of any intended activity in New Zealand for individuals
- Overseas taxpayer identification number
- Business description and code for non-individuals
- Copy of a certificate of incorporation for companies
- A copy of certificate of registration, trust deed or agreement, or equivalent overseas constituting document for entities other than companies
- Details of the stock exchange listing for companies listed on a stock exchange
- Names, addresses and IRD numbers of shareholders, directors, partners and trustees (as applicable)
- Proof of a fully functional New Zealand bank account, or proof that customer due diligence has been completed by a New Zealand reporting entity under the rules in the AML Act

11. Individual offshore persons applying for an IRD number, who are in New Zealand at the time of applying, must personally present their identity documents for verification at an Inland Revenue office, New Zealand Automobile Association, or Kiwibank. Offshore persons not in New Zealand at the time of applying for an IRD number can apply by post or electronically. Those applying for an IRD number on behalf of non-individual offshore applicants, do not need to personally present their identity documents for verification and can apply by post or electronically.

12. Inland Revenue from time to time reviews its identity verification procedures, and changes them as may be required. This is done to ensure that the procedures remain robust and fit for purpose to keep pace with any developments. Another review is currently underway, with the particular focus on:

- Individual IRD number applicants who are not in New Zealand at the time of applying for an IRD number, and
- Non-individuals

13. Under the current anti-money laundering (AML) rules, financial institutions are required to perform customer due diligence and report suspicious transactions. The proposed Phase 2 of the AML measures will require a wider range of professionals, including New Zealand lawyers and conveyancers, to conduct customer due diligence on their clients. The Anti-Money Laundering and Countering of the Financial Terrorism Amendment Bill is expected to be implemented by 2020.

14. There are a limited number of exceptions from the bank account requirement. They are:

- When a person requires an IRD number only because they are a non-resident supplier of goods and services under the Goods and Services Tax Act 1985;
- When a reporting entity under the AML Act has conducted customer due diligence procedures for the offshore person.

15. The bank account requirement has also been simplified for non-resident seasonal workers (for example, workers who come from Pacific countries to pick fruit). They can use the NSW<sup>1</sup> tax code for the first month of their employment, even though they may not have an IRD number and/or a New Zealand bank account. After that month, an IRD number must be provided for the NSW tax code to continue to apply, and a bank account is then required.

16. During the last year, Inland Revenue has been approached by a number of organisations and individuals raising concerns with the current bank account requirement. The submitters advised that due to the difficulties associated with the opening of a bank account, offshore persons are unable to get an IRD number and, in turn, comply with their New Zealand tax liabilities.

17. In the March 2016 report on the Taxation (Residential Land Withholding Tax, GST on Online Services, and Student Loans) Bill, which brought in the exceptions to the bank account requirement, the Finance and Expenditure Committee noted that it is aware of some practical difficulties with the bank account requirement. The Committee also noted that officials have undertaken to continue to work on solutions, whether legislative or operational, to address practical difficulties and unintended consequences.

18. A review of this requirement has been included in the recent refresh of the Tax Policy Work Programme. As part of the review, Inland Revenue has consulted with interested parties.

### **Issues with the bank account requirement**

19. Inland Revenue has received a large volume of feedback from affected persons on the issues caused by the bank account requirement for obtaining an IRD number. There have been many cases where offshore persons have faced difficulties obtaining a bank account in

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<sup>1</sup> NSW tax code has a deduction of 10.5%. Ordinarily, if no IRD number is provided, a “no-notification” tax deduction rate of 45% applies.

New Zealand, which stops them from getting an IRD number, and complying with their New Zealand tax obligations.

20. The issues that have been brought to officials' attention can be generally divided into the following categories:

- New Zealand banks are unwilling to issue bank accounts to offshore persons
- There can be delays for offshore persons in obtaining a New Zealand bank account
- The compliance costs of obtaining a New Zealand bank account are high

### ***Banks unwilling to issue bank accounts***

21. Banks are in a number of instances unwilling to open a bank account for people who are predominantly based overseas and who are not going to have on-going business with the bank. Opening an account for such persons is not cost-effective for the bank, as the cost of customer due diligence outweighs the benefits the bank may get from having them as a customer.

### ***Delays in obtaining New Zealand bank accounts***

22. Officials have been provided with a number of examples demonstrating that it can at times take between 4 to 6 months before a New Zealand bank account is issued to an offshore person.

### ***Compliance costs***

23. New Zealand banks and a number of submitters advised Inland Revenue that to open a bank account in New Zealand, personal presence here is required. In a number of cases, this can include having to fly to New Zealand from other parts of the world.

### **Scale of the problem**

24. Between October 2015 and September 2016, Inland Revenue has issued the following quantum of IRD numbers:

- 101,646 IRD numbers for offshore/non-resident<sup>2</sup> individuals
- 1,582 IRD numbers for offshore/non-resident non-individuals
- 102,307 IRD numbers for resident individuals
- 93,781 IRD numbers for resident non-individuals

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<sup>2</sup> Offshore refers to offshore persons under the definitions in paragraphs 7 and 8 of this RIS. Non-resident refers to persons who are not New Zealand tax resident. These definitions are not identical so it is possible to be an offshore person without being a non-resident and vice versa. As offshore persons and non-resident applicants are required to complete the same IRD number application form it is not possible to isolate the applicants who are offshore persons.

25. 4,512 of offshore/non-resident applications by individuals were sent back as they did not provide all of the required information.

26. Where all required information is not provided on the form, Inland Revenue first contacts the applicant by phone, email or post. In most cases when a contact is made, the issue is either resolved over the phone, or the applicant provides a copy of what is required. The overwhelming majority of the 4,512 applications that were sent back are attributed to the absence of a New Zealand bank account. Some of these applications could have been successfully resolved at a later stage.

27. Officials were advised by some large accounting firms that in a number of cases offshore persons decided not to apply for a New Zealand bank account at all, due to perceived difficulties associated with obtaining it. As a result, they had also not applied for an IRD number. The number of offshore persons affected in this way has not been provided to officials. Therefore, the total number of offshore applicants who experienced difficulties with the bank account requirement is likely to be greater than 4,512.

## **OBJECTIVES**

28. The **main objective** of the review is to resolve in an efficient way the issues arising from the current requirement for offshore persons to have a New Zealand bank account before they can be issued with an IRD number.

29. All options are assessed against the status quo in relation to the main objective and the following criteria:

- (a) **Robustness of the identity checks:** The Commissioner should be satisfied with the identity of the offshore person applying for an IRD number.
- (b) **Economic efficiency:** People should not be prevented from complying with their tax obligations or completing commercial transactions by being unable to get an IRD number.
- (c) **Efficiency of compliance and administration:** The options should, to the extent possible, minimise compliance costs for taxpayers and administrative costs for Inland Revenue.

30. There is a trade-off between criteria (a) and (b) as preventing an IRD number being issued to the person until certain information is available can restrict the person's ability to comply with their New Zealand tax obligations. While these criteria must be balanced against each other it is most important that these requirements do not prevent compliance with New Zealand tax obligations or affect property sales. Criterion (c) is linked to criterion (b), as compliance with tax obligations can be undermined if the costs of compliance are perceived as high.

31. A constraint on the potential options is that Inland Revenue is not, and does not intend to become, an AML agent in its own right.

## REGULATORY IMPACT ANALYSIS

32. Officials have identified four options to address the problem:

- Option 1 – The status quo
- Option 2 – Providing the Commissioner of Inland Revenue with a discretion to issue IRD numbers to offshore persons who do not have a New Zealand bank account
- Option 3 – Making further exceptions to the requirement for specific categories of offshore persons
- Option 4 – Removing the requirement for an offshore person to have a New Zealand bank account before they can be issued with an IRD number

### Option 1

33. Option 1 is the status quo. Offshore persons would continue to be required to hold a functioning New Zealand bank account to obtain an IRD number.

#### *Assessment against criteria – Option 1*

34. Option 1 does not meet the main objective.

35. *Robustness of the identity checks.* Option 1 meets this criterion. The Commissioner can continue to rely on the customer due diligence processes undertaken by New Zealand banks before a bank account is issued to an offshore person.

36. *Economic efficiency.* Option 1 does not meet this criterion. In excess of 4,500 offshore persons had difficulties with or were unable to obtain an IRD number in the year to September 2016, which adversely affected their compliance with New Zealand tax obligations and affected sales of New Zealand property.

37. *Efficiency of compliance and administration.* Option 1 does not meet this criterion. A number of offshore persons are incurring high costs and suffering delays in getting a New Zealand bank account. As Inland Revenue is relying on the processes operated by financial institutions the administration costs are low.

### Option 2

38. Option 2 would retain the bank account requirement but introduce a Commissioner's discretion to issue IRD numbers to offshore persons who do not have a New Zealand bank account. The key principle guiding the exercise of discretion would be that the Commissioner is satisfied as to the offshore person's identity.

#### *Assessment against criteria – Option 2*

39. Option 2 meets the main objective. It will allow the Commissioner to effectively deal with instances where issues with the bank account requirement arise.

40. *Robustness of the identity checks.* Option 2 meets this criterion. The Commissioner will only issue IRD numbers where she is satisfied with the identity of an offshore person.

41. *Economic efficiency.* Option 2 is better than the status quo. It will give the Commissioner sufficient flexibility to deal on a timely basis with a range of different cases where she has confidence in the identity of a person. Although a number of offshore persons who are unable to open a New Zealand bank account could get an IRD number if the Commissioner is satisfied with their identity, there would continue to be other offshore persons who are unable to get an IRD number when discretion was not exercised.

42. *Efficiency of compliance and administration.* Option 2 is better than the status quo for compliance costs, but worse than the status quo for administrative costs. Overall, we consider Option 2 the same as the status quo. Offshore persons' costs would reduce as they would be able to apply for the Commissioner's discretion instead. Administratively, Inland Revenue would have to allocate additional resources to consider the exercise of the discretion on a case-by-case basis. These additional administrative costs are not significant.

### Option 3

43. Under Option 3, the bank account requirement would be retained but there would be further exceptions to the requirement for specific categories of offshore persons. Candidates for exceptions would be offshore persons or groups of offshore persons in relation to whom the risk resulting from not complying with the AML requirements is low. This would be an extension to the limited exceptions already in place.

### *Assessment against criteria – Option 3*

44. Option 3 does not meet the main objective, as the exceptions process is not efficient to address issues of offshore persons who urgently need an IRD number.

45. *Robustness of the identity checks.* Option 3 meets this criterion. The Commissioner can continue to rely on the customer due diligence processes undertaken by New Zealand banks before a bank account is issued to an offshore person. Offshore persons subject to an exception may not be subject to the customer due diligence processes of a bank or another financial institution. Instead, the Commissioner will rely on her own identity checks.

46. *Economic efficiency.* Option 3 is an improvement on the status quo, but not as good as Option 2. Offshore persons who qualified for an exception would be able to obtain an IRD number. There would be no change for offshore persons who did not qualify for one of the exemptions.

47. *Efficiency of compliance and administration.* Option 3 is slightly better than the status quo. Although offshore persons who qualified for the exemption would have their compliance costs reduced by no longer being required to open a New Zealand bank account, there would be no change for offshore persons who did not qualify for an exemption. The following implications may result:

- Legislating for every single instance would be highly resource-intensive and result in complex rules as cases where difficulties arise are wide-spread. As legislative changes require time to be implemented, it may not suit offshore persons experiencing difficulties with the bank account requirement who need a more urgent response.
- There would be an increase in administration costs due to Inland Revenue having to confirm whether an offshore person claiming to meet an exemption actually did so.

## Option 4

48. Option 4 is to remove the requirement for an offshore person to have a New Zealand bank account before they can be issued with an IRD number.

### *Assessment against criteria – Option 4*

49. Option 4 meets the main objective. The removal of the bank account requirement would address the difficulties that offshore persons experience with it.

50. *Robustness of the identity checks.* Option 4 does not meet this criterion. It does not ensure that the Commissioner's identity processes remain robust, as the Commissioner will not be able to rely on the customer due diligence checks performed by financial institutions.

51. *Economic efficiency.* Option 4 is a significant improvement on the status quo. Offshore persons who could not open a New Zealand bank account would be able to obtain IRD numbers and comply with their New Zealand tax obligations and complete commercial transactions.

52. *Efficiency of compliance and administration.* Option 4 is a significant improvement over the status quo. As a New Zealand bank account would no longer be required, offshore persons will not have to be present in New Zealand for the purposes of opening a bank account, and will be able to get an IRD number in a timely manner. Compliance costs for offshore persons will be reduced. Compliance costs for banks will also be reduced as they will no longer have to consider opening accounts for offshore customers who have no other need for a New Zealand bank account. Administration costs will be reduced as Inland Revenue will no longer have to consider whether an offshore person has a functional bank account, and will also not have to consider arrangements where offshore persons are unable to comply with tax or commercial obligations due to being unable to get a bank account and an IRD number.

## CONSULTATION

53. In August and September 2016 targeted consultation was undertaken with Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, New Zealand Bankers' Association and the New Zealand Law Society.

54. All submitters have welcomed the review. There was no support for the status quo and all submitters supported reform. Evidence through further examples where the bank account requirement is causing difficulties was provided. Some submitters preferred the removal of the bank account requirement, while others supported the option of Commissioner's discretion and/or further exceptions.

## CONCLUSIONS AND RECOMMENDATIONS

55. The following table summarises the consideration of the options from the regulatory analysis section above. Within the overview table the following symbols are used:

- ✓✓ Significantly better than the status quo
- ✓ Better than the status quo
- × Same as the status quo

×× Worse than the status quo

Options	Analysis against the objective and criteria
Option 1 – Status quo	Does not meet the main objective Meets the robustness of identity checks criterion Meets economic efficiency criterion Meets efficiency of compliance and administration criterion
Option 2 – Commissioner discretion	Meets the main objective Robustness of identity checks × Economic efficiency ✓ Efficiency of compliance and administration ✓
Option 3 – Specific legislative exemptions	Does not meet the main objective Robustness of identity checks × Economic efficiency ✓ Efficiency of compliance and administration ✓
Option 4 – Removing requirement for bank account	Meets the main objective Robustness of identity checks ×× Economic efficiency ✓✓ Efficiency of compliance and administration ✓✓

56. Two options meet the main objective (Options 2 and 4), and two do not (Options 1 and 3). Option 2 is better than Option 4 because the robustness of identity checks is better maintained under Option 2. Officials therefore, on balance, recommend Option 2.

57. Since the introduction of the status quo officials have been made aware that the bank account requirement is making it difficult for people to comply with their New Zealand tax obligations. Option 2 will reduce these costs while also allowing for the robustness of the identity checks to be maintained.

58. Option 3 is not preferred. Although it will improve the situation for some offshore persons who cannot open a New Zealand bank account, the exceptions process is lengthy and is not suited for offshore persons who need an IRD number urgently. It will also not resolve the issue for offshore persons who do not qualify for an exception.

59. Although Option 4 rates higher than other options on the efficiency criteria, it is not preferred at this time as the robustness of identity checks will be reduced. However, as indicated in the *Monitoring, Evaluation and Review* section of this RIS, once the second phase of the AML legislation is implemented officials will seek approval to review the bank account requirement again. Such a review may result in a recommendation to remove the bank account requirement.

## IMPLEMENTATION

60. Changes to provide the Commissioner with discretion to issue IRD numbers where she is satisfied with the identity of the offshore person would require an amendment to the Tax Administration Act 1994. This amendment would be included in the next available omnibus

tax bill, scheduled for introduction in early 2017. This change would apply from the date of enactment of that bill.

61. This change would reduce compliance costs for offshore persons. It may increase administrative costs. These costs are not expected to be significant.

62. The bill commentary and a *Tax Information Bulletin* article after enactment will explain the changes.

## **MONITORING, EVALUATION AND REVIEW**

63. In general, any changes identified as necessary following enactment would be added to the tax policy work programme, and proposals would go through the Generic Tax Policy Process (GTPP). The GTPP is a multi-stage process that has been used to design tax policy (and subsequently social policy administered by Inland Revenue) in New Zealand since 1995. Opportunities for external consultation are built into various stages of the process. In practice, any changes identified as necessary following enactment will be considered for inclusion in the tax policy work programme, and proposals would go through the GTPP.

64. The scheduled Anti-Money Laundering and Countering of Financing of Terrorism Amendment Bill, promoted by the Minister of Justice, will extend customer due diligence obligations to a wider range of professionals. This is also known as the second phase of AML legislation. It is anticipated that there will be a lead-in period before the amendments are fully implemented, with professionals such as lawyers, conveyancers, accountants, real estate agents, and dealers in some high value goods becoming registered entities on a rolled-out basis by 2020.

65. Following the enactment and the implementation of the scheduled Anti-Money Laundering and Countering of Financing of Terrorism Amendment Bill by 2020, officials will seek approval to review the bank account requirement again.



# Regulatory Impact Statement

## Tax treatment of petroleum mining decommissioning

### Agency Disclosure Statement

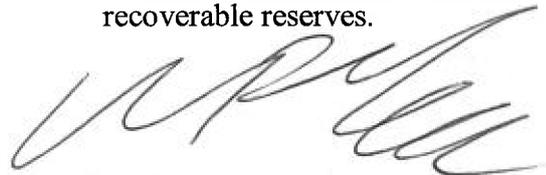
This Regulatory Impact Statement (RIS) has been prepared by Inland Revenue. It provides an analysis of options to address a problem with the tax rules for decommissioning expenditure incurred by petroleum miners.

Petroleum mining decommissioning incurs significant expenditure near or after the end of production at which point there will be little or no assessable income. The tax rules for petroleum mining allow decommissioning expenditure to effectively be offset against income from previous periods, rather than carried forward as a loss against future income (which would be the standard treatment in the absence of these specific rules). A key assumption is that some variant of industry specific rules will continue to ensure that petroleum mining is not disincentivised by its tax treatment.

Officials have worked closely with the petroleum mining industry and other government departments to develop the proposals in this RIS. This consultation is commensurate with the nature of the issue and the parties concerned.

A key constraint on our analysis relates to determination of fiscal cost estimates for each option. Because petroleum decommissioning expenditure is already deductible and eligible to be spread-back the cost of decommissioning is already incorporated into the fiscal cost estimates. Unless otherwise noted, the proposals considered in this RIS are expected to have, at most, a timing effect on the total cost to the Crown of decommissioning. These forecasts, however, are influenced by a number of factors that are unable to be reliably determined at this time. These factors include:

- the regulatory standard for the level of decommissioning required, which is still being determined by the government;
- the timeframe for decommissioning of the various existing rigs which is currently estimated to occur between 2018 and 2046;
- any new exploration discoveries or changes in technology that extend field life;
- estimates of decommissioning costs including how this changes over time because of better information, changes in technology and environmental regulations; and
- changes in estimated oil and gas prices and the effect this has on economically recoverable reserves.



Peter Frawley  
Policy Manager, Policy and Strategy  
Inland Revenue

17 October 2016

## STATUS QUO AND PROBLEM DEFINITION

### Current tax treatment

1. The tax rules for petroleum mining split the life of a field into two distinct phases, namely exploration and development. “Exploration” is generally done under a prospecting or exploration permit<sup>1</sup> and involves looking for oil and gas reserves that can be extracted in commercially feasible quantities, whereas “development” is done under a mining permit and involves the extraction of oil or gas for commercial production.
2. “Exploration expenditure” is deductible when incurred whereas “development expenditure” is spread over either seven years or under the reserve depletion method which spreads the deduction over the remaining life of the field. Changing this tax treatment is not within the scope of the current project.
3. The petroleum mining tax rules apply equally to onshore and offshore installations<sup>2</sup>. However, onshore installations can be decommissioned at a significantly lower cost. Furthermore petroleum miners with onshore installations typically have income from more than one source. Because of these factors onshore petroleum mining has never utilised the spread-back provisions. While onshore petroleum mining would continue to be able to access the same rules (including the proposals in this RIS) as offshore petroleum mining it is not considered further in the analysis in this regulatory impact statement (RIS).
4. A petroleum miner will incur significant decommissioning expenditure before relinquishing their mining permit. Decommissioning is what happens to wells, installations and surrounding infrastructure when a petroleum field reaches the end of its economic life. Offshore decommissioning usually involves:
  - the plugging and abandoning of wells;
  - removal of equipment; and
  - the complete or partial removal of installations and pipelines.

### Policy

5. The policy underlying the current tax rules recognises that this expenditure is an unavoidable consequence of the production process and that industry specific timing rules should allow deductions for this expenditure to effectively be offset against income derived in earlier periods.
6. In the absence of industry specific tax rules a petroleum miner may pay tax in earlier periods then incur decommissioning expenditure which would be carried forward as a loss to

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<sup>1</sup> It can also be done under a mining permit where a petroleum miner is seeking to expand production within a field that has already entered commercial production.

<sup>2</sup> The decommissioning tax rules have always applied to both onshore and offshore decommissioning. The tax treatment of development expenditure was aligned from 2008 to reflect modern drilling and oil and gas extraction techniques making the previous boundary unsustainable as offshore wells could be situated just on the onshore side of the boundary.

future periods. Unless the petroleum miner has income from other sources, such as a separate field, this loss would never be utilised. Officials recognise that this would be inappropriate and would discourage petroleum exploration and development or could encourage a petroleum miner to decommission a field that still contained economically recoverable reserves to ensure that any deductions could be offset against the higher income amounts that are derived in earlier years of a field's life<sup>3</sup>.

7. To address this issue, the petroleum mining tax rules allow a petroleum miner to request that the Commissioner reopen earlier tax years to claim a deduction for decommissioning expenditure incurred "because of the relinquishment of the permit". This process is referred to as a "spread-back". Expenditure is spread-back to the previous year to the extent taxable income was returned and if the expenditure exceeds the amount of profit the remainder is carried back another year and so on.

8. This can be illustrated by the following example:

Tax year	2012	2013	2014	2015
<b>Without spread-back</b>				
Operating profit	60	50	40	30
Decommissioning				100
Total profit	60	50	40	-70
Tax paid (28%)	16.8	14	11.2	0
Loss Carried Forward				-70
<b>After spread-back</b>				
Total profit	60	20	0	0
Tax payable	16.8	5.6	0	0
Less tax paid	-16.8	-14	-11.2	0
Refund	0	8.4	11.2	0

## Problems with current tax treatment

### *Significant problems*

9. The petroleum mining decommissioning tax rules have never been applied as no offshore installations have been decommissioned in New Zealand. The petroleum mining industry has started planning for future decommissioning in recent years and have been working with officials; a number of issues have been identified.

10. The primary concern of the petroleum mining industry is the effect of section RM 2 of the Income Tax Act 2007 (ITA 2007) which prevents the Commissioner from refunding an amount of tax if more than four years have passed from the end of the tax year in which an income tax return was filed. The spread-back does not have an equivalent limit, so the Commissioner could reassess a period from more than four years previous to create a credit balance. However, section RM 2 would then prevent the Commissioner refunding this credit balance to the petroleum miner.

11. There are two possible practical consequences of this restriction:

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<sup>3</sup> Generally output from a field peaks in early years of production and slowly declines. This results in higher profits and tax payments in earlier years than in later years as the field approaches the end of its life.

- i. The petroleum miner is unable to get a refund for the full amount of their decommissioning costs spread-back despite the existing policy that they should be able to.
- ii. The petroleum miner may decommission the field earlier than they otherwise would to ensure they have sufficient profits within the four previous years to fully cover the cost of decommissioning.

12. To the extent the second path is chosen, and the industry has advised this is what would occur, this four year restriction would have no impact on the amount of tax deductions<sup>4</sup> offset against taxable income but would reduce the amount of oil and gas extracted. The Crown Minerals Act 1991 requires the Crown to assess and agree with a petroleum miner as to whether the maximum economic recovery of a field has been reached and cessation of production can occur. If tax deductions for decommissioning costs cannot be effectively utilised this would be factored into the Crown's assessment. Premature decommissioning would result in lost revenue to the Crown in the form of foregone royalties and corporate taxes.

13. A number of other issues and uncertainties also arise with the existing rules. These could be resolved within the existing policy and are explained further below.

#### *Other problems*

14. There are two qualifying criteria for triggering the spread-back of decommissioning expenditure under the current rules, depending on the type of expenditure or loss, these are "in a tax year in which a petroleum miner relinquishes a permit" and "because of the relinquishment of the petroleum permit". While the first is often clear on timing the second is less so and when combined they create uncertainty in a number of situations such as:

- A wide variety of expenditure will be incurred because of the relinquishment of the permit, including planning for decommissioning before drilling has commenced which may be 40 years before the permit is eventually relinquished. It is not clear whether expenditure has to be within a reasonable time period of the permit relinquishment.
- A petroleum miner may undertake activities that look like decommissioning but are not directly linked with the relinquishment of a permit. It is not clear whether this expenditure would ever qualify for the spread-back.
- A petroleum miner may decommission a well several years before relinquishing the permit. It is not clear whether this expenditure would qualify when incurred or whether it would have to wait until the permit was relinquished.
- A petroleum miner may decommission a well and surrender acreage within a permit area without relinquishing the entire permit. It is not clear whether this expenditure would qualify for the spread-back until the entire permit was relinquished.

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<sup>4</sup> For example, a petroleum miner that is subject to the four year limit is generating sufficient income to cover operating costs but with only a small profit. If this situation continued into future periods, each year the additional operating profit would be less than the effectively foregone deduction for decommissioning so it would make economic sense to decommission even if, in the absence of tax, production could continue for several more years. In this example the refund for decommissioning would be identical but tax on profits would be reduced.

15. As well as decommissioning development wells a petroleum miner will incur expenditure on abandoning exploration wells. These exploration wells may have been drilled before, during or after commercial production and may or may not have resulted in a discovery of petroleum reserves that are commercially extractable<sup>5</sup>. It is officials' view that expenditure on abandonment of exploration wells is not eligible to be spread-back but this is not clearly articulated in the legislation and some petroleum miners consider it is currently available.

16. When an exploration well is subsequently used for commercial production the cost that was previously deducted is added back and spread over a number of future years<sup>6</sup> which puts it in the same position as if it was originally drilled as a development well. If the permit is relinquished any undeducted costs are intended to be able to be spread-back. However, an error in the rewrite from the Income Tax Act 2004 to the Income Tax Act 2007 introduced an incorrect cross reference so that only expenditure on an exploration well that is used for commercial production but not expenditure on a development well is eligible for the spread-back.

17. It is officials' view that the spread-back is a mechanism for generating a payment to the taxpayer rather than altering the amount of tax originally payable in that earlier period. Accordingly, when a petroleum miner spreads-back expenditure they should not be entitled to credit use of money interest (UOMI). However, unlike other equivalent sections<sup>7</sup>, there are no specific provisions confirming that UOMI is not payable when a petroleum miner spreads-back expenditure.

#### *Opportunities in amendment*

18. Historically, there were a number of spread-back provisions, for both income and expenditure, in the Income Tax Act. Officials view such spread-backs as an outdated approach that results in high compliance and administration costs. Many spread-back provisions have been removed as part of previous reforms and there are no remaining provisions that spread-back expenditure equivalent to the petroleum decommissioning rules.

19. Officials view the need to amend the petroleum mining rules as an opportunity to modernise the decommissioning rules in a manner that is broadly consistent with existing policy but reduces compliance and administration costs.

#### **Scale of the problem**

20. As noted above, the petroleum mining rules apply to both offshore and onshore installations. However, onshore installations can be decommissioned at a relatively low cost and are typically operated by petroleum miners who have income from other sources. Accordingly, the decommissioning rules, and any problems associated with them, typically only apply in practice to offshore installations.

21. Offshore installations in overseas jurisdictions normally cost between NZ\$100 million and NZ\$1 billion to decommission. The lower end of this range generally incorporates

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<sup>5</sup> The global industry average success rate for exploratory wells is around 1 in 6.

<sup>6</sup> Either 7 years or under the reserve depletion method.

<sup>7</sup> See for example section 120PA of the Tax Administration Act 1994 which states no UOMI is payable when a credit for a supplementary dividend is carried back to create a refund in an earlier period.

FPSO<sup>8</sup> installations, through to smaller unmanned fixed platforms with larger manned fixed platforms at the higher end. New Zealand has examples of all types. The number of offshore decommissioning projects in other jurisdictions has increased over the last decade; however, large scale decommissioning is not yet commonplace. Over the coming decade, more decommissioning projects are expected to commence, which will lead to improvements in best industry practice and will help refine estimates of what decommissioning costs can be expected, with the possibility of reduced costs.

22. Under current settings the Crown may be liable to pay up to 42 percent of decommissioning costs as tax and royalty rebates to operators. The four year limitation does not arise for royalties which are handled through the Ministry of Business, Innovation and Employment. This RIS only considers the tax consequences of decommissioning, which are limited to the tax rate applying to the petroleum miner which for all current petroleum miners is the company tax rate of 28 percent. As the spread-back (and the refundable credit in option 3) are linked to the petroleum miners' tax rate any future increases or decreases in the corporate tax rate would result in the same change in the tax cost to the Crown of decommissioning.

23. In addition to the size of the installation, two other main factors influencing the cost of decommissioning are:

- New Zealand's distance from where decommissioning vehicles are typically located (often in Singapore or the North Sea) which means mobilisation costs are higher than for other jurisdictions; and
- the age of the rig being decommissioned as older rigs were typically built with less planning towards eventual decommissioning<sup>9</sup>.

24. There are currently four offshore producing petroleum operations in New Zealand's Exclusive Economic Zone and a fifth offshore operation in the territorial sea<sup>10</sup>. Decommissioning of these existing offshore installations has yet to occur, but the first offshore decommissioning project could commence as early as 2018.

25. Although there are only five operations these are typically operated by joint ventures of several different taxpayers<sup>11</sup>, each of which would be affected by these proposals. In addition further taxpayers are in the exploration phase or may enter the exploration phase in the future. These petroleum miners may subsequently enter the production phase and eventually decommission.

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<sup>8</sup> Floating Production, Storage and Offloading units – dedicated vessels attached via anchor chains to the seabed and removable lines to the oil wells. Once a field is exhausted the FPSO can be moved to a new location.

<sup>9</sup> Overseas jurisdictions tend to require modern installations or structures to be fully removed except in circumstances where the installation was constructed prior to 1998 or where safety or environmental risks require the infrastructure to remain. New Zealand has examples of rigs constructed before and after this date. New Zealand's decommissioning requirements and how they relate to specific installations are still being determined.

<sup>10</sup> The territorial sea covers the area up to 12 nautical miles from land while the exclusive economic zone covers from 12 to 200 nautical miles.

<sup>11</sup> For example one particular field is a joint venture of five operators.

26. The most recent Ministry of Business, Innovation and Employment estimate of the cost of decommissioning the existing offshore installations is \$2,200 million between 2019 and 2046. At a 28% tax rate the tax cost would be \$616 million<sup>12</sup>. These amounts are already refundable under the current law.

27. The options in this RIS would not affect the cost of decommissioning or the deductibility of those costs. The options could have a minor impact on timing of tax payments and refunds which could have some behavioural impacts on production and, therefore, tax payments. These impacts are difficult to quantify for the reasons provided below:

- the regulatory standard for the level of decommissioning required, which is still being determined by the government;
- the timeframe for decommissioning of the various existing rigs which is currently estimated to occur between 2018 and 2046;
- any new exploration discoveries or changes in technology that extend field life;
- estimates of decommissioning costs including how this changes over time because of better information, changes in technology and environmental regulations; and
- changes in estimated oil and gas prices and the effect this has on economically recoverable reserves.

## OBJECTIVES

28. The **main objective** is to modernise the tax rules that apply to petroleum mining decommissioning.

29. All options are assessed against the status quo in relation to the main objective and the following criteria:

- (a) **Neutrality:** the tax rules should not influence a petroleum miner's decision about when to decommission
- (b) **Fairness and equity:** the tax rules should reflect the income and expenditure profile of the petroleum mining industry but should not otherwise provide a concession not available to other taxpayers
- (c) **Efficiency of compliance and administration:** the impacts on taxpayers of compliance with the rules and administrative impacts on the government should be minimised as far as possible

30. The neutrality and fairness and equity criteria are equally weighted as it is important that petroleum mining is not disincentivised by the tax system but it is equally important that the petroleum mining industry is not provided with tax concessions that create an advantage over other industries.

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<sup>12</sup> This estimate does not factor in any tax refunds that may not be available due to the four year limit or insufficient tax being paid in previous periods. For the reasons set out elsewhere in this RIS officials do not expect either of these factors to provide a significant impediment to the amount of tax refunds available to petroleum miners from decommissioning.

31. While efficiency of compliance and administration is an important factor it is secondary to the other two criteria as the costs and any inefficiencies arising from them are smaller than inefficiencies arising from the first two criteria.

32. There are no relevant constraints to this analysis.

## REGULATORY IMPACT ANALYSIS

33. Officials have identified five options to address the problem:

- Option 1 – The status quo
- Option 2 – Amendments to the spread-back provision
- Option 3 – Introduce a refundable credit
- Option 4 – Introduce an environmental restoration account
- Option 5 – Allow deductions for provisions

34. There are no social or cultural impacts associated with any of the identified options. There may be an environmental impact from any one of the options to the extent they create or remove incentives or disincentives for petroleum mining.

35. We consider that the options would have no material impact on fiscal costs or revenue. The options consider the timing of deductions and there would be no change in the ultimate treatment of decommissioning expenditure – it would continue to be deductible. Options 1 to 3 would allow a deduction at the end against income previously returned whereas options 4 and 5 would allow the same deductions (or at least a proxy for them via provisions) against income as it is returned. Therefore, options 4 and 5 would have a higher fiscal cost than options 1 to 3. However, it is difficult to estimate the extent that this would occur. To the extent the existing four year limit accelerates decommissioning, removing this would raise revenue; but this is not considered significant given the other uncertainties in the forecasts which are explained in paragraph 27.

### Option 1

36. Option 1 is the status quo. The spread-back provision would be retained, including the four-year refund limitation.

#### *Assessment against criteria – option 1*

37. The status quo does not meet the main objective. Spread-backs are considered an outdated approach that has high compliance and administration costs. Previous reforms have not introduced any new spread-back provisions for a long time and many have been removed.

38. *Neutrality.* The current rules do not meet the neutrality criterion. They encourage a petroleum miner to decommission earlier than they otherwise might and to relinquish a permit earlier than they otherwise might.

39. *Fairness and equity.* The current rules do not meet the fairness and equity criterion. The four year refund limit disincentivises petroleum mining because of the industry specific

income and expenditure profile. It also provides a concession not available to other industries by potentially paying UOMI on spread-backs when no UOMI is paid in other spread-back situations. The petroleum mining industry considers abandonment costs of exploration wells can be spread-back which, if allowable, would be concessionary compared to other industries where current period losses from non-profitable ventures cannot be spread-back against profits from previously profitable ventures.

40. *Efficiency of compliance and administration.* The current rules do not meet the efficiency of compliance and administration criterion. The current rules require prior assessment periods to be reopened which requires manual intervention by Inland Revenue staff. This may also impose higher compliance costs on petroleum miners who will have to account for refunds from various periods that have previously been finalised.

## Option 2

41. Option 2 is to amend the status quo. This would retain the spread-back but would remove the four year refund limitation and make other clarifying amendments to address the problems in paragraphs 14 to 17 consistent with the existing policy. These include clarifying when the spread-back is available, that the spread-back is not available when an exploration well is abandoned and that no UOMI is payable when the spread-back results in a refund in prior years.

### *Assessment against criteria – option 2*

42. Option 2 does not meet the main objective. While the amendments would clarify the legislation so that its application is consistent with the policy intent the spread-back would be maintained which, as covered in option 1, is not a modern approach to tax compliance and administration.

43. *Neutrality.* Option 2 is an improvement over the status quo. The amendments would remove the incentives and disincentives present in the current rules.

44. *Fairness and equity.* Option 2 is an improvement over the status quo. The amendments clarify a number of issues that could be concessionary towards petroleum miners.

45. *Efficiency of compliance and administration.* Option 2 is worse than the status quo. It would have all the problems of the status quo plus removing UOMI from refunds from prior periods would require manual intervention<sup>13</sup> to override the standard treatment.

## Option 3

46. A refundable credit has a very similar effect to a spread-back under option 1 and 2. The difference is that qualifying decommissioning expenditure would generate a refundable tax credit in the petroleum miner's current income tax return instead of requiring the Commissioner to reopen prior periods to reassess and reduce previous tax liabilities already paid. The refund would be limited to the amount of income tax paid in prior years.

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<sup>13</sup> Manual intervention would be required under Inland Revenue's FIRST computer system. The replacement system – START – will be operational by the time these changes would be enacted. It is not confirmed what the process would be for this; however, it would still be a variation from the standard treatment.

47. Unlike the spread-back mechanism, there are a number of refundable credits already in the ITA 2007<sup>14</sup>. Most relevant is a refundable credit for mineral mining which relates to rehabilitation expenditure at the end of mining operations. Officials see many similarities between rehabilitation by mineral miners and decommissioning by petroleum miners and there would also be many similarities between how refundable credits would work for the two industries<sup>15</sup>. This option would also incorporate the same clarifying amendments covered in option 2 above.

### ***Assessment against criteria – option 3***

48. Option 3 meets the main objective. The refundable credit mechanism would broadly align with other credits already available and would be consistent with the policy intent of the petroleum mining rules.

49. *Neutrality*. Option 3 is an improvement over the status quo. The rules would remove the incentives and disincentives present in the current tax rules.

50. *Fairness and equity*. Option 3 is an improvement over the status quo. The rules would include clarification of a number of issues that could be concessionary towards petroleum miners. Providing a refundable credit recognises the different income profile of petroleum mining but does not otherwise provide a concession not available to other industries.

51. *Efficiency of compliance and administration*. Option 3 is a significant improvement over the status quo. It would remove the need for any interaction between Inland Revenue and petroleum miners regarding reopening prior assessment periods. In comparison with options 4 and 5, it would also reduce the focus on verifying provisions for decommissioning with Inland Revenue at any point prior to claiming the refundable credit.

### **Option 4**

52. An environmental restoration account would allow a petroleum miner to make a payment into an account operated by the Commissioner based on provisions for decommissioning. Provisions are an accounting deduction for expenditure or loss expected to be incurred by the person in a future period and allow a more conservative accounting profit to be recorded to reflect deductions that would have otherwise arisen in a later period. Generally accounting provisions are not deductible for tax purposes. Amounts deposited into this account would be deductible when paid and the petroleum miner could withdraw them from this account at a later date to satisfy decommissioning expenditure when it was incurred. Modest interest on the account balance would be paid in the meantime.

53. This option would be closely based on existing provisions for environmental restoration accounts in subpart EK of the ITA 2007. Existing environmental restoration accounts are not industry specific and can be available whenever the necessary criteria are met. An example of a current use of an environmental restoration account would be a taxpayer operating a landfill.

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<sup>14</sup> A list of refundable credits is in section LA 6(1) of the ITA 2007

<sup>15</sup> Further detail on how refundable credits for mineral miners operate can be found in Tax Information Bulletin Volume 26, No 4, May 2014. <http://www.ird.govt.nz/resources/a/e/aee2f96e-f5c6-4b1f-ae75-e951c8bae62e/tib-vol26-no4.pdf>

54. Environmental restoration accounts were also proposed for rehabilitation expenditure for mineral mining in the October 2012 *Taxation of specified mineral mining officials' issues paper*<sup>16</sup>. However, upon considering feedback from submitters, which was strongly opposed particularly because of the negative cash flow impact of making deposits into the account, this was replaced by the refundable credit mechanism covered by option 3.

#### ***Assessment against criteria – option 4***

55. Option 4 meets the main objective. The proposal is consistent with rules that already apply to similar restoration processes.

56. *Neutrality*. Option 4 is an improvement over the status quo. The rules would remove the incentives and disincentives present in the current rules.

57. *Fairness and equity*. Option 4 is an improvement over the status quo. The amendments clarify a number of issues that could be concessionary towards petroleum miners.

58. *Efficiency of compliance and administration*. Option 4 is worse than the status quo. Petroleum miners are likely to strongly oppose this option because it would have a significant negative cashflow impact on them. It would also incur administration costs as the Commissioner would have to operate the appropriate accounts.

#### **Option 5**

59. As with other industries, petroleum miners create accounting provisions for expenditure or loss they expect to incur in a future period. This option would allow a petroleum miner to claim a deduction based on accounting provisions for decommissioning expenditure that is expected to be incurred in a future period. Although a petroleum miner would commit themselves to decommissioning expenditure once they started the development phase the cost of decommissioning would be spread over the expected life of the field so that the timing would align with the income derived.

60. When this option is discussed it is usually referenced back to the Privy Council decision in *C of IR v Mitsubishi Motors*<sup>17</sup> which was a case regarding the deductibility for tax purposes of provisions created upon the sale of new cars based on prior history of warranty claims.

#### ***Assessment against criteria – option 5***

61. Option 5 meets the main objective. Prior returns would not need to be reopened.

62. *Neutrality*. Option 5 is an improvement over the status quo. The option would remove the incentives and disincentives present in the current rules.

63. *Fairness and equity*. Option 5 is worse than the status quo. Petroleum miners would be eligible for deductions for expenditure based on provisions which is a treatment not available to other industries. With the international focus on removing concessions for the fossil fuel industry this would be likely to be very controversial.

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<sup>16</sup> <http://taxpolicy.ird.govt.nz/publications/2012-ip-mineral-mining/overview>

<sup>17</sup> *Commissioner of Inland Revenue v Mitsubishi Motors New Zealand Limited* (1995) 17 NZTC 12,351

64. *Efficiency of compliance and administration.* Option 5 is an improvement over the status quo. It would remove the need to reopen prior periods. However, basing deductions on provisions would likely increase the focus on ensuring these were correct, which would be more difficult than verifying expenditure incurred.

## CONSULTATION

65. Because decommissioning consideration is being undertaken concurrently by various government departments an interagency petroleum decommissioning working group was formed including Inland Revenue, the Treasury, the Ministry of Business, Innovation and Employment, the Ministry for the Environment and other departments. Officials have discussed details of the current rules and proposed changes with this group and its members, who have not raised any concerns.

66. Officials also undertook targeted consultation with the petroleum mining industry and their advisors during August and September 2016. This consultation proposed that the current spread-back be replaced by a refundable credit.

67. Submitters were all in favour of replacing the current spread-back (which is subject to the 4 year refund limitation period) with a refundable credit. The two common themes in submissions were around not limiting the refund to tax previously paid by an entity – this limit already exists in the status quo, and allowing a refundable credit for abandonment costs – where the industry disagrees with officials and considers that a spread-back is already available. A number of other more minor changes have also been incorporated as a result of the consultation. Officials have extended their recommendations to include tax paid by a petroleum miner before joining a consolidated group and to allow a refundable credit for certain abandonment provided that is done as part of decommissioning a production well.

## CONCLUSIONS AND RECOMMENDATIONS

68. The following table summarises our consideration of the options from the regulatory analysis section above. Within the overview table the following symbols are used:

- ✓✓ Significantly better than the status quo
- ✓ Better than the status quo
- × No better than the status quo
- ×× Worse than the status quo

Options	Analysis against the objective and criteria
Option 1 – Status quo	Does not meet the main objective
Option 2 – Amendments to the spread-back	Does not meet the main objective  Neutrality ✓ Fairness and equity ✓ Efficiency of compliance and administration ××
Option 3 – Introduce a refundable credit	Meets the main objective  Neutrality ✓ Fairness and equity ✓ Efficiency of compliance and administration ✓✓

Option 4 – Introduce an environmental restoration account	Meets the main objective  Neutrality ✓ Fairness and equity ✓ Efficiency of compliance and administration ××
Option 5 – Allow deductions for provisions	Meets the main objective  Neutrality ✓ Fairness and equity ×× Efficiency of compliance and administration ✓

69. Options 3, 4 and 5 satisfy the main objective of ensuring that the petroleum mining decommissioning rules are appropriate.

70. Officials recommend option 3 as it is the only option that provides an overall improvement on the status quo (option 1). This is for the following reasons:

- Option 1 is not sustainable as it has a number of uncertainties and inappropriate outcomes that both disincentivise petroleum mining and provide concessions not available to other industries. Option 3 is preferable over option 2 as it would result in lower compliance and administration costs from not having to reopen prior periods to include all or part of the decommissioning costs that could not be included in the original return and would not require manual intervention of UOMI calculations.
- While option 3 provides a treatment not available to most other industries this reflects their unique income profile and is not an unjustified concession.
- Option 3 is preferable over option 4 as it would result in lower compliance costs from the petroleum miner not having to make upfront payments into an account operated by the Commissioner before the expenditure is incurred. It would also result in lower administration costs from the Commissioner not having to operate this account.
- Option 3 is preferable over option 5 as it corrects the issue arising from significant expenditure at or near the end of the production process without providing a concession that is not available to other industries (being able to claim a current period deduction for expenditure that will be incurred in a future period).

## IMPLEMENTATION

71. Changes to introduce a refundable credit for petroleum decommissioning expenditure would require amendments to the Income Tax Act 2007. These amendments would be included in the next available omnibus tax bill, scheduled for introduction in early 2017.

72. These amendments would apply equally to all petroleum miners, including those that are already in production as well as those still in the exploration phase who need to plan for future decommissioning. The bill containing these amendments would be expected to be enacted before the first offshore installation begins decommissioning which may occur in 2018. As no petroleum miners have decommissioned an offshore installation in New Zealand this timeline would ensure that the new rules apply equally to all petroleum miners.

73. These changes would not impose significant compliance costs on petroleum miners as the primary change would be to include decommissioning expenditure in the relevant period's income tax return rather than calculating this amount and requesting it be included in previous

years' assessments. Depending on how the petroleum miner accounts for refunds from prior periods the change may also reduce compliance costs of recording these refunds.

74. The bill commentary and a *Tax Information Bulletin* publication upon enactment to explain the changes would be required. Minor systems changes would also be required to START to allow petroleum miners to obtain a refund in a current income year that exceeded tax paid in that year. However, these changes have previously been implemented in FIRST and would be incorporated into START for the mineral mining industry, so replicating these for petroleum mining is not expected to be a significant cost and would be met within existing baselines.

## **MONITORING, EVALUATION AND REVIEW**

75. Inland Revenue would closely monitor the effectiveness of the proposed changes once income tax returns including decommissioning start being prepared – with the first possibly to be in the 2018-19 income year.

76. In general, any changes identified as necessary following enactment would be added to the tax policy work programme, and proposals would go through the Generic Tax Policy Process (GTPP). The GTPP is a multi-stage process that has been used to design tax policy (and subsequently social policy administered by Inland Revenue) in New Zealand since 1995. Opportunities for external consultation are built into various stages of the process. In practice, any changes identified as necessary following enactment would be considered for inclusion in the tax policy work programme, and proposals would go through the GTPP.

# Regulatory Impact Statement

## Taxation of Employee Share Schemes

### Agency Disclosure Statement

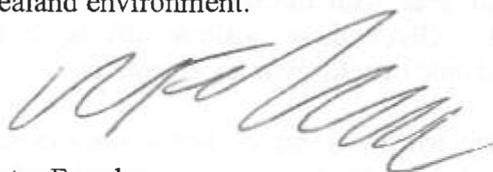
This Regulatory Impact Statement has been prepared by Inland Revenue.

It provides an analysis of options to improve the framework for taxing employee share schemes (ESS). In some circumstances, the current tax rules can result in over-taxation; in others they result in under-taxation. The options considered in this Regulatory Impact Statement seek to address these issues.

To analyse the options for taxing ESS, tax policy officials gathered case-based evidence of the range of commercial practices that currently exist. We researched the historic basis of the existing law. We then identified areas where the current law is deficient in light of our broad-base, low-rate taxation framework. Having identified areas where the law is deficient and unclear, we undertook an analysis of the optimal taxation framework for taxing ESS and tested possible solutions against that framework.

In considering various options, we considered quantitative data where it was available. Unfortunately, there are no comprehensive statistics on how widespread employee share schemes are and what form they take. There is also no comprehensive data on the tax treatment of these schemes. So while we know ESS are an important form of remuneration, we cannot be sure of the number of employees participating in different types of schemes or how much remuneration is provided through ESS. Accordingly, officials are also unable to provide quantitative estimates of the costs and benefit of maintaining the status quo.

To address this limitation, in some cases we had to look to Australia for data. We made some adjustments to the Australian data to attempt to more accurately reflect the New Zealand environment.



Peter Frawley  
Policy Manager, Policy and Strategy  
Inland Revenue

28 November 2016

## STATUS QUO AND PROBLEM DEFINITION

### Overview

1. Employee share schemes (ESS) – arrangements providing shares and share options by companies to employees – are an important form of employee remuneration in New Zealand and internationally. Although the commercial design and the accounting treatment of these plans have evolved considerably over recent decades, the tax rules applying to them in New Zealand have not been comprehensively reviewed during that period and are now out of date.
2. ESS can have beneficial economic effects (in terms of aligning employee and shareholder interests, promoting financial literacy and allowing cash poor companies to attract top employees) and it is important that the tax rules do not raise unintended barriers to their use. In some circumstances, the current rules can result in over-taxation; in others they result in under-taxation. There is no comprehensive data to quantify the size of this problem.

### Status quo

3. The taxation of ESS is governed by the Income Tax Act 2007 (ITA).

### *Framework for taxing employee share schemes*

4. Broadly speaking, there are two potential frameworks for taxing ESS:
  - a **neutral tax framework** consistent with New Zealand's BBLR tax policy settings. Under a neutral tax framework, the tax treatment of employment income paid in shares should be consistent with the taxation of employment income paid in cash. That is, ESS should not be at a tax advantage or disadvantage compared to a cash salary; or
  - a **concessionary framework** where ESS are offered tax incentives. ESS are offered to help align incentives of employees with those of the firm and to improve general employee engagement. Given these positive effects, it is sometimes suggested that these schemes should benefit from tax incentives.
5. The current framework for taxing employee share schemes is mixed, and in some cases, unclear. Generally speaking, most ESS are intended to be taxed under a neutral tax framework. However, there are inadvertent tax benefits associated with some schemes that make them more attractive than other types of schemes, or equivalent cash salary (notably the recharacterisation of labour income as tax-free capital income). In addition, the current law contains a deliberate, narrow tax exemption and deemed notional interest deduction for widely-offered schemes.

### *Treatment of employees' income*

6. Employee share schemes may be divided into three general categories:
  - *Unconditional ESS* – which provide shares or options to employees free from further conditions.
  - *Conditional ESS* – where the shares or options received by employees are subject to future employment conditions.

- *Options and option-like arrangements* – options allow employees to purchase shares in their employer at a predetermined time in the future for a predetermined price (“strike price”). Option-like arrangements are in the form of a share purchase, but have terms and conditions (often based on the price of the shares) and other features that make the arrangement similar in economic effect to an option. Option-like arrangements often have employment conditions in addition to the price conditions.

7. **Unconditional and conditional ESS** are currently taxed as follows. Employees are taxed when they acquire the shares. In the case of a conditional scheme, the shares are commonly given to a trustee to hold until the condition is met. This is treated as acquisition by the employee. The taxable income is the difference between the value of the shares at that time and the price they pay for them. If employees pay full market value for the shares, then no taxable income arises. At the other extreme, if employees are given shares for no consideration, then the full market value of the shares is taxable income.

8. With **share options**, employees are given a right to purchase shares at some future date for a set price (the strike price). This right itself may be subject to the satisfaction of a future condition. In that case, the options are often referred to as “vesting” when the condition is met. An employee will exercise the option if the shares’ value at the future date exceeds the strike price – the option effectively allows them to acquire the shares at a discount. If the strike price exceeds the shares’ value the employee will not exercise their option. When an employee receives an option, employment income equal to the value of the option is received and that income should be subject to tax.

9. Under current rules, no tax is paid when the option is issued or vests. An employee participating in a share option plan is taxed only if and when the option is exercised. The difference between the market value of the shares at exercise and the strike price is taxable income. This approach is *tax at exercise*.

10. A number of employee share schemes make use of interest-free loans. Interest-free loans provided to employees by their employer are generally subject to FBT. However, FBT is not payable in respect of an interest-free loan provided by an employer to enable an employee to purchase the employer’s shares, provided certain criteria are satisfied. The FBT exemption is appropriate because it ensures the tax treatment of the interest-free loan is the same as if the employer had charged interest, but paid the employee extra salary to meet the interest cost.

### ***Treatment of employers***

11. Under current law there is no explicit deduction for a company that provides shares to an employee at a discount. However, there are structures that can be adopted by employers to achieve a deduction. While we do not have comprehensive data on the use of these structures, we understand they are very widespread.

### ***Widely-offered schemes***

12. The ITA currently provides a concessionary regime to encourage employers to offer shares to employees under certain widely-offered employee share schemes.

13. There are two main tax benefits available under the concessionary regime:

- **Exemption for employee:** The value of a benefit received by an employee under a concessionary scheme is not taxable to the employee.
- **Deemed interest deduction for employer:** The employer company is given a deemed deduction of 10% notional interest on loans made to employees to buy shares. This is additional to any deduction for actual interest incurred on money borrowed to finance the scheme. There is not intended to be any deduction for the cost of acquiring shares, although we understand in practice many companies have structures in place to achieve unintended deductions.

14. Another benefit under the concessionary regime is that interest-free loans made under a qualifying employee share scheme are automatically exempt from fringe benefit tax (FBT).<sup>1</sup>

### *Start-up companies*

15. There are currently no special rules for ESS offered by start-up companies, although they face particular practical barriers to offering ESS.

16. As stated above, they may have difficulties valuing employee share scheme benefits. They also may not have sufficient cash at the employee and employer level to fund tax imposed on the grant or vesting of shares, or the exercise of options.

17. While similar problems can exist for any unlisted companies, more mature companies can generally put in place mechanisms to deal with them. Start-ups are especially affected by these problems because they lack the cash to pay the tax on behalf of employees and their shares are very difficult to value using orthodox methodologies.

### *Reporting and administrative requirements*

18. There are currently no specific reporting requirements for employers offering, or employees participating in, employee share schemes. While employers offering the tax-exempt schemes discussed above must apply to the Commissioner of Inland Revenue initially for approval, there are no on-going reporting requirements with respect to these schemes.

19. From 1 April 2017, employers will be required to include employees' ESS benefits in the employer monthly schedule (EMS) (whether they elect to withhold PAYE or not). However, this amendment does not require the employer to provide specific details of the share scheme benefits provided.

20. The current lack of reporting raises a number of issues:

- it is difficult to know whether employers and employees understand and are complying with their share scheme tax obligations;
- employees may not have sufficient information to complete their tax return; and
- there are no comprehensive statistics on how widespread employee share schemes are and what form they take.

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<sup>1</sup> The majority of employee share scheme loans are exempt from FBT.

### *Other government interventions/programmes*

21. The New Zealand Government is committed to removing barriers to offering these schemes – especially for start-ups. Recent changes to the Financial Markets Conduct Act 2013 exempt many ESS from the requirement to offer a prospectus to employees. This was seen as a major simplification measure and was welcomed by the business community. In the course of our consultation it was mentioned as a step which was likely to increase the use of ESS.

### **Problem definition**

22. As discussed above, in some circumstances the status quo results in over-taxation and, in others, under-taxation. There are also significant administrative and compliance costs associated with the status quo. There is no comprehensive data to quantify the size of this problem.

### *Current impediments and potential over-taxation*

23. The current system impedes the use of ESS in a number of ways. These problems can be particularly relevant for start-up companies.

- There is considerable uncertainty about how the current tax rules apply to employees and employers, which may deter firms from offering these schemes.
- The costs to employers of providing shares to employees are not explicitly deductible. Non-deductibility creates a disincentive to using employee share schemes.
- Unlisted, and in particular start-up, companies may have difficulties valuing employee share scheme benefits.
- Start-up companies may not have sufficient cash-flow at the employee and employer level to fund tax payments triggered by the vesting or receipt of illiquid shares.

### *Potential under-taxation*

24. The current treatment of some sophisticated employee share schemes can result in taxable employment income being treated as tax-free capital gains and so escaping taxation. This undermines the fairness of the tax system. These sophisticated employee share schemes can provide a significant amount of untaxed employment income for some high income earners.

### *Root causes of these problems*

25. The root causes of these problems are:

- that New Zealand does not tax capital gains, but does tax labour income. This creates incentives and opportunities for people to recharacterise labour income as tax-free capital gains. These transactions are possible where tax rules are unclear or contain loopholes;
- the tax law relating to ESS is out of date, ambiguous and has not kept up with commercial developments – the legislation was enacted in the late 1960s and early 1970s and has not been comprehensively reviewed since then. Therefore, there is

scope for employers/employees to avoid tax on what is essentially remuneration for services.

***Quantifying the costs and benefits of the status quo***

26. Employee share schemes are fairly widespread in New Zealand businesses. Large listed companies use them, as do start-up companies and medium sized privately-held companies. There are different types of schemes: high value schemes offered to a small group of senior executives, moderate value schemes offered to a wider range of managers and low value schemes offered to all employees. Some companies offer more than one type of scheme.

27. However, there is no comprehensive data on employee share schemes in New Zealand. KPMG has recently published a survey of NZX listed companies suggesting that 78% of NZX 50 Index companies offer at least one employee share scheme.<sup>2</sup> The New Zealand Venture Investment Fund (NZVIF) also published a report into the use of employee share schemes by New Zealand start-up companies. Of the 50 companies that responded to their survey, 88% currently have a specific provision in their shareholders’ agreement/constitution allowing them to offer employee share schemes.<sup>3</sup>

28. So officials know ESS are an important form of remuneration, but cannot be sure of the number of employees participating in different types of schemes or how much remuneration is provided through ESS. Accordingly, officials are also unable to provide quantitative estimates of the costs and benefit of maintaining the status quo.

29. The table below lists the costs and benefits of the status quo based on anecdotal evidence.

<b>Costs of status quo</b>	<b>Benefits of status quo</b>
Lack of legislative certainty increases compliance and administrative costs. Examples of legislative uncertainty include: whether the law currently requires a widely-offered scheme to have a loan and what the “acquisition” point is for shares.	Rules have been in place for 40 years so companies have bedded in ESS arrangements. Maintaining the status quo avoids companies and Inland Revenue having to incur the costs associated with changing schemes and systems.
Efficiency costs as employers structure arrangements to provide tax-free capital gains instead of providing taxable labour income – this may result in an inefficiently high amount of ESS income.	Some private sector advisors and companies argue being able to access capital gains tax-free adds to incentive effects and allows companies to more easily attract skilled workers.
Unnecessary transaction costs to implement complicated tax-driven structures to achieve tax-free gain/a deduction for the employer when one would not otherwise be available.	
Equity costs – people who are able to participate in ESS and obtain tax-free capital gains are advantaged versus those who can only earn taxable salary and wages.	
There is a cost to Government revenue as some labour income currently goes untaxed (this is mitigated to some extent by the lack of deduction at the employer level).	

<sup>2</sup> <https://assets.kpmg.com/content/dam/kpmg/pdf/2016/02/NZ-Employee-Share-Schemes-Brochure-Feb-2016.pdf>

<sup>3</sup> <http://www.nzvif.co.nz/assets/publications/ESOP-Survey-Report.pdf>

## OBJECTIVES

30. The **main objective** of this reform is to modernise and improve the taxation of ESS so it is simple, efficient and fair.

31. All options are assessed against the status quo in relation to the main objective and the following **five criteria**:

- **Neutrality** – this means that the imposition of tax should not affect the form in which employees are paid. Tax neutrality is a core part of New Zealand’s general BBLR approach to taxation. Tax neutral treatment of the employment income means, as much as possible, we should tax all types of employee remuneration, whether paid in cash or shares or other assets, consistently; and ensure that taxation does not distort remuneration decisions. This ensures employees are remunerated in the most economically efficient (rather than the most tax efficient) form. An alternative approach would be to provide tax concessions for employee share schemes. In our view, it is only appropriate to consider tax concessions if there are positive externalities associated with an activity – that is positive benefits to wider society, not just benefits captured by the parties to the arrangements. Because there is no evidence that ESS provide positive externalities the best tax policy framework for ESS is one that is neutral.
- **Equity** – to support fairness in the tax system, options should, to the extent possible, seek to treat similar taxpayers in similar circumstances in a similar way. In particular:
  - i. employees paid in shares should not have a tax advantage compared to employees receiving cash salary and wages; and
  - ii. employers paying employees in shares should not be disadvantaged compared to employers paying cash.
- **Compliance costs** – compliance costs to businesses and employees should be minimised as much as possible.
- **Administrative costs** – administrative costs for Inland Revenue should be minimised as much as possible.
- **Integrity** – options should safeguard the tax system against tax avoidance and evasion. The options should also contribute to a coherent set of rules for taxing labour income.

### *Constraints*

32. We were also constrained in terms of the administrative options we were able to consider because of Inland Revenue’s current Business Transformation programme.

### *Trade-offs*

33. There are trade-offs between the various criteria.

34. In particular, there is a trade-off between minimising administrative and compliance costs, and increasing the integrity and equity of the system. In the case of executive level schemes, more weight is placed on increasing equity and integrity than minimising compliance costs. This is because there are often high levels of remuneration being provided through these schemes and compliance costs are relatively smaller as a proportion of the remuneration being provided. This high level of benefit also makes integrity and equity relatively more important.

35. In the case of the widely-offered schemes, there is a trade-off between neutrality and minimising compliance costs (see table 3 below). In these schemes compliance costs had a higher weighting than neutrality because of the low level of benefits that are able to be provided through the schemes and the feedback we received from submitters as to how increased compliance costs would affect them. Potential compliance costs for these schemes are high as a relative proportion of benefits provided through the scheme. In some cases submitters indicated the compliance costs associated with removing the tax exemption and requiring employers to return these amounts on the employer monthly schedule would outweigh the amount of benefit provided, meaning the schemes would no longer be viable.

## REGULATORY IMPACT ANALYSIS

36. There are three areas of reform covered in this regulatory impact analysis:

1. Taxing employees' income
2. Allowing deductions for employers' costs
3. Tax exemption for widely-offered schemes

37. Within each of these areas, the practical options for reform that may wholly or partly achieve the main objective are exclusively regulatory.

38. In the following paragraphs, we outline the options for reform we considered. Each topic has a corresponding table where we analyse each option by reference to the **five criteria** we identified in paragraph 31 and the **main objective** in paragraph 30.

39. Within the tables, the following symbols are used to assess each option against the status quo:

- ✓✓ Significantly better than the status quo
- ✓ Better than the status quo
- × No better than the status quo
- ×× Worse than the status quo

40. None of the options identified in any of the areas have social, environmental or cultural implications.

## Taxing employees' income

41. The options we considered are as follows:

1. **Option A – status quo:** this option is summarised in paragraphs 6 to 10. Essentially shares are taxed when they are acquired by an employee (or trust), even if they have not yet been earned or they are subject to an arrangement that protects employees from suffering an economic loss if the share price declines. Options are taxed on exercise. In both cases, the assessable income is the market value of the shares at the time they are acquired (including through the exercise of an option), less any amount paid for them.
2. **Option B – tax employee on grant:** this would involve taxing an employee on the value of the arrangement when they enter into it. For example, when an option is granted to an employee or when an employee is promised shares under an ESS if they perform services for a certain period of time.
3. **Option C – tax employee when the shares vest:** this involves taxing employees when they have done everything they have to do to earn the shares and they hold them on (essentially) the same basis as other shareholders (including not having any protection from suffering an economic loss if the share price declines). Under this option, employees are taxable on the market value of the shares at the time they vest, less any amount they pay for the shares. Consistent with existing law, options would be taxed when they are exercised (even if the options themselves have vested at an earlier date). The assessable income would be the market value of the shares at the time they are acquired through the exercise of the option, less any amount paid for them.
4. **Option C2 – same as Option C above, but tax options when they vest, not when they are exercised.** An option vests when an employee has done everything they have to do to earn it and it can no longer be forfeited. An option may vest some time before it is (or is able to be) exercised. Under this option, the assessable income would be equal to the value of the option on the date it vests, estimated using an option valuation model (such as the Black-Scholes-Merton model), rather than when the option is exercised on the value of the shares at that time less any amount paid for them.
5. **Option D – tax employee when they sell the shares:** tax could be imposed on shares at the time they are sold. The assessable income would be equal to the proceeds of sale less any amount the employees paid to acquire the shares. This means employees will have the cash to pay the tax and the market value will be more easily established.

**Table 1 - Taxing employees' income**

	Neutrality	Equity	Minimises compliance costs	Minimises administrative costs	Integrity	Assessment against main objective	Fiscal impact
Option A – status quo	ESS benefits taxed differently from cash salary and other in-kind benefits. Taxation of shares at grant is not consistent with taxation of options on exercise.	ESS benefits are often tax advantaged.	Significant compliance costs associated with uncertainty of the law. Valuation and cashflow issues also cause significant compliance costs – especially for start-up companies.	Significant administrative costs associated with uncertainty of the law	Many opportunities for tax avoidance and evasion. The law is not coherent	<i>Does not meet the main objective</i>	Not applicable
Option B – tax on grant	✘✘Worse than the status quo ESS benefits taxed differently from cash salary and other in-kind benefits.	✘No better than status quo ESS benefits taxed differently from cash salary and other in-kind benefits.	✘✘Worse than the status quo Significant compliance costs involved in valuing the “promise” to pay in the future.	✘✘Worse than the status quo Significant administrative costs involved in valuing the “promise” to pay in the future.	✘No better than status quo Does not address all opportunities for tax avoidance and evasion. Taxation of employment income is not coherent	<i>Does not meet the main objective</i>	Unable to estimate
Option C – tax on shares vesting (and options on exercise)	✓✓Significantly better than the status quo ESS benefits taxed the same as cash salary and other in-kind benefits. In some cases the shares cannot be realised to pay tax. There are ways to address this.	✓✓Significantly better than the status quo ESS benefits taxed the same as cash salary and other in-kind benefits. However, in some cases the shares cannot be realised to pay tax. There are ways to address this.	✓Better than the status quo The law will be clearer and more certain, which reduces compliance costs. Valuation issues and tracking vesting may increase compliance costs for some segments of the market. These costs will largely fall on businesses. We do not expect start-up companies to face significantly higher compliance costs as a result of this option.	✓Better than the status quo The law will be clearer and more certain, which reduces administrative costs. However, auditing valuation and vesting may increase administrative costs.	✓✓Significantly better than the status quo Addresses avoidance concerns and makes the taxation of employment income more coherent.	<i>Meets the main objective</i>  <b>Preferred option</b>	Likely to increase revenue compared to status quo
Option C2 – tax options on vesting	✓Better than the status quo As for Option C, but taxing options on vesting exacerbates this cash-flow problem.	✓Better than the status quo As for Option C, but taxing options on vesting exacerbates this cash-flow problem.	✓Better than the status quo As for Option C, but valuing options is difficult and unreliable in this context. Extra compliance costs involved in valuing option correctly.	✓Better than the status quo As for Option C, but valuing options is difficult and unreliable in this context. Extra administrative costs involved in testing valuations.	✓✓Significantly better than the status quo Addresses avoidance concerns and makes the taxation of employment income more coherent.	<i>Partially meets the main objective</i>	Likely to increase revenue compared to status quo
Option D – tax on sale	✘✘Worse than the status quo ESS benefits taxed differently from other in-kind benefits.	✘✘Worse than the status quo ESS benefits taxed differently from other in-kind benefits. However, it is more equitable in that it only taxes employees when they have the cash to pay the tax. It is also easier to establish the value of the shares.	✘No better than status quo There will be some extra compliance costs in tracking sale of shares, but the real benefit of this option is that it reduces compliance costs involved in arranging for cash to pay the tax and getting valuations.	✘✘Worse than the status quo The administrative costs in tracking and auditing ESS will increase under this option	✘✘Worse than the status quo Deferral opens up opportunities for evasion	<i>Does not meet the main objective</i>	Unable to estimate

## Allowing deductions for employers' costs

42. The options we considered are as follows:

1. **Option A – status quo:** no specific statutory deduction, but employers generally structure their ESS to achieve a deduction. Deductions are generally achieved by the employer (a) paying employees a deductible bonus which is used to buy the shares (or repay a loan used to buy the shares); (b) making a payment to an ESS trust which is used to buy shares for the employees; or (c) making a “recharge” payment to a parent company to procure the parent company to provide shares to the subsidiary company’s employees. Deductions are for the actual cash costs incurred and are generally deductible when paid (although in some cases the payment may be spread over the term of the ESS or deductible on a deferred basis).
2. **Option B – matching deduction:** employers would be entitled to a statutory deduction equal in timing and quantum to the employees’ income.
3. **Option C – following International Financial Reporting Standards (IFRS):** IFRS requires companies to recognise an expense association with the provision of options or shares under an ESS. The expense is generally calculated at the date of grant and spread over the term of the ESS.

**Table 2 - Allowing deductions for employers' costs**

	Neutrality	Equity	Minimises compliance costs	Minimises administrative costs	Integrity	Assessment against main objective	Fiscal impact
<b>Option A – status quo</b>	The provision of ESS benefits may be non-deductible. If they are deductible, the deduction does not generally match the employees' income. This is inconsistent with the way the cost of cash salary and wages are treated.	The lack of statutory deduction for ESS benefits means employers are disadvantaged vis-à-vis paying cash salary. To achieve deductions they have to incur costs to structure around this issue.	Significant transaction and compliance costs associated with structuring to achieve deductibility. There is also uncertainty in the law which results in high compliance costs. Borne by employers.	Administrative costs associated with uncertainty of the law.	Some opportunities to potentially accelerate deductions. The law relating to employment income is not coherent	<i>Does not meet the main objective</i>	Not applicable
<b>Option B – matching deduction</b>	✓✓ <b>Significantly better than the status quo</b> ESS benefits taxed the same as cash salary and wages for both employer and employee, and taxed consistently between themselves.	✓✓ <b>Significantly better than the status quo</b> ESS benefits taxed the same as cash salary and wages.	* <b>No better than status quo</b> Reduced compliance costs associated with structuring, but will need to value shares when they vest to determine deduction. Some companies report that there will be increased compliance costs associated with accounting for the tax effect of the new regime under IFRS. This issue seems to be confined to certain types of structures and certain taxpayers. Costs borne by employers.	✓ <b>Better than the status quo</b> Reduced administrative costs because law is more certain. Potentially increased administrative costs as more companies having to value shares.	✓✓ <b>Significantly better than the status quo</b> Removes opportunities for tax avoidance and evasion, more coherent and clear law relating to employment income	<i>Meets the main objective</i>  <b>Preferred option</b>	Likely to slightly reduce revenue
<b>Option C – follow IFRS</b>	✘✘ <b>Worse than the status quo</b> ESS benefits taxed differently from cash salary and wages. Other deductions do not follow IFRS.	✘✘ <b>Worse than the status quo</b> ESS benefits would potentially be tax advantaged or disadvantaged.	✘✘ <b>Worse than the status quo</b> Many companies do not use IFRS, so they may need to use them just for ESS benefits. IFRS rules are complex and require the use of option pricing models. For some large taxpayers who use IFRS already, there would be reduced compliance costs.	✘✘ <b>Worse than the status quo</b> Increased administrative costs associated with monitoring IFRS compliance.	✘✘ <b>Worse than the status quo</b> Potential for avoidance and abuse (IFRS allows a wide range of values). Rules around employment remuneration not coherent.	<i>Does not meet the main objective</i>	Likely to significantly reduce revenue

## Tax concessions for widely-offered schemes

43. The options we considered are as follows:

1. **Option A – status quo:** complex legislation allowing shares to be provided tax-free to employees so long as they pay no more than \$2,340 to buy them over a three year period and all employees are entitled to participate on an equal basis. A number of other criteria must be met. Employers are entitled to a deemed deduction equal to 10% of any loans provided to employees to purchase shares under a qualifying scheme. Currently employers are able to claim unintended deductions for amounts contributed to trusts to purchase shares.
2. **Option B – repeal tax concessions for widely-offered schemes:** remove tax exempt schemes – all employee share schemes treated the same for tax purposes.
3. **Option C – retain and modernise widely-offered schemes:** as well as improving some of the ambiguous drafting, the current limit on the amounts employees can pay for their shares could be increased to take account of inflation since the threshold was last increased. In addition:
  - a. the scheme could be relaxed so it only has to be offered to 90% of employees (rather than 100%);
  - b. an upper limit would need to be placed on the exempt benefit to employees;
  - c. the deemed interest deduction should be removed;
  - d. it should be made clear that any deduction for the cost of providing shares under the scheme is to be denied;
  - e. the legislation could clearly state that a loan is only mandatory to the extent that employees have to pay something for the shares; and
  - f. the requirement for the scheme to be “approved” by the Commissioner of Inland Revenue (CIR) should be replaced by a registration requirement.

Table 3 – Tax concessions for widely-offered schemes

	Neutrality	Equity	Minimises compliance costs	Minimises administrative costs	Integrity	Assessment against main objective	Fiscal impact
<b>Option A – status quo</b>	ESS benefits are exempt from tax, whereas comparable salary is not. Deemed 10% interest deduction and deduction for contribution to trust also different to treatment of standard salary and other types of ESS.	ESS benefits are tax advantaged.	Significant transaction and compliance costs associated with setting up schemes. There is also uncertainty in the law which results in high compliance costs. Borne by employers.	Administrative costs associated with uncertainty of the law.	Some avoidance opportunities. Does not fit with BBLR system.	<i>Does not meet the main objective</i>	Not applicable
<b>Option B – repeal tax concessions for widely-offered schemes</b>	✓ <b>Better than the status quo</b> ESS benefits taxed the same as cash salary and wages for both employer and employee, and taxed consistently between themselves. However, ESS incurs significantly more compliance costs for low level of benefit.	✓ <b>Better than the status quo</b> ESS benefits taxed the same as cash salary and wages. However disadvantaged as compared to salary and wages that do not incur compliance costs.	✖✖ <b>Worse than the status quo</b> Significant transaction and compliance costs associated with bringing tax-exempt schemes into the tax system. In many cases these costs likely to outweigh the benefits offered under the scheme.	✖✖ <b>Worse than the status quo</b> Reduced administrative costs because law is more certain. However, potentially more resources needed to monitor previously tax-exempt schemes.	✓✓ <b>Significantly better than the status quo</b> Removes opportunities for tax avoidance and evasion. Coherent and clear law relating to employment income	<i>Meets the main objective</i>	Broadly fiscally neutral
<b>Option C – retain and modernise widely-offered scheme</b>	✖ <b>No worse than the status quo</b> ESS benefits are exempt from tax, whereas comparable salary is not. Denial of deduction also different to treatment of standard salary and other types of ESS – however this is a necessary corollary of the tax-exemption.	✖ <b>No worse than the status quo</b> ESS benefits are tax advantaged. However, compliance cost barrier is removed.	✓✓ <b>Significantly better than the status quo</b> Significantly reduces compliance costs.	✓✓ <b>Significantly better than the status quo</b> Reduces administrative costs.	✓ <b>Better than the status quo</b> Loopholes removed, but differential treatment does not fit with BBLR framework.	<i>Meets the main objective</i>  <b>Preferred option – on balance compliance costs are a major consideration</b>	Broadly fiscally neutral

## CONSULTATION

44. Consultation is an important part of the Generic Tax Policy Process (GTPP). Tax policy officials undertook numerous discussions with stakeholders before releasing an issues paper for formal public consultation. Submitters had six weeks to submit on the issues paper. Twenty seven submissions were received. Thirteen were from corporates, seven were from industry bodies and seven were from professional services firms. After submissions were received, officials met with a number of submitters to discuss their submissions. As a result of submissions, it became apparent there were specific issues that would benefit from further consultation. Officials released a subsequent consultation letter and allowed a further four weeks for submissions. During this time, officials again met with a number of submitters to help inform their further submissions. Eighteen further submissions were received. Six were from corporates, three were from industry bodies and nine were from professional services firms. The analysis of options to improve the framework for taxing ESS was significantly informed by submissions received.

45. As an overall observation, submitters were not generally in favour of the proposals to change the tax treatment of ESS benefits in the hands of employees. This is to be expected. Some submitters have argued that the reforms tax capital gains. While ESS benefits might sometimes look like capital gains because employees are being paid in shares, the reality is that this is just another form of employment income and should be taxed as such. The proposals isolate employment income and tax that. They ensure that all employment income is treated the same and will reduce opportunities to substitute non-taxable gains for taxable salary. The proposals do not prevent employees from ever being able to hold their shares on capital account and receive gains tax-free. They simply ensure that employees are taxed on the value of the shares they receive when those shares are payment in-kind for services. Once the employee owns the shares like any other investor they can derive tax-free capital gains.

46. Some submitters also advocated for a concessionary framework, rather than the neutral tax framework described above. For the reasons already explained, we did not support a concessionary framework.

47. Submitters were generally in favour of providing a statutory deduction for providing ESS benefits, but some disagreed with the proposed basis for those deductions.

48. As a result of consultation, officials made a number of changes to the proposals including:

- a. recommending retaining and modernising the widely-offered tax exempt schemes – based on concerns about compliance costs;
- b. clarifying when the new rules will and will not apply to common commercial structures – based on some confusion about the border between holding shares as an employee and holding them just like any other shareholder; and
- c. extending the transitional/grandparenting arrangements – to address concerns that the proposed transitional arrangements were not long enough for companies to implement new arrangements and to take account of longer terms schemes.

49. Based on feedback from submitters, we have also recommended considering a second stage of ESS reforms to consider whether it is feasible and desirable to design a start-up deferral regime which would address issues of cash flow and liquidity for early stage companies.

50. Tax policy officials consulted with other government agencies – specifically The Treasury, a number of units within the Ministry of Business, Innovation and Employment (MBIE) and Callaghan Innovation.

51. Tax policy officials also contacted officials in Australia, the United Kingdom and South Africa to gain insights into the way they tax ESS. This has provided us with some useful guidance in terms of areas where New Zealand’s rules are consistent with the treatment in those jurisdictions and where we recommend deliberately departing from the approach in other jurisdictions for some reason – for example, because our tax policy settings are different (for example, we do not have a comprehensive capital gains tax) or because there are particular aspects of the laws of these jurisdictions that officials report are problematic.

## CONCLUSIONS AND RECOMMENDATIONS

52. Based on the analysis above, the table below summarises the conclusions of the regulatory impact analysis.

Area of reform	Options	Analysis against the objective and criteria
Taxing employees’ income	<b>Option A</b> – status quo	<i>Does not meet the main objective</i>
	<b>Option B</b> – tax employee on grant	<i>Does not meet the main objective</i>  Neutrality xx Equity x Compliance costs xx Administrative costs xx Integrity x
	<b>Option C</b> – tax employee when the shares vest  Preferred option	<i>Meets the main objective</i>  Neutrality ✓✓ Equity ✓✓ Compliance costs ✓ Administrative costs ✓ Integrity ✓✓
	<b>Option C2</b> – same as Option C above, but tax options when they vest, not when they are exercised	<i>Partially meets the main objective</i>  Neutrality ✓ Equity ✓ Compliance costs ✓ Administrative costs ✓ Integrity ✓✓
	<b>Option D</b> – tax employee when they sell the shares	<i>Partially meets the main objective</i>  Neutrality xx Equity xx Compliance costs x Administrative costs xx Integrity xx
Allowing deductions for employers’ costs	<b>Option A</b> – Status quo	<i>Does not meet the main objective</i>
	<b>Option B</b> – Matching deduction  Preferred option	<i>Meets the main objective</i>  Neutrality ✓✓ Equity ✓✓ Compliance costs x Administrative costs ✓ Integrity ✓✓
	<b>Option C</b> – following IFRS	<i>Does not meet the main objective</i>  Neutrality xx Equity xx Compliance costs xx Administrative costs x Integrity xx

Tax concession for widely-offered schemes	Option A – status quo	<i>Does not meet the main objective</i>
	Option B – repeal tax concessions for widely-offered schemes	<i>Meets the main objective</i> Neutrality ✓ Equity ✓ Compliance costs ×× Administrative costs ×× Integrity ✓✓
	Option C – retain and modernise widely-offered schemes  Preferred option	<i>Meets the main objective</i> Neutrality × Equity × Compliance costs ✓✓ Administrative costs ✓✓ Integrity ✓

53. In summary, the proposed package involves aligning the taxing point of ESS with when the employee has earned the shares and generally holds them like other shareholders, allowing employers a matching deduction and modernising the widely-offered tax-exempt schemes.

54. It is difficult to quantify the direction or size of the fiscal impacts from this combined package relative to baseline estimates since there is no New Zealand data on the amount of income from ESS. However, on balance the proposals are expected to raise revenue of \$30 million per annum once fully phased in.

## IMPLEMENTATION

55. The preferred options will primarily require changes to the ITA.

56. Officials recommend any legislative changes be included in the taxation bill scheduled for introduction in early 2017 and should generally apply, unless otherwise stated, from enactment.

57. Transitional rules are very important to ensuring the reforms are fair and give companies and employees an opportunity to update their schemes. However, there is also a need to prevent opportunities for tax structuring. We consulted extensively on transitional rules as part of the consultation on the policy proposals.

58. In broad terms, the transitional rules proposed give companies six months post-enactment where the old law still applies, so they can update their schemes with the benefit of looking at finalised legislation.

59. Specifically, for ESS benefits issued in the ordinary course, there will be:

- a. open-ended grandparenting for ESS existing before the issues paper was released in May 2016 if there is a taxing point under the existing law (the “old taxing point”) before the 6 month period ends; and
- b. grandparenting for other schemes where the old taxing point falls within that 6 month period and the new taxing point occurs before a sunset date of 1 April 2022.

60. The transitional rules have been designed to minimise compliance costs for businesses and employees in moving to the new rules.

61. Otherwise the new rules should apply from the date of enactment.

62. When introduced into Parliament, a commentary on the bill will be released explaining the amendments and further explanation of their effect will be contained in Inland Revenue's *Tax Information Bulletin*, which would be released shortly after the bill receives Royal assent.

63. Inland Revenue will administer the proposed changes. Enforcement of the changes would be managed by Inland Revenue as business as usual.

64. Inland Revenue has completed an impact assessment of the policy proposal and is confident that it has the capacity to provide the administrative measures necessary to implement these reforms.

## **MONITORING, EVALUATION AND REVIEW**

65. In general, Inland Revenue's monitoring, evaluation and review of these proposals would take place under the generic tax policy process (GTPP). The GTPP is a multi-stage policy process that has been used to design tax policy (and subsequently social policy administered by Inland Revenue) in New Zealand since 1995.

66. 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 built into this stage. In practice, any changes identified as necessary would be added to the tax policy work programme, and proposals would go through the GTPP.

67. Because there is no quantitative data on the use of ESS to provide remuneration, it will not be possible to judge the effect of the proposals either on the amount of ESS benefits provided in the economy or on the amount of tax collected on ESS benefits.