

Coversheet: Introducing a new top personal income tax rate

Advising agency	Inland Revenue
Decision sought	Agreement to introduce a new top personal income tax rate of 39 percent for income over \$180,000
Proposing Ministers	Minister of Finance Minister of Revenue

Summary: Problem and Proposed Approach

Problem Definition

What problem or opportunity does this proposal seek to address? Why is Government intervention required?

As signalled in the Labour party's 2020 Election Manifesto, the Government has committed to introducing a new top personal income tax rate of 39 percent on income over \$180,000. This is to meet two objectives:

- A **revenue objective**: The Government is raising extra revenue to reduce the fiscal impact of higher operating allowances proposed in its fiscal strategy.
- A **distributional objective**: The Government is seeking to raise this additional revenue in a way which has as little as possible impact on low- and middle-income earners and thus increases the progressivity¹ of the tax system.

This Impact Statement analyses how to implement the new rate in a way that best meets the Government's **revenue** and **distributional** objectives while minimising unintended impacts.

¹ Progressivity of income tax refers to the degree to which the tax system taxes a larger share of an individual's income as it increases.

Summary of Preferred Option or Conclusion (if no preferred option)

How will the agency's preferred approach work to bring about the desired change? Why is this the preferred option? Why is it feasible? Is the preferred approach likely to be reflected in the Cabinet paper?

The proposal is for a new marginal tax rate and threshold to raise the top personal income tax rate. The options identified in this Impact Statement analyse the other potential changes that could be made to complement and/or buttress the introduction of a 39 percent tax rate on income exceeding \$180,000.

Option 5 is for the 39 percent personal rate to be implemented alongside a corresponding increase in the trustee income tax rate (the trustee rate) and with consideration of integrity measures, s 9(2)(f)(iv), over the next year. This is Inland Revenue's preferred option.

This is the preferred option as it will reduce opportunities to avoid the 39 percent personal income tax rate through the use of trusts. For example, without increasing the trustee rate, income can be taxed in a trust at a rate of 33 percent and then distributed tax-free to a beneficiary of the trust. Increasing the trustee rate eliminates this possibility for stepping around the 39 percent rate.

s 9(2)(f)(iv)

Alignment of the top personal income tax rate and the trustee rate, with integrity measures being investigated over the next year, will ensure that both the **revenue objective** and the **distributional objective** are best met when introducing a new top personal income tax rate.

Option 4, which increases the top personal rate without increasing the trustee rate but involves consideration of integrity measures, will be less effective than **Option 5** at preventing structuring activity with the purpose of avoiding the top tax rate due to continuing misalignment of tax rates.

Inland Revenue expects **Option 4** and **Option 5** to be raised in the Cabinet paper as alternative options, with timing variation options for raising the trustee rate also being presented. Inland Revenue's preferred approach is **Option 5**.

Section B: Summary Impacts: Benefits and costs

Who are the main expected beneficiaries and what is the nature of the expected benefit?

In general, all taxpayers not subject to a new top personal income tax rate will benefit from higher government expenditure or lower expected tax rates on their income in the future.

Assuming **Option 2** (raising the top personal rate with no change to the trustee rate), the introduction of a new top personal income tax rate will generate more revenue for the

Government. This is likely to be used to reduce the fiscal impact of higher operating allowances proposed in the Government's fiscal strategy.

Introducing a new top personal rate of 39 percent applying to income over \$180,000 (without any other changes to tax settings) is expected to raise \$2.22 billion over the forecast period as shown in **Table 1**:

Table 1: Estimated revenue from a 39 percent tax rate on income above \$180,000²

Fiscal year	2020/21	2021/22	2022/23	2023/24	2024/25	Total over forecast period
Estimated tax revenue (\$m)	95	160	830	540	595	2,220

These revenue estimates are highly uncertain. This uncertainty arises because:

- The revenue estimates are sensitive to assumptions about how much people change their behaviour in response to the tax (e.g. reducing hours, diverting income into another entity). There is significant uncertainty in these assumptions and changing them results in substantial changes in revenue.
- The full impact of COVID-19 on the income distribution is not yet clear.

This proposal will raise additional tax revenue from some high-income earners with no direct impact on low- and middle- income earners. It is likely to increase the progressivity of the tax system and reduce measured after-tax income inequality.

The Treasury estimates that a 39 percent top personal rate applying to income above \$180,000 (without any other changes to tax settings) will reduce the Gini coefficient³ for individual after-tax income by an estimated 0.2 percentage points (from 0.493 to 0.491). This small impact reflects the relatively few people earning above \$180,000 and, consequently, the relatively small impact this tax increase has on the overall income distribution. This is a very imprecise impact as it assumes no behavioural response and does not account for shifting of income into other (lower-taxed) entities.⁴

The benefits of the proposal will reduce to the extent that the 39 percent tax rate can be sidestepped by taxpayers e.g. by earning income through a trust. Therefore, options which reduce the scope for this behaviour will increase the benefits of the proposal. As shown in **Table 2**, raising the trustee rate at the same time as the top personal rate (**Option 5**) is expected to raise \$3.7 billion in total over the forecast period.

² The figures in **Table 1** and **Table 2** are affected by the timing of provisional and final tax payments. The revenue has a lumpy profile due to the timing of provisional and terminal tax of non-wage earners. Initially, non-wage earners are forecast to pay the higher top personal rate through terminal tax, which is measured with a lag as returns for 2021/22 are filed during the 2022/23 fiscal year. Subsequently, they pay the higher top personal rate through provisional tax payments also impacting the 2022/23 fiscal year. This results in a spike measured within the 2022/23 fiscal year.

³ The Gini coefficient is one measure of income inequality ranging from zero (perfect equality; a uniform income distribution) to one (maximal inequality; one person derives all income).

⁴ Unless effective integrity measures are adopted, it could be regressive at the highest income levels where people earning amounts just over \$180,000 pay a marginal tax rate of 39 percent and people earning very high incomes from businesses and investments pay a marginal tax rate of 33 percent.

Table 2: Estimated revenue from a 39 percent tax rate on income above \$180,000, and an increase in the trustee rate to 39 percent

Fiscal year	2020/21	2021/22	2022/23	2023/24	2024/25	Total over forecast period
Estimated tax revenue (\$m)	95	355	1,390	890	975	3,705

Where do the costs fall?

Introducing a new top personal income tax rate as designed in this proposal will directly impact those people earning above \$180,000 of personal income. This includes salary and wage earners, investors holding assets and shares directly, as well as sole traders and partners in partnerships. The additional expected tax paid by this group is noted in the section above (\$2.22 billion over the forecast period if the 39 percent rate is introduced without any other changes). An increase in the trustee rate would impose the 39 percent tax rate on taxpayers who benefit from income in trusts, resulting in total tax of \$3.7 billion over the forecast period.

Table 3 below shows the number of people potentially impacted by the introduction of a higher top personal rate and the additional tax they would pay. The table assumes no change in the income distribution as a result of COVID-19-related shocks.

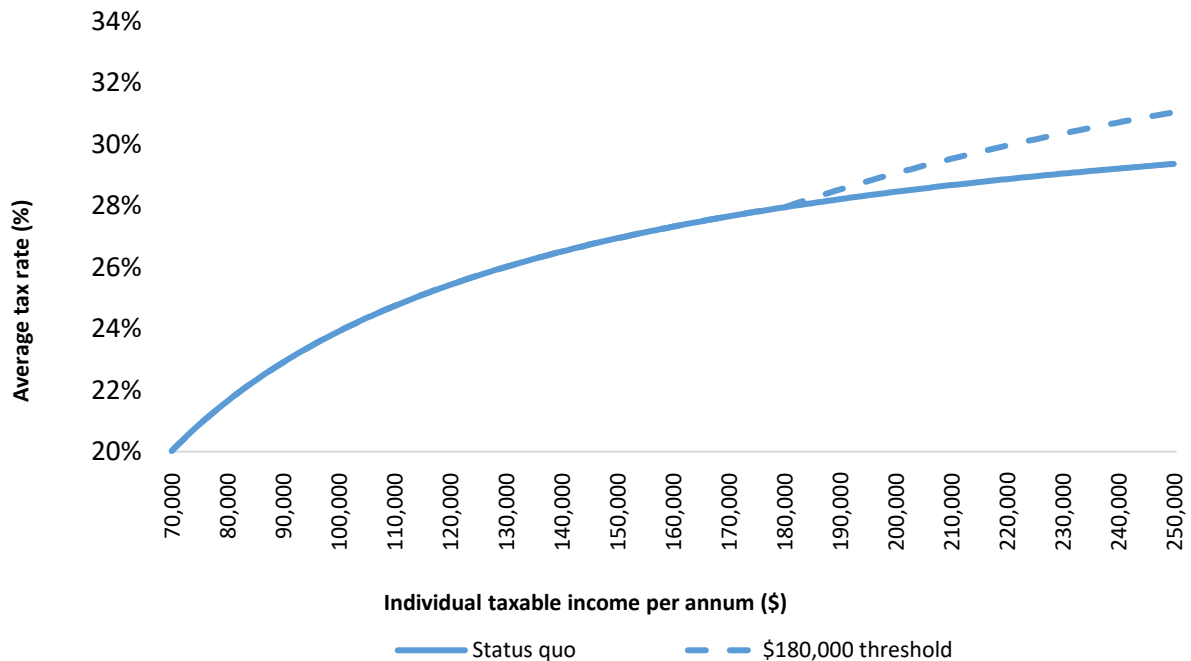
Table 3: Number of people and additional tax to pay with new top personal rate of 39 percent (using 2018/2019 income year data)

For individuals earning between	Number of people (2018/2019)	Maximum additional tax an individual would pay (\$)
\$180,000 - \$190,000	10,500	600
\$190,000 - \$200,000	8,600	1,200
\$200,000 - \$210,000	7,000	1,800
\$210,000 - \$220,000	7,000	2,400
\$220,000 - \$230,000	5,700	3,000
\$230,000 - \$240,000	4,800	3,600
\$240,000 - \$250,000	4,200	4,200
\$250,000+	38,900	>4,200
Total:	86,700	N/A

Source: Inland Revenue and The Treasury.

Figure 1 below illustrates how an increase in the marginal tax rate to 39 percent for income above \$180,000 would increase average personal tax rates for individuals. This graph only relates to income taxed at the personal rate (i.e. does not include trustee, company, or PIE income).

Figure 1: Average tax rates for top rate of 39 percent applying at \$180,000



Source: The Treasury.

If more structuring activity than expected occurs as a result of people avoiding the 39 percent rate, then the revenue generated by this proposal will be less than forecast. This has non-monetary impacts as well, such as eroding public confidence in the tax system and voluntary compliance. This would have a negative impact on tax integrity.

The Cabinet paper proposes that Inland Revenue will collect more information on trust assets, liabilities, and distributions. This will increase compliance costs for trustees on top of recent changes to the Trust Act 2019, but it is necessary to ensure the effectiveness of the policy and it will be an important part of monitoring any systemic issues. These costs will be mitigated by endeavouring to collect the information in the most efficient manner, but a lack of consultation may mean that lower-cost options to collect the information are missed. The cost is likely to be material because of the large number of trustee tax returns (245,000) Inland Revenue collects annually.

What are the likely risks and unintended impacts? How significant are they and how will they be minimised or mitigated?

The unintended impacts of the proposal can generally be categorised as **economic impacts** or **integrity impacts**. The main risk of the proposal is that the tax revenue collected from the proposal may be less than expected due to structuring arrangements.

Unintended **economic impacts** include the efficiency costs from higher taxes on individual investment and savings, business investment, and human capital and labour markets. These are inevitable (but unintended) downsides of a new higher top marginal tax rate. The costs are likely to be higher per dollar of revenue raised the easier it is for high-income earners to sidestep the new higher tax rate. If it is particularly easy to step around paying higher rates of tax, the additional revenue raised falls while total costs increase as more people change their behaviour, even if the cost to any individual is small. This results in the costs per dollar of

revenue raised being high, because the numerator (costs) likely grows while the denominator (revenue) falls.

Given that the Government has committed to introducing a new top personal income tax rate, Inland Revenue is recommending an option that minimises the unintended economic impacts through ensuring alignment of the top personal rate and the trustee rate as well as further investigation of integrity measures.

Unintended **integrity impacts** include impacts resulting from structuring to avoid the 39 percent rate. Inland Revenue considers the risk of these impacts to be significant and the preferred approach for mitigating these risks is to increase the trustee rate as well as investigating integrity measures. The integrity risks can be mitigated in two ways:

- By imposing a 39 percent rate on trustee income, since trusts are the primary vehicle that high-income taxpayers are most likely to use to divert income that would otherwise be taxed at their 39 percent personal rate.⁵
- By investigating specific integrity measures ^{s 9(2)(f)(iv)} [REDACTED]. These would necessarily be less effective than taxing the entities themselves at 39 percent.

A more substantial discussion of these impacts is included later.

Section C: Evidence certainty and quality assurance

Agency rating of evidence certainty?

Tax policy settings and the impact of tax rate changes have been comprehensively studied both nationally and internationally. Theoretical effects of tax rate changes are well-established and are mostly supported by empirical research. Inland Revenue collects comprehensive data on relevant parameters concerning tax rate changes, such as on distributions of taxable income, on self-employment data, on trustee income, and other measures.

Inland Revenue is confident that it can assess the likely *qualitative* and *directional* impacts of the proposal. However, it is recognised that there is significant uncertainty in attempting to quantify the *magnitudes* of these impacts. This is largely because it is difficult to forecast the aggregate behavioural response to an increase in the top personal income tax rate. This uncertainty will become even greater over time as more people consider whether they can successfully step around the new rate via a structuring arrangement.

There is also a risk to the expected benefit associated with a high level of uncertainty surrounding the revenue estimates. This is a further consequence of being unable to accurately predict the overall behavioural response to the proposal. This uncertainty has been emphasised in advice provided to the Government.

⁵ This would still allow taxpayers to divert income to a company, which would be taxed on that income at 28 percent. That income would then be subject to a further 11 percent of tax when distributed to the shareholder. This reduces the attractiveness of companies to avoid the 39 percent rate compared to trusts. However, it does not eliminate it, as the company could still be sold by the taxpayer without any further tax impost.

To be completed by quality assurers:

Quality Assurance Reviewing Agency:

Quality Assurance Panel with representatives from Inland Revenue and the Treasury.

Quality Assurance Assessment:

The Quality Assurance Panel considers that the information and analysis summarised in the RIS **partially meets** the quality assurance criteria. This is because some key elements of the proposals have not been consulted on and will not be consulted on prior to being implemented.

As noted in section 2.4, stakeholders are likely to raise concerns with the lack of consultation on proposed changes to increase the trustee tax rate and to introduce new information reporting requirements for trusts. Under these proposals additional tax and compliance costs would be imposed on a large number of trustees – Inland Revenue receives approximately 245,000 income tax returns from trustees per year.

The absence of consultation means Inland Revenue currently has a limited understanding of the compliance costs that trusts will face with the proposed new information requirements and how large these costs are. The RIS was therefore unable to determine whether the potential integrity benefits from the proposed trust information disclosure outweighed the compliance costs it would impose. However, as noted in section 7.2, Inland Revenue will conduct a post-implementation review of the proposed information requirements for trusts in 2021 which will include consultation with the affected trustees to determine the compliance costs associated with the new requirements and to identify if any changes could be made to reduce these compliance costs. In addition, the lack of consultation was a constraint imposed on the policy process in order to implement the proposal for the 2021/22 tax year, and the risks caused by this lack of consultation are clearly spelt out in the RIS.

The RIS does not consider the options presented in the Cabinet paper for collecting past-year information from trusts and for collecting trust information for purposes other than the proposed 39% personal tax rate. If these options are taken by Cabinet, the compliance costs imposed by these options should be included in the post-implementation review of the trust information measure.

Section 2.4 also notes that Inland Revenue intends to consult with stakeholders on the other proposed integrity measures § 9(2)(f)(iv) over the first half of 2021 so that they can be legislated for 1 April 2022.

Reviewer Comments and Recommendations:

Impact Statement: Introducing a new top personal income tax rate

Section 1: General information

1.1 Purpose

Inland Revenue is solely responsible for the analysis and advice set out in this Regulatory Impact Statement, except as otherwise explicitly indicated. This analysis and advice have been produced for the purpose of informing key policy decisions to be taken by Cabinet.

This Impact Statement analyses the Government's proposal to introduce a new top personal income tax rate of 39 percent on incomes over \$180,000. This was the Labour party's main tax policy in its fiscal plan released ahead of the 2020 General Election.

A number of different options are considered in this Impact Statement for the purposes of introducing a new top personal income tax rate.

1.2 Key Limitations or Constraints on Analysis

The key limitations and constraints applying to the analysis in this Impact Statement are as follows:

- Restricted range of options considered:** The Government has already announced its intention to introduce a new top personal income tax rate of 39 percent on income over \$180,000 as part of the Labour party's 2020 Election Manifesto. The approaches considered in this Impact Statement are limited to options that could better ensure (based on traditional tax policy criteria) that this proposed top rate applies to taxpayers as broadly as intended while minimising negative impacts. It does not consider any other ways of achieving the Government's objectives given the pre-election announcement.
- Time constraints:** Ministers have decided to plan for the introduction of the new top personal income tax rate from the 2021–22 income year onward (1 April 2021 for most taxpayers). With that commencement date in mind, the proposals must be included in legislation introduced before 31 December 2020 to allow payroll software providers and employers enough time to update their systems. That leaves a significantly shortened amount of time to undertake sufficient analysis of this proposal.
- Uncertainty surrounding magnitude of impacts:** Inland Revenue has a strong evidence base to determine the expected qualitative effects of a higher top personal income tax rate but cannot easily quantify the magnitudes of these effects. Revenue estimates throughout this Impact Statement are sensitive to assumptions about how much people change their behaviour in response to the new rate (e.g., reducing hours, diverting income into another entity). One assumption underlying the estimates is that there is no change in the income

distribution because of current and future COVID-19-related shocks. There is significant uncertainty in these assumptions and changing them results in substantial changes in revenue. Hence, some estimates provided in this Impact Statement are subject to a wide margin of error, while other impacts are unable to be estimated at all.

- **Consultation:** The speed at which this proposal is being advanced has meant that no active consultation has taken place. However, the intention to introduce a new top personal income tax rate was announced to the public prior to the 2020 general election, so taxpayers have been notified of the intended policy change. Inland Revenue also recommends implementing integrity measures alongside introducing a new top personal income tax rate. It would seek to consult on these measures in 2021 with implementation for 1 April 2022 (a year after the introduction of the new top personal tax rate). Inland Revenue will seek feedback on the proposed information reporting requirements for trusts following their implementation. This will occur in lieu of formal consultation before the requirements come into effect but will allow Inland Revenue to evaluate post-implementation whether the benefits of the requirements outweigh the compliance costs imposed upon trustees.

1.3 Responsible Manager:



Phil Whittington
Chief Economist
Policy and Strategy
Inland Revenue

18 November 2020

Section 2: Problem definition and objectives

2.1 What is the current state within which action is proposed?

New Zealand's tax system is based on a broad-base low-rate framework. This means that the system seeks to minimise exemptions/concessions (broad-base) while mitigating any distortionary effects arising from absolutely or relatively high taxes (low-rate). This ensures that substantial amounts of revenue can be raised by the Government without having high tax rates. This provides two benefits:

- Tax-induced distortions between different activities are minimised by having the widest possible base.
- The widest possible base means a lower rate of tax is sufficient to collect required revenue. This lower rate of tax minimises any distortions between any remaining non-taxed and taxed activities.

Within this framework, New Zealand has a progressive personal income tax scale. This means that the system taxes a larger share of an individual's income as it increases. There are currently four rates and thresholds within the New Zealand personal income tax system:

For each dollar of income between:	Marginal tax rate:
\$0 to \$14,000	10.5%
\$14,001 to \$48,000	17.5%
\$48,001 to \$70,000	30.0%
\$70,001 and upward	33.0%

These rates have been in place since 1 October 2010. New Zealand had a top personal income tax rate of 39 percent from 1 April 2000 to 31 March 2009 (and an effective 38 percent rate from 1 April 2009 to 30 September 2010).

The progressiveness of the personal income tax scale affects several other areas of the tax system, including secondary earnings and extra pay codes, fringe benefit tax, resident withholding tax, resident land withholding tax, and employer superannuation contribution tax.

New Zealand's tax system taxes trustee income at a rate of 33 percent, and distributions of trustee income from complying trusts to beneficiaries are non-taxable. Beneficiary income is taxed at the beneficiary's marginal rates⁶ (subject to the minor beneficiary rule).

Portfolio investment entities (PIEs) are collective investment vehicles that pool contributions from many people for investment purposes. Income from PIEs is taxed at rates that approximate personal income tax rates. One of the key differences is that the top PIE rate is 28 percent (rather than 33 percent in the personal income tax scale). This was set due to a concern that, unless the top PIE rate matched the company rate (28

⁶ Whether income is treated as trustee income or beneficiary income depends on when it is distributed. Income is beneficiary income if it is distributed by the trust to the beneficiary within six months from the end of the income year in which the income is derived. Any income accumulated by a trustee for longer than this is taxed as trustee income.

percent), taxpayers would use unit trusts (unit trusts are taxed at the company rate) and avoid dividend taxation at their personal rate by having the managers of the unit trusts buy back their units. Buy-back arrangements like this are not treated as dividends and the taxpayer's profit from the buyback is usually a non-taxable capital gain.

Other important tax rates in New Zealand include a company rate of 28 percent and GST of 15 percent. Changes to these settings are out of scope for this Impact Statement.

2.2 What regulatory system(s) are already in place?

The tax system is a key regulatory system in New Zealand. Tax enables the government to fund its desired spending. The tax system has a regulatory role of raising revenue in an efficient and fair way. It is desirable that the tax system is easy to comply with and hard to avoid or evade.

The tax system is mostly administered by Inland Revenue. Inland Revenue is responsible for administering several different Acts and Legislative Instruments. The key tax legislation is contained in the Income Tax Act 2007 and the Tax Administration Act 1994.

2.3 What is the policy problem or opportunity?

The primary role of tax policy is to raise revenue for the government to spend on its functions. Good tax policy seeks to raise revenue in a way that is efficient (at a low cost to the economy as a whole) and fair (for example, taking into account distributional objectives).

Inland Revenue understands that the Government wishes to raise extra revenue to reduce the fiscal impact of higher operating allowances proposed in its fiscal strategy, and that this revenue collection should have as little an impact as possible on low- to middle-income earners and add to progressivity.

As signalled in the Labour party's 2020 Election Manifesto, the Government has committed to introducing a new top personal income tax rate of 39 percent on income over \$180,000. This is to meet two objectives:

- A **revenue objective**: The Government is raising extra revenue to reduce the fiscal impact of higher operating allowances proposed in its fiscal strategy.
- A **distributional objective**: The Government is seeking to raise this additional revenue in a way which has as little as possible impact on low- and middle-income earners and which thus increases the progressivity of the tax system.

This Impact Statement analyses how to implement the new rate in a way that best meets (using traditional tax policy criteria) the Government's **revenue** and **distributional** objectives while minimising unintended impacts.

2.4 What do stakeholders think about the problem?

The personal income tax system directly affects all New Zealanders, whether that is through each individual taxpayer being liable for an amount of income tax or through the Government's spending as a result of income tax collection, or both. Any way of raising additional revenue that falls on some taxpayers and not on others is likely to be of most concern to those who are directly affected.

A July 2020 Newshub-Reid Research poll found that 50 percent of those polled⁷ supported an additional higher income tax bracket.⁸ In contrast, an August 2020 *BusinessNZ* survey found that only 9 percent of the 1,193 business respondents supported increases in personal tax rates to address the fiscal challenges of COVID-19.⁹

Inland Revenue has regular engagement with tax practitioners on policy issues/proposals and is aware of comments made in the media by parts of the sector regarding this proposal.¹⁰ There is concern that, without corresponding increases in the trustee rate and the top PIE rate, the 39 percent rate will apply to wage/salary earners but investment income will be able to be earned through companies, PIEs, and trusts at lower rates.¹¹ There are concerns that this would be unfair and reduce the integrity of the tax system. The proposal would exacerbate existing tax system pressures associated with unaligned rates.¹² Because of these reasons, many commentaries are forecasting that the introduction of a new top personal income tax rate will raise less revenue than the \$550 million estimated by the Labour party in its 2020 Election Manifesto.

One public viewpoint is that the proposal comprises only a small adjustment to tax rates given the number of people it affects and the extent to which it affects them. The proposal can be perceived as a signal that redistribution to meet the Government's wider objectives might happen through channels outside of the tax system.¹³

Other public commentary on the policy has expressed an opinion that there have long been deficiencies in the redistribution of income, and so the proposal is a step in the right direction to fix that problem. At the same time, some people believe that this problem will exist after the implementation of the policy as well since they believe it does not go far enough.¹⁴

⁷ No sample size provided, though Newshub-Reid Research polls tend to have a sample size of 1,000.

⁸ See <https://www.newshub.co.nz/home/politics/2020/08/newshub-reid-research-poll-half-of-kiwis-support-taxing-biggest-earners-at-higher-rate.html>

⁹ See page 8 of <https://www2.deloitte.com/content/dam/Deloitte/nz/Documents/public-sector/businessnz-2020-election-survey.pdf>

¹⁰ See, e.g., <https://www.stuff.co.nz/business/122708323/labours-ultracautious-tax-policy-will-be-a-relief-to-the-wealthy>; <https://www.stuff.co.nz/business/123131106/labours-promised-tax-hike-may-create-rush-to-tax-lawyers>

¹¹ See, e.g., <https://thespinoff.co.nz/business/16-09-2020/labours-dead-end-tax-policy-is-straight-out-of-last-century/>

¹² See, e.g., <https://www.stuff.co.nz/business/122712011/wealthy-could-mostly-get-around-the-39-top-tax-rate-experts-say>

¹³ See, e.g., <https://www.nzherald.co.nz/nz/election-2020-labours-balanced-tax-plan-draws-flak-from-political-allies-and-rich-lister/GL4F6L7GPA456TUXLNKZPPVCDY/>

¹⁴ See, e.g., <https://thespinoff.co.nz/politics/13-09-2020/labour-and-national-promise-to-lock-in-existing-unfairness-in-nzs-tax-system/>

Some people have noted the pre-election statements that the trustee rate would not be increased. They recognise that there is an existing problem regarding misalignment between companies/PIEs and the top personal rate/trustees, and that this problem is exacerbated by not increasing the trustee rate. At the same time, it was noted that Inland Revenue will be expected to crack down on any aggressive structuring that seeks to exploit the discrepancies between the tax rates of different entities.¹⁵

Given the short timeframes for developing and implementing this proposal, Inland Revenue has not undertaken any active consultation to date on introducing a new top personal income tax rate.

Inland Revenue intends to consult with stakeholders on the possible integrity measures over the first half of 2021 so that they can be legislated for 1 April 2022. Inland Revenue considers that the success of these integrity measures depends on sufficient engagement with stakeholders given their potential complexity compared to the introduction of the new top personal rate alone. Although these measures would still come into effect quicker than preferred, Inland Revenue believes that the benefits of consultation during 2021 outweighs the potential integrity benefits of implementing these measures in 2021 with no consultation.

If options other than **Option 2** are progressed, the lack of consultation on issues to do with the trustee rate will likely be raised as a particular concern. However, if the Government raises the trustee tax rate, consultation may still be able to occur to provide useful information on potential over-taxation problems, with any solutions being able to resolve problems in the future, or potentially with retrospective effect if the design of solutions allows that.

The absence of consultation is likely to result in Inland Revenue having a limited understanding of the compliance costs that trusts will face with the new information requirements and how large these costs are. Inland Revenue will conduct a post-implementation review of the proposed information requirements for trusts, which will include consultation with the affected trustees to determine the compliance costs associated with the new requirements and to identify if any changes could be made to reduce these compliance costs.

2.5 What are the objectives sought in relation to the identified problem?

There are two objectives sought in relation to the issues discussed:

- A **revenue objective**: The Government is raising extra revenue to reduce the fiscal impact of higher operating allowances proposed in its fiscal strategy.
- A **distributional objective**: The Government is seeking to raise this additional revenue in a way which has as little as possible impact on low- and middle-income earners and is progressive.

The analysis will focus on how well each proposed option meets these **revenue** and **distributional** objectives by applying traditional tax policy criteria which provide an analytical framework to assess strengths and weaknesses of individual options.

¹⁵ See, e.g., <https://www2.deloitte.com/content/dam/Deloitte/nz/Documents/tax/Tax-alert/2020/nz-en-tax-alert-november-2020.pdf>

Section 3: Option identification

3.1 What options are available to address the problem?

This options analysis looks at several packages of key design options for introducing a new top personal income tax rate of 39 percent for income over \$180,000.

The options identified here differ in two ways – those are whether or not they incorporate:

- **Alignment** of the top personal income tax rate and the trustee income tax rate.¹⁶
s 9(2)(f)(iv)
- **Integrity measures** designed to minimise opportunities for structuring activity with the purpose of avoiding the new personal rate.

The analysis investigates each of the following options:

- **Option 1:** Status quo.
- **Option 2:** Introducing a new top personal income tax rate of 39 percent for income over \$180,000 (**no alignment** and **no integrity measures**).
- **Option 3:** **Option 2** plus increasing the trustee income tax rate to 39 percent (**alignment with trustee rate** but **no integrity measures**).
- **Option 4:** **Option 2** plus investigating integrity measures to buttress the new higher personal income tax rate (**no alignment** but **integrity measures**).
- **Option 5:** **Option 2** plus both increasing the trustee income tax rate to 39 percent and investigating integrity measures to buttress the new higher personal income tax rate (**alignment with trustee rate** and **integrity measures**).

These options are assessed against five criteria:

- **Efficiency:** The options should minimise the excess burden or economic efficiency cost of the tax system (i.e., the cost of raising tax from New Zealanders which is over and above the tax revenue actually raised). This ensures that tax is doing as little as possible to distort labour supply, savings and investment, and entity decisions.
- **Equity:** The options should ensure that taxpayers with similar levels of income pay similar levels of tax (horizontal equity) and that taxpayers on higher incomes pay higher levels of income tax in a way which reflects the Government's views on how progressive the tax system should be (vertical equity). In Inland Revenue's assessment of the options, the phrase "improves vertical equity" is used if a measure better meets the Government's distributional objective of increasing the progressivity of the tax system.

¹⁶ Alignment of rates in tax contexts can also include the company rate. No change to the company rate is contemplated as part of this Impact Statement because a change to this rate is considered to be out of scope of the Government's proposal. The company tax rate has impacts beyond its role taxing New Zealanders, including impacts on foreign investment.

- **Complexity:** The options should minimise the introduction of complexity as much as possible. Generally, complexity should be minimised so that tax laws are easy to comply with and difficult not to. This encourages voluntary compliance over time, which benefits both the tax take as well as paying tax at rates intended by the Government.
- **Integrity:** The options should maintain protection against taxpayers using other vehicles taxed at lower rates to avoid the proposed top personal income tax rate. Integrity in the tax system ensures that taxpayers cannot access methods or vehicles to avoid paying tax at rates applicable to them given their economic circumstances. This also leads to greater collection of tax revenues as well as high-income individuals paying their full amount of tax without being able to successfully engage in avoidance behaviour. This improves the fairness of the tax system and is an important factor that supports voluntary compliance.
- **Revenue raised:** The options should be effective at raising the intended amount of revenue for the Government. Using this criterion is important to ensure the primary function of tax collection is achieved by the policy settings.

The analysis of the five options against these five criteria follows.

Option 1: Status quo.

This option involves doing nothing. It therefore fails to achieve the Government's fundamental revenue objective. It retains the distributional and progressivity outcomes resulting from the current personal income tax settings.

Efficiency: There is no gain or loss in efficiencies associated with leaving the top personal income tax rate at 33 percent for incomes over \$70,000. This is a notably low upper tax rate compared to the highest rate imposed in other jurisdictions. However, it applies at a low threshold.

Equity: The status quo has no impact on any dimension of equity in the tax system.

Complexity: The status quo has no impact on complexity. The existing settings are well understood publicly.

Integrity: The status quo has no impact on integrity but there are already existing concerns with taxpayers undertaking arrangements that seek to avoid the application of the current top personal income tax rate of 33 percent. This is partly a function of the existing misalignment between that rate and the company rate. For example, dividend avoidance arrangements can allow a shareholder taxed at 33 percent to derive income from a company that is only subject to the corporate tax rate of 28 percent (with no 5 percent top-up tax).

Revenue raised: No change in revenue raised under the status quo.

Option 2: Introducing a new top personal income tax rate of 39 percent for income over \$180,000 (no alignment and no integrity measures).

This option constitutes the existing commitment contained in the Labour party's 2020 Election Manifesto regarding a new higher top personal income tax rate. It will also include consequential changes to secondary earnings and extra pay codes, fringe benefit tax, resident withholding tax, resident land withholding tax, and employer superannuation contribution tax (and this will be true for all options except for the status quo). No integrity measures would be implemented to guard against avoidance activities. However, there would still be data monitoring by Inland Revenue. This would include Inland Revenue collecting more information on trust assets, liabilities, and distributions (and again, this will be true for all options except for the status quo). This will increase compliance costs for trustees, but it will be an important part of monitoring any systemic avoidance issues.

The consequential changes to other tax types and trust information collection will not constitute part of the analysis between options since they hold true for all options bar **Option 1**.

Efficiency: The introduction of a higher top personal income tax rate, all else being equal, will create further disincentives to earn income above the level at which that new rate applies from. This change is likely to have a number of efficiency costs including through its impacts on labour supply, savings, and through influencing the allocation of investment. The efficiency costs are likely to be high per dollar of additional revenue raised compared to alternative ways to raise that revenue (including **Option 3**, **Option 4**, and **Option 5**) because of increased tax-induced activity of people circumventing higher rates of tax (an efficiency cost), and consequential lower amounts of additional revenue raised. If it is particularly easy to step around paying higher rates of tax, the additional revenue raised falls while total costs increase as people change their behaviour, even if the cost to any individual is small. This results in the costs per dollar of revenue raised being high, because the numerator (costs) likely grows while the denominator (revenue) falls.

Equity: Introducing a new top personal tax rate will support the Government's objective of raising additional revenue in a way that adds to progressivity without impacting on low- or middle-income earners. Individuals earning above \$180,000 will have a greater amount of tax collected from them. However, incentives to structure around the new rate may result in a decrease in horizontal equity and a reduction in the progressivity benefits. Some people will find it too costly/difficult to structure to avoid the new rate (e.g., salary/wage earners), whereas other high-income earners will choose and be able to structure around the rate when they might not have under the status quo. This would decrease horizontal equity between people earning over \$180,000. It could also be regressive within the group of taxpayers earning over \$180,000. This is because people earning a little over \$180,000 may be unwilling (due to the cost of setting up structures compared to the tax saving) or unable (due to their income being wages and salary) to reduce their marginal tax rate from 39 percent to 33 percent. However, taxpayers earning a lot more than \$180,000 are more likely to derive income that can be diverted into structures (primarily trusts) that will allow them to effectively have a personal income tax rate of 33 percent, while also being more likely to have such structures. Therefore, the wealthiest will be taxed at a lower rate than those earning just over \$180,000.

Complexity: The introduction of a new rate alone will increase complexity to the extent that it raises questions and induces compliance activity about whether structuring around the rate constitutes tax avoidance. It will impose compliance costs on taxpayers that need to make systems changes to accommodate the new rate. However, the absence of new integrity measures under this option also means that, outside of the question of what does and does not constitute tax avoidance, it is not significantly complex.

Integrity: This option has the worst integrity outcomes. It is worse than the status quo; under existing settings, the top personal rate is the same as the trustee rate and 5 percentage points higher than the company rate and the top PIE rate. Under this option, that discrepancy would increase to an 11 percentage-point discrepancy between the top personal rate versus the company rate and the top PIE rate, and it would introduce a 6 percentage-point discrepancy between the top personal rate versus the trustee rate. This will create significant incentives for entering into arrangements to avoid the 39 percent rate. The difference between the top personal rate and the trustee rate is particularly significant, as earning income through a trust is the easiest way to avoid the top personal tax rate. The existing general anti-avoidance provision can provide some integrity protection, but this will be incomplete due to the fact-specific nature of the inquiry required to apply anti-avoidance provisions as well as the requirement to demonstrate a more-than-merely-incidental purpose of tax avoidance.

Revenue raised: This option will raise more revenue than the status quo but the least compared to the other options due to the opportunities for structuring around the top personal income tax rate, as well as trustee income continuing to be taxed at 33 percent rather than 39 percent

Option 3: Option 2 plus increasing the trustee income tax rate to 39 percent (alignment with trustee rate but no integrity measures).

This option recognises the significant integrity concerns associated with **Option 2** and attempts to mitigate some of them by aligning the trustee rate with the proposed new top personal income tax rate. The top personal rate and trustee rate would both be 39 percent (though the top PIE rate and the company rate would remain unaligned at 28 percent). No integrity measures would be investigated to guard against structuring activities.

Potential downsides of this option include taxing some income accruing in trusts at 39 percent that may be attributable to lower-income beneficiaries. There are ways to mitigate this, such as distributing income to beneficiaries on lower rates as beneficiary income (so it is taxed at their marginal rates) rather than accumulating it in the trust. However, these will have their own costs and may not always be feasible (for example, the trust deed may call for restrictions on the distribution of income to beneficiaries such as before they reach a certain age). It would be possible to consult after the increase and then try to address over-taxation with any remedy having potentially retrospective effect, though this would not be an ideal consultation process.

Efficiency: There will be some efficiency costs, which are an inevitable part of raising the top marginal tax rate. By raising more revenue, the total efficiency costs are likely to be higher than **Option 2**. However, the efficiency costs per dollar of revenue raised are likely to be lower than **Option 2** because it will mean that the higher top marginal tax

rate is less able to be circumvented¹⁷. This is because trusts are one of the key vehicles for high-income individuals to use when a gap between the top personal rate and the trustee rate exists, which is nullified under this option.

Equity: Increases in the top personal rate and the trustee rate will do a better job of raising additional tax revenue in a way that supports the Government's vertical equity objectives than **Option 1** or **Option 2** as the changes will ensure a broader range of income will be taxable at the new 39 percent rate. Increasing both of these rates will be perceived to be fairer from a horizontal equity perspective compared to only introducing the new personal rate. However, opportunities for structuring will still reduce horizontal equity, making this option worse than the status quo on horizontal equity.

Complexity: This option involves two rate changes but, in Inland Revenue's view, would be less complex than having the top personal rate at 39 percent and the trustee rate at 33 percent. Not developing integrity measures under this option also means it would not be significantly complex compared to other options.

Integrity: By aligning the trustee rate with the top personal rate, this option improves on the integrity concerns associated with only introducing a new top personal rate. Companies and PIEs would still be potential vehicles for stepping around the 39 percent rate, but this option would leave taxpayers with significantly fewer avenues for tax-driven restructuring (and would eliminate the easiest way to sidestep the rate). From an integrity perspective, it would lack any further measures to buttress the higher rates, which are present in some of the other options.

Revenue raised: Increasing the trustee rate to 39 percent will increase revenue in addition to the revenue collected through the 39 percent personal rate. This option will also ensure less leakage from the personal tax system by mitigating structuring opportunities, meaning that more people earning income above \$180,000 will pay the 39 percent rate compared to **Option 2**. Of these two channels, the majority of the revenue increase arises through the first (higher rate on trustee income).

Option 4: Option 2 plus investigating integrity measures to buttress the new higher personal income tax rate (no alignment but integrity measures).

Under this option, the introduction of the new top personal income tax rate is not matched by a corresponding increase in the trustee rate. Instead, integrity concerns are addressed to an extent by investigating and developing specific integrity measures to minimise opportunities for tax-motivated structuring activity in the absence of rate alignment. Integrity measures alone are less ideal than alignment for countering structuring arrangements. They are more complex and Inland Revenue would expect them to be less effective than rate alignment in preventing income earned by a 39 percent taxpayer from being taxed at 33 percent. The measures themselves require more development and Inland Revenue would prefer that these measures were not

¹⁷ It is possible that **Option 3** could have higher aggregate efficiency costs compared to **Option 2** (since the 39 percent rate would apply to more structures used for earning labour and capital income). It will also raise more revenue than **Option 2** so that the efficiency cost per dollar raised is lower. This means, for example, if **Option 2** and **Option 3** were compared, and the rates for each chosen so that they raised the same amount of revenue, **Option 3** would have a lower efficiency cost. This means **Option 3** is the better policy choice from an efficiency perspective.

brought in until 1 April 2022 to allow for sufficient consultation. ^{s 9(2)(f)(iv)}

Efficiency: Again, this would involve the inevitable efficiency costs associated with raising the top marginal tax rate. It is likely to involve lower efficiency costs per dollar of revenue raised than **Option 2** but higher efficiency costs per dollar of revenue raised than **Option 3** as it would be a less effective way of preventing the top marginal tax rate from being circumvented. Total efficiency costs will depend on the nature of the integrity measures and the aggregate revenue they raise, though this is unable to be quantified.

Equity: Introducing integrity measures may be perceived to be closing tax loopholes and therefore better meets horizontal equity objectives compared to **Option 2** (as the measures will prevent some instances of taxpayers structuring their way out of the 39 percent rate). However, it is still worse than the status quo in terms of horizontal equity because opportunities for avoidance will still remain open to some taxpayers. The Government's vertical equity objectives are likely to be better met than under **Option 1** and **Option 2**, as the 39 percent rate is more enforceable with the integrity measures compared to without them. However, the misalignment of rates under this option may still present some taxpayers with opportunities to use entities to avoid the new top personal rate, thus resulting in unequal treatment among the group of taxpayers earning more than \$180,000.

Complexity: Investigating and developing integrity measures are likely to introduce significant complexity to the proposal. Any rules are likely to be new or not well known. These problems will be mitigated through a consultation process where stakeholders can have input into the development of integrity measures. Some arrangements that would be acceptable under any new rules may not be undertaken by taxpayers due to uncertainty as to how some integrity measures may apply, while other arrangements may be in breach of any new rules despite no malintent by the parties entering into that arrangement. This will create significant uncertainty for taxpayers. These effects will be mitigated through providing advice on how these measures would be applied/enforced on the Inland Revenue website and in the Tax Information Bulletin. Inland Revenue will also face administrative costs in enforcing any new rules, particularly if they are unfamiliar measures.

Integrity: The integrity measures are less ideal than alignment of tax rates but are also an improvement on having no integrity measures at all. So long as rates are not aligned, it is likely that some taxpayers will seek to enter into structures or arrangements that enable them to bypass the 39 percent rate.

Revenue raised: Although there is no alignment under this option, the introduction of a new top personal income tax rate combined with supporting integrity measures to counter structuring behaviours will lead to higher tax revenues than both **Option 1** and **Option 2** but lower tax revenues than **Option 3**.

Option 5: Option 2 plus both increasing the trustee income tax rate to 39 percent and investigating integrity measures to buttress the new higher personal income tax rate (alignment with trustee rate and integrity measures).

This option involves the most comprehensive reform in tandem with the proposal to introduce a new top personal income tax rate. It combines both the alignment of the trustee rate in **Option 3** and the investigation of integrity measures in **Option 4**. This is to ensure that the proposed introduction of a new top personal income tax rate is as effective as possible by reducing avenues for that new rate to be avoided.

Potential downsides of this option include taxing some income accruing in trusts at 39 percent that may be attributable to lower-income beneficiaries. As noted above there are ways to mitigate this, but these will have their own costs and may not always be feasible.

s 9(2)(f)(iv)

Efficiency: Again, this would involve the inevitable efficiency costs associated with raising the top marginal tax rate. It is likely to involve the highest aggregate efficiency costs because of the amount of revenue it raises, but lower efficiency costs per dollar of revenue raised than any of the other options by being the most comprehensive way of preventing the top marginal tax rate from being circumvented.

Equity: The combination of alignment and integrity measures will ensure the most robust equity outcomes. This option would be the most difficult for people on incomes over \$180,000 who are trying to structure around paying the 39 percent rate, leading to improvements in both vertical equity (compared to **Options 1 to 4**) and horizontal equity (compared to **Options 2 to 4**).

Complexity: Given alignment between the new top personal rate and the trustee rate, it is likely that fewer integrity measures would be needed under this option than under **Option 4**. Consequently, this is likely to be a less complex option than Option 4, though it will still be more complex than the other options. The same concerns regarding taxpayer uncertainty and reluctance to undertake potentially aggressive transactions will exist, though not to the same extent as if rates were not aligned and more integrity measures were required.

Integrity: This option reduces avoidance opportunities the most for the 39 percent rate. Alignment of the trustee rate with the top personal rate ensures that trusts cannot be used to avoid the new top personal rate, s 9(2)(f)(iv)

This option will result in the least long-term pressure on the tax system regarding rate alignment and anti-avoidance rules, resulting in the best tax integrity outcomes.

Revenue raised: This option will raise the most revenue of any of the options. The corresponding increase in the trustee rate will raise extra revenue alone (as with **Option 3**) and the integrity measures will raise additional revenue. This measure is also the most comprehensive at minimising structuring behaviours to avoid the new top personal rate.

3.2 What criteria, in addition to monetary costs and benefits have been used to assess the likely impacts of the options under consideration?

The two objectives of the tax policy reform considered in this proposal are the **distributional objective** and the **revenue objective**. These objectives encapsulate why the introduction of a new top personal income tax rate is being proposed. The criteria for analysing the options (**efficiency, equity, complexity, integrity, and revenue raised**) were chosen because they are some of the most important criteria for measuring the success of tax policy and directly determine how well the objectives are achieved. The importance of each of these measures for evaluating tax policy was described earlier.

These criteria can conflict with one another; for example, options that rank high on integrity may tend to rank poorly on complexity (since implementing more rules reduces loopholes but creates complexity). This analysis does not consider there to be any individual criterion that will trump the others in all cases of criteria conflict. The overall evaluation and comparison of each option should be a holistic exercise based on all of the criteria in their entirety and taking note of how well each option achieves the two overarching objectives.

3.3 What other options have been ruled out of scope, or not considered, and why?


The tax policy settings under practical consideration in this Impact Statement include the top personal income tax rate, the trustee income tax rate, and the investigation of integrity measures to support any rate increases.

One tax policy setting of potential relevance is aligning the company tax rate. Changes to this setting were not under consideration for the analysis in this Impact Statement because this is out of scope of the Government's proposal. Unlike the personal and trustee rates, the company rate affects the taxation of foreign investment in New Zealand. ^{s 9(2)(f)(iv)}

There are also other potential tax policy reforms that could serve to achieve the distributional and revenue objectives posited in this Impact Statement, such as increasing the rate of GST while giving tax relief or other support to those on lower incomes (so the net tax increase falls on those with higher incomes) or adjusting existing tax rates/thresholds (in contrast to introducing a new one). These options and others were not discussed in this Impact Statement as they were considered to be too far removed from the current proposal.

s 9(2)(f)(iv)

s 9(2)(f)(iv)



Section 4: Impact Analysis

Marginal impact: How does each of the options identified in section 3.1 compare with taking no action under each of the criteria set out in section 3.2?

	Option 1: Status quo	Option 2: No alignment and no integrity measures	Option 3: Alignment with trustee rate but no integrity measures	Option 4: No alignment but investigation of integrity measures	Option 5: Alignment with trustee rate and investigation of integrity measures
Efficiency	0	--- Increases tax disincentives and increases distortions	-- Increases tax disincentives but increases distortions by less than Option 2	-- Increases tax disincentives but increases distortions by less than Option 2	- Increases tax disincentives but increases distortions the least of Options 2 to 5
Equity	0	0 Improves vertical equity but offset by worsening of horizontal equity	+ Improves vertical equity, worsens horizontal equity to a lesser extent than Option 2	+ Improves vertical equity, worsens horizontal equity to a lesser extent than Option 2	++ Improves vertical equity most and horizontal equity most of Options 2 to 5
Complexity	0	- Small complexity associated with tax rate increase	- Some complexity but mitigated by trust alignment	-- Misalignment as well as complex integrity measures	- Some complexity but less than Option 4 due to fewer complexities with trusts
Integrity	0	--- Significant structuring incentives for avoidance	- Larger gap between top personal/trustee rates and company rate	-- Integrity measures designed to counter avoidance but offset by no alignment	+ Multiple effective measures to prevent avoidance
Revenue raised	0	+ Raises some revenue subject to structuring	++ Raises some revenue but with some structuring possibilities	++ Raises some revenue but with some structuring possibilities	+++ Raises the most revenue with the least opportunities for structuring
Overall assessment	0	-	+	0	++

					Inland Revenue's recommended option
--	--	--	--	--	--

Key:

- +++ very much better than doing nothing/the status quo
- ++ much better than doing nothing/the status quo
- + better than doing nothing/the status quo
- 0 about the same as doing nothing/the status quo
- worse than doing nothing/the status quo
- much worse than doing nothing/the status quo
- very much worse than doing nothing/the status quo

Section 5: Conclusions

5.1 What option, or combination of options is likely to best address the problem, meet the policy objectives and deliver the highest net benefits?

Inland Revenue's analysis of the options presented in this Impact Statement concludes that **Option 5** is the best package for advancing the Government's proposal to introduce a new top personal income tax rate of 39 percent on income over \$180,000. This involves both increasing the trustee rate and investigating integrity measures to buttress the new top personal income tax rate.

Inland Revenue concludes that **Option 5** is best because it comprises a package that implements the new 39 percent rate in a way that best meets the Government's revenue and distributional objectives while minimising unintended impacts:

- Inland Revenue considers both **alignment with the trustee rate** and **investigating integrity measures** to be key complementary decisions to support the effective introduction of a new top personal income tax rate. **Option 5** incorporates both these features. Other options omitted either alignment, integrity measures, or both and, as a result, will have reduced revenue and distributional benefits.
- The efficiency benefits from removing misalignment distortions as well as minimising opportunities for avoidance means that **Option 5** best meets the **revenue objective**, by reducing the total cost of achieving the objective.
- Ensuring alignment of rates alongside investigating integrity measures will likely have the strongest impact on integrity and equity within the tax system, meaning that the **distributional objective** is best met by this option.

This Impact Statement noted that the analysis undertaken was constrained by several factors, including a restricted range of options available for consideration, time constraints, uncertainty surrounding magnitude of impacts, and insufficient consultation.

Although there is a strong evidence base for the general impact of tax rate changes, the point of insufficient consultation to date will be particularly significant for the integrity measures to buttress the new higher personal income tax rate. To mitigate this, Inland Revenue's preference is for these measures to be consulted on over the first half of 2021 so that they can be legislated for 1 April 2022, despite the likelihood that the introduction of a new top personal income tax rate could occur as early as 1 April 2021. Inland Revenue also notes that many aspects of this analysis are qualitative due to significant uncertainty around estimating fiscal costs/revenues for the various options.

Given a divergence of views across New Zealand society on the optimal level of progressivity for the tax system, there will be significant numbers of people that both agree and disagree with the recommendation of this Impact Statement. Some stakeholders will hold a more direct interest in the practicalities of a tax change, such as payroll software providers who will want enough time to make the requisite changes to their products.

Inland Revenue notes that its recommendation of **Option 5** is one of the options that it expects the Government to seriously consider.

5.2 Summary table of costs and benefits of the preferred approach (Option 5)

Affected parties	Comment	Impact	Evidence certainty
Additional costs of proposed approach compared to taking no action			
Regulated parties: Taxpayers earning over \$180,000 and trustees	Trustees, and individual taxpayers earning more than \$180,000, will be taxed at 39 percent on that income.	\$3.7 billion over the forecast period ¹⁸ Refer to Table 3 for breakdown of income distribution of individuals earning above \$180,000.	Medium
Regulated parties: Taxpayers earning under \$180,000	N/A		
Regulated parties: Trustees and beneficiaries	As part of integrity measures, the Commissioner of Inland Revenue will collect more information on trust assets, liabilities, and distributions. This will impose compliance costs on trustees. Inland Revenue receives approximately 245,000 income tax returns from trustees per year.	Medium	Medium
Regulators: Inland Revenue	Further policy development required to progress the integrity measures. There is also likely to be increased work associated with enforcing those measures.	Medium	Medium
Wider Government	N/A		
Other parties: Payroll software providers and related parties	Any person who is required to make technical/software changes to accommodate the introduction of a new top personal tax rate will face some administrative costs.	Low	Medium
Total monetised cost		\$3.7 billion over the forecast period	Low

¹⁸ This only includes revenue attributable to the introduction of the 39 percent rate. It does not reflect any additional revenue from any integrity measures (still to be developed). Note that this will flow through as an omission to the total monetised cost at the end of the table as well.

Total non-monetised cost		Medium	Medium
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Expected benefits of proposed approach compared to taking no action

Regulated parties: Taxpayers earning over \$180,000	N/A		
Regulated parties: Taxpayers earning under \$180,000	These taxpayers do not face the new top personal income tax rate and so stand to gain from government spending or lower future taxes resulting from increased progressivity of the income tax scale	Low	Low
Regulated parties: Trustees and beneficiaries	N/A		
Regulators: Inland Revenue	N/A		
Wider Government	The revenue collected under this option will reduce the fiscal impact of higher operating allowances proposed in the Government's fiscal strategy. Over the longer term, the Government may have more flexibility in spending this extra revenue. The Government also moves toward achieving its vertical equity objectives with this change.	\$3.7 billion Medium	Medium Medium
Other parties: Payroll software providers and related parties	N/A		
Total monetised benefit		\$3.7 billion over the forecast period	Low
Total non-monetised benefit		Medium	Medium

5.3 What other impacts is this approach likely to have?

This section provides more detail on the unintended impacts of the proposal, which can generally be categorised as **economic impacts** or **integrity impacts**. The main risk of the proposal is that the tax revenue collected from the proposal may be less than expected due to avoidance arrangements. This might be the case because of a greater-

than-expected behavioural response to a new tax rate (noting that the behavioural response is highly uncertain). These economic and integrity impacts are considered in turn.

Unintended **economic impacts** include the efficiency costs from higher taxes on individual investment and savings, business investment, and human capital and labour markets. These are inevitable (but unintended) downsides of a new higher top marginal tax rate. The costs are likely to be higher per dollar of revenue raised the easier it is for high-income earners to sidestep the new higher tax rate.

Individual investment and savings impact

Taxation has economic costs when it distorts the allocation of investment due to different investments being taxed at different rates. An increase in the top personal rate would thereby impose economic costs by increasing the existing distortions in the allocation of individuals' savings under the current tax system, which favour investment into certain under-taxed assets (such as land) over fully-taxed investments (such as interest-earning assets). Furthermore, having different entities taxed at different rates may also impose economic costs if it affects the allocation of savings, for example, due to restrictions on which investments are allowed for particular entities (e.g. PIEs cannot control a business), or imposes additional compliance costs.

In terms of the housing market, a higher top tax rate would be expected to place some upward pressure on the ratio of property prices to rents, although the effects are uncertain.¹⁹ The effect will partly depend on whether the "marginal investor" in the housing market is subject to the higher top tax rate. The effect may be small owing to the small proportion of taxpayers that will be subject to the proposed new tax rate.

The impact of a higher top tax rate on the level of household saving is uncertain as there are competing effects. Affected individuals with a savings goal in mind may save more so as to save the same amount after tax, while a higher tax rate on savings income may discourage savings. Most evidence suggests that there would be a small negative impact on aggregate household saving.

Business investment

A higher top personal rate is likely to only have a relatively small impact on the level of business investment. This is because New Zealand can access capital from foreign investors and, for foreign investors, the company tax rate is the rate that determines the amount of tax paid on investment income. However, there may be a small impact on business investment to the extent that domestic saving influences domestic investment. A higher top rate would likely matter more in sectors where the ability of New Zealand firms to access foreign capital is limited (particularly small businesses, unlisted businesses, and rental property investments).

¹⁹ Because housing is favourably taxed (for capital gains), the value of housing as an investment should increase relative to other investments where tax has increased. This means investors are willing to accept a lower rate of return; the rent-to-price ratio should fall by either the price rising or rents falling or some combination of those effects.

Human capital and labour market impacts

The introduction of a new top personal tax rate would likely have a small negative effect on labour supply overall through its effects on hours worked and job choice. There is also a risk that an increase in the top personal rate would reduce the number of highly skilled workers in New Zealand and reduce the efficiency of the allocation of labour.

These impacts would arise through the following channels:

- **Migration.** Personal taxes affect after-tax incomes, and international evidence indicates this affects migration decisions.²⁰ The impact is greater for mobile, high-income, and highly skilled workers.
- **Human capital accumulation.** A higher top personal tax rate would reduce the financial returns from education and upskilling, and may discourage human capital accumulation. The international evidence regarding the impact of taxation on human capital accumulation is mixed, and Inland Revenue expects the impact of this channel to be relatively small overall.
- **Allocation of labour.** A potential mismatch between the top personal rate and the tax rate for trusts and companies will lead to many self-employed workers being able to access a lower tax rate than employees. This will favour self-employment over standard employment arrangements which may reduce the efficiency of the allocation of labour.

Introducing a new top marginal tax rate will inevitably have some efficiency costs. However, a top marginal tax rate of 39 percent is not high compared with other OECD countries, and other countries have been willing to accept the efficiency costs of their top marginal tax rates when they have traded off those efficiency costs against their distributional objectives.

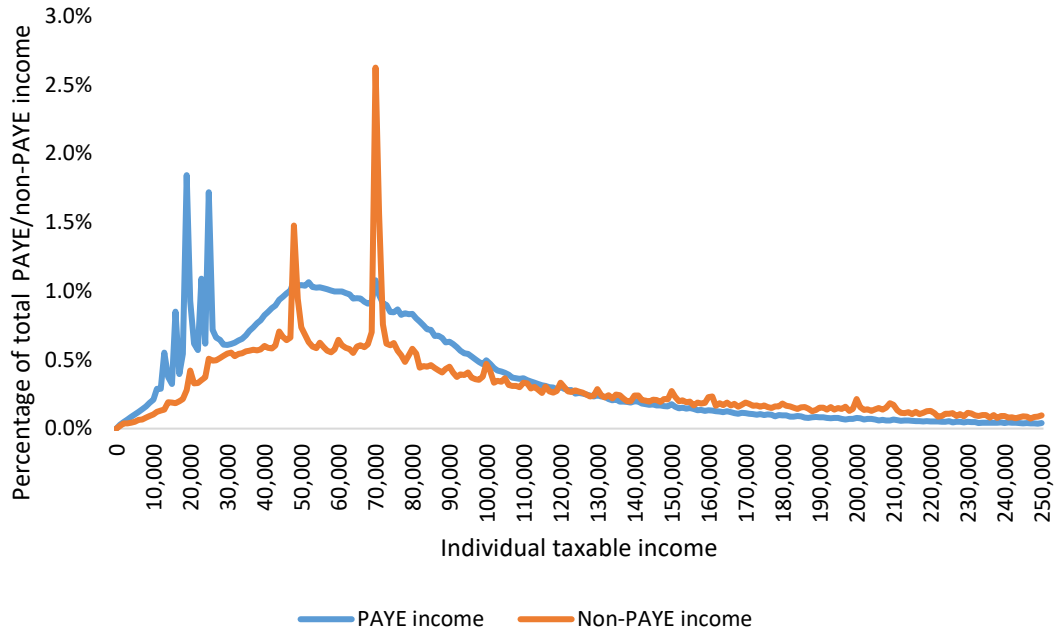
There are other possible reforms that would have a lower efficiency cost per dollar raised relative to the current proposal, such as having a smaller increase in all income tax rates or raising GST. However, these options may not meet the Government's distributional objectives. The efficiency costs of the current proposal would be mitigated somewhat by the possible integrity measures discussed in this Impact Statement.

Unintended **integrity impacts** include impacts resulting from structuring to avoid the 39 percent rate. These include reduced revenue, but also a negative impact on voluntary compliance if taxpayers have a view that avoidance is widespread. Inland Revenue considers the risk of these impacts to be significant and the preferred approach for mitigating these risks is to increase the trustee rate and to investigate supporting integrity measures.

Some of the integrity impacts arise from a misalignment between the top personal tax rate and the company tax rate. Even with a top marginal tax rate of 39 percent, the gap between the company tax rate and the top personal rate of 11 percentage points would be smaller than the gap in most OECD countries. However, New Zealand is particularly vulnerable to a gap between the company tax rate and the top personal marginal tax rate because of the absence of a general tax on capital gains.

There are already existing concerns arising from the differences between entity and personal rates in the current system. The bunching of self-employed people at the current tax thresholds in **Figure 2** suggests that structures are being used by taxpayers to avoid the current top personal rate:

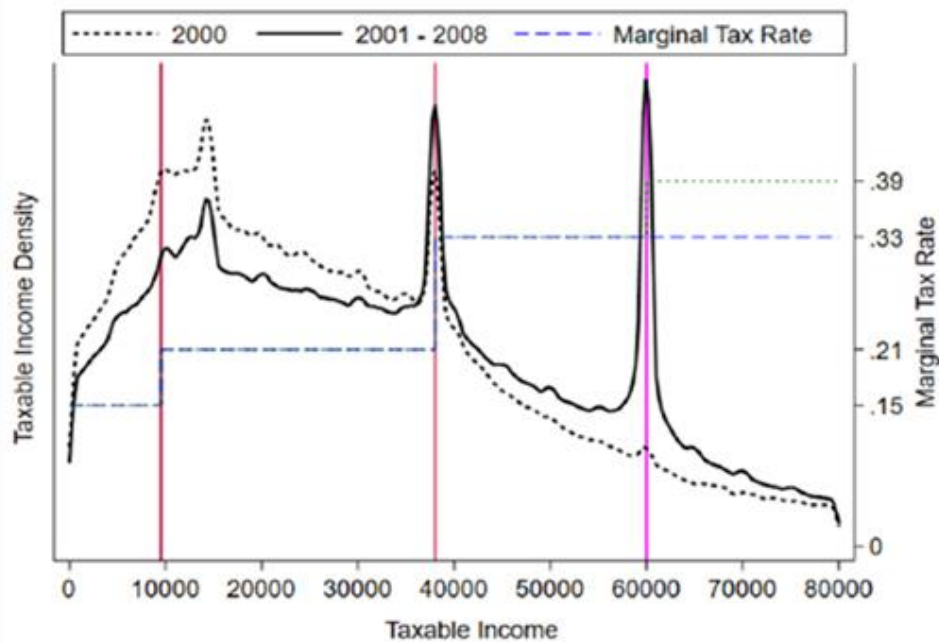
Figure 2: Taxable income distribution: PAYE and non-PAYE income (2018)



Source: The Treasury's analysis of Inland Revenue administrative data.

Inland Revenue considers that a higher top personal rate will increase integrity pressures. Evidence to support that expectation comes from the increased avoidance of the top personal tax rate that occurred in response to the increase in the top personal rate in 2000:

²⁰ This assumes that borders are open during the forecast period and migration is possible.

Figure 3: Taxable income distribution: self-employed (2000 vs. 2001-2008)

Source: Alinaghi, Creedy, & Gemmell.²¹

Figure 3 shows the distributions of income from self-employment before and after the increase in the top personal rate. The bunching of self-employed people at the new threshold after 2000 shows that there was substantial movement by the self-employed to avoid the higher top personal rate. Measures were taken to mitigate the avoidance of the top rate, including court cases²² and new income tax rules.²³ The measures reduced the use of the relevant structures to some extent.

Officials are concerned that increased structuring could have unintended integrity impacts on:

- Revenue. Tax collected from a higher top personal rate will be reduced due to structuring activity. This is due to the direct impact of taxpayers being able to earn their income through lower-taxed entities, such as trusts and companies. It is also because an inconsistent rate structure makes it harder for courts to find tax avoidance when the different rates mean it is difficult to determine whether a structure undermines what Parliament contemplated.
- Social capital: Perceptions of arbitrary outcomes, such as when some taxpayers can structure to avoid the 39 percent rate, will erode public confidence in the integrity of the tax systems and the feeling that all taxpayers are treated fairly.
- Horizontal and vertical equity: In the absence of integrity measures, more income of high-wealth individuals and others with substantial capital income is likely to

²¹ This figure is drawn from Nazila Alinaghi, John Creedy and Norman Gemmell, *Estimating Elasticities of Taxable Income and Adjustment Costs from Tax Kink Bunching: Evidence from Register Data for New Zealand* (2019).

²² For example, the decision in *Penny and Hooper v CIR* [2011] NZSC 95 limited the ability of taxpayers to use trusts to avoid paying themselves a market salary and therefore avoid the top personal rate in certain circumstances.

²³ An example is the tightening of the personal services attribution rules.

flow to lighter-taxed entities. This suggests that a new top personal tax rate in itself will have little effect on taxing the income of the very wealthiest but will instead fall on less wealthy salary and wage earners.

- The tax system. Substantial misalignment between the top personal rate and the rates for companies, trusts, and PIEs will raise broader questions about the coherence of New Zealand's tax policy settings. There is likely to be considerable pressure on the integrity of the tax system over the long term in the absence of more substantive reform, as taxpayers take advantage of the opportunities to pay tax at lower rates on their income.

The integrity risks can be mitigated in two ways:

- By imposing a 39 percent rate on trustee income, since trusts are the primary vehicle that high-income taxpayers are most likely to use to divert income that would otherwise be taxed at their 39 percent personal rate.²⁴
- By investigating specific integrity measures ^{s 9(2)(f)(iv)}

These would necessarily be less effective than taxing the entities themselves at 39 percent.

All of these unintended **economic** and **integrity** impacts are heavily influenced by taxpayers' reactions to the introduction of a new top personal income tax rate. The uncertainty in trying to predict this response means there is an overarching risk that the tax revenue collected from this proposal may be less than expected.

²⁴ This would still allow taxpayers to divert income to a company, which would be taxed on that income at 28 percent. That income would then be subject to a further 11 percent of tax when distributed to the shareholder. This reduces the attractiveness of companies to avoid the 39 percent rate compared to trusts. However, it does not eliminate it, as the company could still be sold by the taxpayer without any further tax impost.

Section 6: Implementation and operation

6.1 How will the new arrangements work in practice?

The proposal to introduce a new top personal income tax rate is to be legislated via a taxation bill that is likely to be introduced in December 2020. The new personal tax scale would apply from 1 April 2021. A separate taxation bill would likely be required to implement any integrity measures recommended for development under **Option 5**. Inland Revenue recommends that these measures come into effect from 1 April 2022.

The proposal is high profile and Inland Revenue does not anticipate any confusion about the introduction of a new top personal tax rate or the alignment of rates under **Option 5**. The complexity of potential integrity measures is likely to be the most confusing aspect of the recommended option. There is likely to be uncertainty about whether some arrangements are permitted under these measures. For all aspects of the proposal, guidance will be communicated through normal channels, such as through the Inland Revenue website and the Tax Information Bulletin.

Inland Revenue is responsible for the administration and enforcement of the tax system, including the implementation and operation of this proposal. Inland Revenue has not identified any concerns with its ability to implement the proposal with respect to the Government's "Expectations for regulatory stewardship by government agencies" aside from a short timeframe in which to undertake the initial work required. This short timeframe justifies why Inland Revenue does not recommend integrity measures being implemented on 1 April 2021 given the significant work and consultation still required to develop these measures.

6.2 What are the implementation risks?

Because of the one-year difference in recommended implementation dates between the introduction of a new top personal income tax rate and the recommended implementation of integrity measures, the risk for structuring activity will be greatest in the 2021–22 income tax year under **Option 5**. Inland Revenue recommends differing implementation dates because it believes there are worse consequences associated with accelerating the implementation measures for effect on 1 April 2021.

Aside from this specific risk, an increase in tax rates will generally lead to more tax-induced structuring activity as it becomes relatively more appealing to taxpayers to try to circumvent the 39 percent rate. This will likely result in disputes with taxpayers seeking to avoid the new rate and possibly court cases. Inland Revenue already undertakes significant compliance activity to minimise avoidance and will be expecting that incentives created by higher taxes create more pressures in this area.

Inland Revenue expects that implementation risks are mitigated by ensuring taxpayers have the least recourse for structuring around the new top personal rate. This is best achieved by **Option 5**. If the Government chooses to implement another package to buttress the introduction of a new top personal rate, then there are likely to be greater implementation risks with respect to avoidance and compliance activity.

For stakeholders that need to make technical/software changes, there is a risk that the legislation comes into effect too quickly for all of these stakeholders to have made the requisite changes to their systems. Businesses will generally require an amount of time to adequately prepare for significant tax changes such as adjustments to the personal income tax scale. The intention to introduce a new top personal income tax rate was announced in the Labour party's 2020 Election Manifesto, so it is not expected that affected parties need to wait for detailed legislation to begin preparatory work to accommodate the reforms.

Section 7: Monitoring, evaluation, and review

7.1 How will the impact of the new arrangements be monitored?

The revenue impact of this proposal will be estimated through tax collected by Inland Revenue. There are concerns as to the extent of any implications for structuring activities and how effective the package is at preventing those. In practice, it will be difficult to evaluate the effect that a given package has on minimising top-rate avoidance compared to the effect that another package might have had. However, investigations that rely on the proposed integrity measures will indicate how effective those measures are from a legal perspective.

Inland Revenue routinely collects significant amounts of data through taxpayers filing their returns, through income payers withholding tax and providing information to Inland Revenue, and through other means. This information will be used to monitor and evaluate the impact of the changes to the personal income tax scale. Inland Revenue also records data on its customer compliance and customer support activities, so existing systems are already in place to record new administrative impacts arising from this proposal.

Inland Revenue will collect more information on trust assets, liabilities, and distributions. This will increase compliance costs for trustees, but it will be an important part of monitoring any systemic issues. Due to the lack of consultation on the new information requirements, Inland Revenue will likely have limited understanding of the compliance costs that trusts will face with the new information requirements and how large these costs are.

Inland Revenue's policy function also has processes in place to review the impacts of the proposal based on data already collected. Inland Revenue will therefore be in a position to both provide follow-up advice to the Government as necessary and/or respond to any further directions from the Government on consequential tax reforms following the implementation of this proposal.

Inland Revenue will report to the Government on the impacts of the proposal and the integrity of the system once data becomes available.

7.2 When and how will the new arrangements be reviewed?

Inland Revenue regularly reviews tax settings on an ongoing basis and provides advice/updates to the Government accordingly. As a result, there are currently no plans for a specific review of the 39 percent rate at some future point in time.

The most concerning potential result following the implementation of the proposal would be if tax revenue collected on incomes above \$180,000 is significantly less than expected. That may suggest that taxpayers are entering into arrangements that structure around the new top personal income tax rate. The risk of this being the case will be highest in the year prior to the recommended implementation of integrity measures to buttress the new top personal rate.

Inland Revenue wishes to consult with stakeholders on the detailed design of those integrity measures in the first half of 2021 subject to the Government's agreement to those measures. This will help to ensure that those measures are fit for purpose. Inland Revenue expects that any wider concerns or feedback about the general proposals in this Impact Statement will be raised in that consultation.

As part of this consultation, Inland Revenue will be seeking feedback on the implementation of the information reporting requirements for trustees. This will occur in lieu of formal consultation before the new requirements come into effect. The post-implementation review of the proposed requirements will be used to evaluate whether the expected benefits of collecting more information on trust assets, liabilities, and distributions justify the compliance costs that these requirements will impose on trustees. It will also be used to determine whether and how compliance costs imposed by the requirements could be reduced.