

Regulatory Impact Statement: Local authority taxation – dividends and deductions

Coversheet

Purpose of Document	
Decision sought:	Legislative changes to improve the integrity of local authority taxation.
Advising agencies:	Inland Revenue
Proposing Ministers:	Minister of Revenue
Date finalised:	17 June 2021
Problem Definition	
<p>Council-controlled organisations (CCOs) are treated as ordinary companies and are taxed to ensure competitive neutrality with the private sector. However, current tax law allows local authorities to transfer the benefit of their tax-exempt status to their taxable CCOs. That is, local authorities are able to shelter their CCOs from tax.</p> <p>This undermines the integrity of the tax system by allowing local authorities to effectively extract profits from their CCOs tax-free. This reduces the government’s tax revenues from CCOs.</p>	
Executive Summary	
<p>The current tax policy settings for local authorities are that:</p> <ul style="list-style-type: none"> • A local authority is tax-exempt on income (primarily rates) derived from carrying on activities within its statutory purposes, as per the Local Government Act 2002 (such as water supply). • A local authority is taxable on income (e.g. rent, management fees, dividends) derived from a CCO. • A CCO that operates a trading undertaking is taxed to ensure competitive neutrality with the private sector. <p>The original policy rationale for treating all income a local authority derives from a CCO as taxable was to prevent profit shifting from these taxable entities to exempt local authorities.</p> <p>Without this provision, income from a CCO could effectively be extracted tax-free by the local authority charging the CCO above-market rental or management fees, which would be deductible to the CCO but not taxable to the local authority due to its tax-exempt status. Despite the above provision, structures can be entered into which allow local authorities to transfer the benefit of their tax-exempt status to their taxable CCOs.</p>	

Dividends

Officials consider that the current treatment of taxing dividends derived by a local authority from a wholly-owned CCO is an overreach. This is because a dividend is not a deductible expense of a CCO so there are no profit shifting concerns. Taxing these dividends is an impediment to the movement of capital within a local authority's group to where it can most efficiently be used.

Officials' preferred option to this issue is to exempt these dividends from tax, consistent with similar settings for dividends derived by the Crown from State enterprises, and dividends paid between companies with 100% common ownership.

Officials undertook targeted consultation with the local government sector in early 2021, and this option was supported. Exempting dividends derived by local authorities from wholly-owned CCOs would have no fiscal impact. This is because these dividends are generally fully imputed, and the attached imputation credits would satisfy any tax on the dividends.

Deductions

Current law allows local authorities certain deductions for expenditure not incurred in deriving assessable income (such as corporate gifts and some interest expenses). Access to these deductions allows local authorities to have tax losses despite being largely exempt from tax and these losses can be used to shelter their CCOs from tax. This reduces the government's tax revenues from CCOs.

To address this concern, officials consulted the local government sector on denying loss grouping between a local authority and its CCOs. Officials have accepted feedback from the sector that this option would be an overreach. This is because local authorities can legitimately incur deductible expenditure (such as providing administration services to their CCOs), and, economically, they should be entitled to deduct this expenditure against the taxable income of their CCO group.

After consideration of submissions from the local government sector, officials' preferred option is to prevent local authorities from accessing the corporate gift deduction and limiting interest deductions to the extent they relate to deriving assessable income. Going forward, this will protect the government's tax revenues by reducing the ability for local authorities to transfer the benefit of their tax-exempt status to their CCOs.

Imputation

Current tax rules allow local authorities to use deductions to satisfy their income tax liabilities on dividends from CCOs, without using the full amount of imputation credits attached to those dividends. This results in the local authority having excess imputation credits. The local authority can then convert the excess imputation credits to a tax loss and offset this loss against the taxable income of its CCOs. This is not an intended policy outcome and allows the local authority to shelter its CCOs from tax. Similar to the current rules for deductions, the imputation rules result in reduced tax revenues from CCOs. Officials' preferred option is to prevent a local authority from converting unused imputation credits to a tax loss.

Additionally, local authorities in consolidated groups can access the group's imputation credit account (ICA) and the local authority can credit to the group's ICA imputation credits attached to dividends it derives from a CCO. These credits are then available for reuse by CCOs within the group. This is not an intended policy outcome. Officials' preferred response is to ensure that a credit does not arise to a consolidated group's ICA for imputation credits attached to a dividend derived by a local authority from a CCO.

These imputation proposals were tested with the local government sector in consultation in early 2021 and received support.

Impact on local government sector

The fiscal impact of officials' preferred options is expected to be a revenue increase of \$23.8m per year. For context, the surplus for all council groups in the 2020 financial year was \$2,322m. Since the tax increases are relatively small, the flow-on economic impacts are expected to be relatively small.

Limitations and Constraints on Analysis

The scope of this project is limited to the immediate integrity risks to local government taxation. Reviewing the taxation of the local government sector as a whole is not currently on the Tax Policy Work Programme and is beyond the scope of this project.

Responsible Manager

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Inland Revenue

17 June 2021

Quality Assurance (completed by QA panel)

Reviewing Agency:	Inland Revenue
Panel Assessment & Comment:	The Quality Assurance reviewer at Inland Revenue has reviewed the <i>Local authority taxation – dividends and deductions</i> Regulatory Impact Statement prepared by Inland Revenue, and considers that the information and analysis summarised in the Regulatory Impact Statement partially meets the quality assurance criteria. This is because the affected stakeholders have not yet had an opportunity to submit on how they would be affected by two of the specific options (denying deductions for donations to donee organisations and denying interest deductions incurred in earning exempt income). Accordingly, the analysis of how these stakeholders would be affected is limited and uncertain.

Section 1: Diagnosing the policy problem

What is the context behind the policy problem and how is the status quo expected to develop?

The current tax policy settings for local authorities stem from local government reforms of the late 1980s. Broadly speaking, since these reforms the tax settings for local authorities have been as follows:

- A local authority is exempt from tax on income (primarily rates) derived from its core activities (such as water supply).
- A local authority is taxed on income (e.g. rent, management fees and dividends) derived from a council-controlled organisation (CCO) or a port company (trading subsidiaries of a local authority).
- To ensure competitive neutrality with the private sector, CCOs are treated as ordinary companies and are taxed.

The original policy rationale for treating all income a local authority derives from a CCO as taxable was to prevent profit shifting from these taxable entities to exempt local authorities.

Without this provision, income from a CCO could be extracted tax-free by the local authority charging above-market rental or management fees, which would be deductible expenditure for the CCO but not taxable to the local authority due to its tax-exempt status. Despite the above treatment, structures can be entered into which allow local authorities to transfer the benefit of their tax-exempt status to their taxable CCOs.

What is the policy problem or opportunity?

Dividends

Local authorities are taxed on dividends derived from their CCOs. In contrast, an exemption applies for dividends derived by similar entities, such as dividends derived by the Crown from State enterprises, and for dividends paid between New Zealand resident companies where there is 100% common ownership.

Officials consider that the current treatment of taxing dividends derived by a local authority from a wholly-owned CCO is an overreach because it reduces the coherence of the tax rules. The taxation of dividends from CCOs is not consistent with dividends paid to wholly-owned companies nor with the exemption of dividends paid to other exempt entities. There is no tax policy justification for treating these dividends differently. Since a dividend is not a deductible expense of a CCO, there are no profit shifting concerns with treating the dividends as exempt income of the local authority.

Furthermore, the current tax rules are providing an impediment to the most efficient allocation of resources in local government. The local government sector has argued that in addition to improving the coherence of the tax rules, exempting these dividends from tax will allow councils to deliver on their commitments to their communities more efficiently. This would ensure that tax is not an impediment to the movement of surpluses from CCOs to their local authority.

Deductions

Broadly, a local authority should be allowed deductions for any expenditure incurred to the extent to which the expenditure is incurred in deriving assessable income – *not* exempt income.

However, current law allows local authorities certain deductions for expenditure not incurred in deriving assessable income, such as corporate gift deductions and certain interest deductions. We have identified that access to these deductions has allowed local authorities to have tax losses despite being largely exempt from tax, and these losses are being used to shelter their CCOs from tax. This unintentionally reduces the government’s tax revenues from CCOs.

Corporate gift deductions

Changes to the corporate gift deduction provision from the 2008-09 income year allowed companies a deduction for charitable donations to donee organisations, only limited by the company’s net income. As local authorities are treated as companies under the Income Tax Act 2007, they are able to access this provision.

A significant proportion of corporate gift deductions are claimed by local authorities – they accounted for 38% of all company donations from 2016-17 to 2019-20.

Table 1: Company gift donations from 2016-17 to 2019-20

		2016-17	2017-18	2018-19	2019-20	Total	Four-year average	Four-year average tax effect
Local authorities	Value (\$m)	40.7	54.4	55.1	37.7	187.9	47.0	13.2
	% of total	38%	33%	46%	38%	38%	38%	38%
All other companies	Value (\$m)	66.5	112.7	64.6	60.4	76.1	76.1	21.3
	% of total	62%	67%	54%	62%	62%	62%	62%
Total value		107.2	167.1	119.7	98.1	492.1	123.0	34.4

The corporate gift deduction is intended to encourage companies to redirect part of their otherwise taxable income to charitable, benevolent, philanthropic or cultural purposes. The corporate gift deduction should not apply to primarily exempt entities like local authorities as this results in the tax system subsidising local government funding.

The corporate gift deduction is effectively a tax concession for local government to undertake its legislated purpose (under the Local Government Act 2002) is to promote the social, economic, environmental, and cultural well-being of communities. Consequently, the corporate gift deduction is providing an increase to local government funding that has not been explicitly mandated by central government or considered through the Budget process.

Allowing local authorities to access the corporate gift deduction allows them to transfer the benefit of their exempt status to their taxable CCOs, contrary to the policy intent. This reduces the incidence of tax paid by CCOs.

Interest deductions

A local authority should only be allowed a deduction for interest on money borrowed for the purpose of deriving assessable income. Local authorities are currently allowed deductions for interest on money borrowed to acquire shares in a CCO that is part of the same local authority group. These deductions are not limited to expenditure incurred in deriving assessable income. A local authority can shelter taxable income streams with deductions available for capitalising a CCO that is not carrying on a business to make a profit

Access to deductions for interest expenditure not limited to interest incurred in deriving assessable income is problematic because these deductions can result in local authorities having tax losses. A local authority can then offset these losses against the taxable income of their CCOs. The ability for local authorities to claim these interest deductions results in reduced tax revenues from CCOs.

Imputation

Current tax rules allow some local authorities to satisfy their income tax liabilities on dividends without using the full amount of imputation credits attached to those dividends (e.g. by using corporate gift deductions). This results in the local authority having excess imputation credits. The local authority can then convert the excess imputation credits to a tax loss and offset the tax loss against the net income of its CCO group. This allows the local authority to shelter its CCOs from tax and reduces the government's tax revenues.

The purpose of converting imputation credits to a tax loss was part of the original design of the imputation system, as unused imputation credits are not refundable to the shareholder. The policy intent was to provide a mechanism for taxpayers in tax loss to carry forward the benefit of unused imputation credits to satisfy future income tax liabilities. It was never intended that an exempt shareholder would be able to convert unused imputation credits to a tax loss.

Similar to a final natural person shareholder, local authorities cannot operate an imputation credit account (ICA). However, through the consolidated group rules, local authorities in consolidated groups can access the group's ICA. Consequently, the local authority can credit to the group's ICA imputation credits attached to dividends it derives from a CCO. These credits are then available for reuse by CCOs within the group. This is not an intended policy outcome.

What objectives are sought in relation to the policy problem?

The objective sought in relation to the policy problems is to ensure that the tax rules do not provide opportunities for local authorities to reduce the incidence of tax paid by CCOs, contrary to the policy intent. The policy intent is that CCOs, like State enterprises, are taxed.

Achieving this objective will ensure that the tax rules do not provide opportunities to reduce the government's tax revenues and to ensure that CCOs pay their fair share of tax.

Section 2: Deciding upon an option to address the policy problem

What criteria will be used to compare options to the status quo?

The following criteria were used to assess the options considered:

- Integrity of the tax system: The primary function of the tax system is to provide revenue to fund government spending priorities.
- Fairness and equity: Taxpayers in similar situations carrying out similar transactions should be subject to similar tax treatment. Like-transactions should have similar or equivalent tax outcomes.
- Impact on local government sector: How does the option affect local government's ability to deliver activities within its statutory purpose? How does the option affect local government funding?
- Fiscal impact: Tax reforms need to be affordable given fiscal constraints.
- Stakeholder support: Is the option supported by the local government sector?

Compliance and administration cost implications have not been considered because there is little difference between the options in terms of impact.

What scope will options be considered within?

The scope of this project is focused on the immediate integrity risks to local government taxation. Options relating to broad sweeping changes to local government taxation are beyond the scope of this project.

What options are being considered?

To analyse the available options, the problem was broken down into three sub-problems: dividends, deductions, and imputation.

Dividends

Option One: Status Quo

Under this option, dividends derived by local authorities from CCOs would continue to be taxed.

Integrity of the tax system: The status quo for dividends poses no integrity risks to local government taxation.

Fairness and equity: Taxing dividends derived by local authorities from CCOs is inconsistent with similar entities, such as the Crown and State enterprises, charities, and wholly-owned companies.

Dividends paid between New Zealand resident companies are exempt where there is 100% common ownership, but local authorities are excluded from this exemption. This exclusion is a legislative overreach. The current setting does not support or harm the original policy intent

of preventing profit shifting but weakens the coherence of the tax system by treating similar types of entities differently.

Impact on local government sector: Taxing these dividends is an impediment to the movement of capital within a local authority's group to where it can most efficiently be used.

Taxing dividends does not pose a funding cost for local government. Inland Revenue data shows that dividends derived by local authorities from CCOs in the 2019-20 income year were fully imputed (the dividends have enough imputation credits attached to fully satisfy any tax liability).

Fiscal impact: None. As noted above, dividends derived by local authorities are generally fully imputed. Therefore, taxing or exempting dividends will have no fiscal impact.

Stakeholder support: The local government sector has expressed limited support for maintaining the status quo in regard to dividends.

Option Two – Exempting dividends derived by local authorities from wholly-owned CCOs

This option would exempt dividends derived by local authorities from wholly-owned CCOs, similar to wholly-owned groups of companies.

Integrity of the tax system: Both options for dividends would have the same neutral impact on the integrity of local government taxation.

Fairness and equity: This option would improve the fairness and equity of the local government tax settings. Local authorities and CCOs will be treated similarly to wholly-owned companies with regard to dividends. This would also improve the coherence of local government taxation by removing an unnecessary complication in the tax rules.

Impact on local government sector: Exempting dividends would allow the free movement of surpluses from a CCO to its local authority. This will allow councils to help their communities and deliver their services more efficiently. This option would also ensure that tax is no longer an impediment to possible group restructuring.

Fiscal impact: None. Officials expect dividends derived by local authorities from CCOs to be fully imputed (the dividends have enough imputation credits attached to fully satisfy any tax liability). Taxing or exempting dividends will have no fiscal impact.

Stakeholder support: Officials undertook targeted consultation with the local government sector in early 2021, and the proposal to exempt dividends was broadly supported.

Deductions

Option One – Status Quo

Under this option, local authorities would continue to be allowed certain deductions for expenditure not incurred in deriving assessable income, such as corporate gifts and interest expenses. Local authorities would continue to be able to offset their tax losses against the taxable income of their CCOs.

Integrity of the tax system: The status quo poses significant integrity risks for local government taxation. Allowing local authorities to claim these deductions provides

opportunities for local authorities to transfer the benefit of their tax-exempt status to their CCOs. This results in reduced government tax revenues and allows CCOs to not pay their fair share of tax.

Fairness and equity: All local authorities are subject to the same tax rules. However, the current integrity risks are being taken advantage of to varying degrees across the sector. Over the 2016 to 2020 income years, 26 different councils (out of a total of 78 local authorities) claimed corporate gift deductions. Three councils accounted for 80% of the total corporate gift deductions claimed by local authorities. This represents 30% of all corporate gift deductions claimed by companies.

The corporate gift deduction represents a cost to all taxpayers but is currently only being used by some local authorities.

These deductions allow local authorities to reduce the incidence of tax paid by CCOs, which is unfair.

Impact on local government sector: The current tax rules are providing unintentional tax subsidies to local government.

As noted above, the current integrity risks are being taken advantage of to varying degrees across the sector. Due to limited data on which interest deductions are being claimed by local authorities, officials are unable to determine the exact overall impact of the current tax rules across the local government sector.

The availability of these deductions allows local authorities to shelter their CCOs from tax. Since CCOs would have less tax to pay, this means they are able to pay larger dividends to their local authorities. That is, the current rules increase local government funding by facilitating larger dividends to be paid from CCOs to local authorities.

Fiscal impact: Allowing local authorities to continue to claim the corporate gift deduction has a fiscal impact. The yearly average tax impact of charitable donations by local authorities over the 2016-17 to 2019-20 income years is \$13.2m. This represents lost tax revenue for central government and an increase to local government funding.

Stakeholder support: The local government sector strongly supported maintaining the status quo over denying loss grouping. Option Three, denying certain deductions, was developed by officials based on feedback from submitters on Option Two and has not been tested with stakeholders.

Option Two – Loss grouping

This option would prevent local authorities from grouping their tax losses against the taxable income of their CCOs.

Integrity of the tax system: Preventing loss grouping between a local authority and its CCOs would mean that a local authority could not use tax losses arising from deductions or excess imputation credits to shelter its CCOs from tax. This would prevent the current integrity risks from eroding government tax revenues.

Fairness and equity: Although local authorities are generally exempt, they do not sit fully outside the tax base. A local authority should be entitled to offset any losses arising from deductions for expenditure incurred in deriving assessable income against its CCOs.

Denying loss grouping would be an overreach and would treat local authorities more harshly than other companies.

Impact on local government sector: Preventing loss grouping between a local authority and its CCOs would mean that a local authority could not offset *any* tax losses against its CCOs' income. This option would lead to inefficiencies in local government, as it would disincentivise councils from providing administrative support and other functions to their CCOs, as they would be unable to offset any losses arising from the underlying expenditure. Any losses arising from this expenditure would be stranded in local authorities.

This option would negatively impact local government funding by leading to CCOs paying smaller dividends to their local authorities. This is because denying loss grouping will mean that CCOs will have higher tax liabilities since local authorities will not be able to offset any of their losses against the taxable income of their CCOs.

Fiscal impact: It is expected that the fiscal impact of the loss grouping proposal would generate more tax revenue than Option Three. This is because it would prevent local authorities from grouping any losses with its CCOs, as opposed to just focusing on certain deductions as in Option Three. The exact fiscal impact of Option Two was not quantified.

Stakeholder support: In early 2021 the local government sector provided strong feedback against the proposal to deny loss grouping between local authorities and CCOs. The sector argued that local authorities can incur genuinely deductible expenditure and should be entitled to offset these deductions against taxable income in its CCO group.

Option Three – Denying deductions (corporate gift deduction and certain interest deductions)

This option would prevent local authorities from claiming deductions for charitable donations to donee organisations and would limit access to interest deductions to expenditure incurred in deriving assessable income. This option was developed by officials following feedback by the local government sector on Option Two above.

Integrity of the tax system: This option would result in local authorities not being able to claim deductions for expenditure incurred in funding CCOs that do not have a profit-making purpose.

This option would limit the ability of local authorities to shelter their CCOs from tax. This will ensure that CCOs pay their fair share of tax and will help maintain the government's tax revenues.

Fairness and equity: Over the 2016 to 2020 income years, 26 different councils (out of a total of 78 local authorities) claimed corporate gift deductions. Three councils accounted for 80% of the total corporate gift deductions claimed by local authorities. This represents 30% of all corporate gift deductions claimed by companies. The corporate gift deduction is an indirect cost to all taxpayers but is being claimed by a minority of councils.

Access to these deductions allow local authorities to reduce the incidence of tax paid by CCOs. This option would improve the fairness of the tax settings for taxpayers by reducing the ability to shelter CCOs from tax.

Impact on local government: The impact of this option will be uneven on the local government sector since these deductions are being claimed to varying degrees across the sector.

As noted above, over the 2016 to 2020 income years, only 26 councils claimed the corporate gift deduction. This provision is benefiting the funding flows of a minority of councils despite their largely tax-exempt status. Most councils would not be affected by preventing local authorities from claiming this deduction.

This option will result in increased costs for councils to the extent that they are receiving a benefit from these deductions. Due to limited data on interest deductions, officials are unable to estimate the exact impact of this option on local government. Reducing the ability of these local authorities to shelter their CCOs from tax will result in lower dividends being paid by CCOs to their local authorities. This is because these CCOs will have greater tax liabilities.

The cost to local government of denying access to the corporate gift deduction is expected to be \$23.8m per year. For context, the surplus for all council groups in the 2020 financial year was \$2,322m. Since the impact of this proposal is relatively small, the flow-on economic impacts are expected to be relatively small.

Fiscal impact: The fiscal impact of preventing local authorities from accessing the corporate gift deduction is expected to raise approximately \$13.2 million per year. Inland Revenue has limited data on the breakdown of which specific interest deductions are being claimed by local authorities and is unable to quantify the full fiscal impact of the interest deduction proposals.

Stakeholder support: In consultation on the loss grouping proposal, some submitters suggested focusing on the specific deductions that are considered inappropriate, rather than denying loss grouping outright. Submitters argued that denying loss grouping would be an overreach, as local authorities can incur genuinely deductible expenditure.

Officials accepted these arguments from the sector and developed the narrower proposal to limit certain deductions. Officials expect that the local government sector will not support this proposal but will prefer it to the loss grouping proposal.

Officials expect that donee organisations would oppose this proposal, as it reduces the incentives for councils to make donations. Donee organisations were not consulted on this proposal, as this proposal was developed after consultation was undertaken with the local government sector. During consultation on Option Two, officials received feedback from the sector that although preventing access to the corporate gift deduction would increase the cost of these donations, it was unlikely to lead to councils not making them. This is because councils have a commitment to improve the social, economic, environmental, and cultural well-being of their communities, and donee organisations often play a key role in fulfilling these objectives.

Imputation

Option One – Status Quo

Under current settings, local authorities can convert excess imputation credits to a tax loss. Local authorities in consolidated groups can access the group's imputation credit account (ICA) and the local authority can credit to the group's ICA all imputation credits attached to dividends it derives from a CCO.

Integrity of the tax system: The current imputation settings pose significant integrity risks to the tax system. By maintaining current settings, local authorities will be incentivised to satisfy the tax liability on dividends with available deductions and convert the excess imputation credits to tax losses. This will allow local authorities to transfer the benefit of their tax-exempt status by sheltering their CCOs from tax, resulting in lower tax revenues.

Fairness and equity: The ability to convert excess imputation credits to a loss is inconsistent with other generally exempt entities (such as charities).

Local authorities cannot maintain their own ICA. However, a council's consolidated group can benefit via the group's consolidated group account. The status quo is unfair for councils that are not part of a consolidated group, as they are not able to take advantage of the same benefits.

Impact on local government: The current settings allow a local authority to convert excess imputation credits to a loss and use this loss to satisfy a future tax liability of the local authority, or to offset against the income of the CCO group.

Local authorities are prohibited from maintaining an imputation credit account in their own right. The current imputation rules provide an economic benefit to councils in consolidated groups. CCOs in a consolidated group can use imputation credits that have been received by a local authority and credit to the group's imputation credit account. This can result in recycling of imputation credits.

The flow-on effect of the current imputation rules is that CCOs can pay larger dividends to councils because they have less tax to pay.

Fiscal impact: In the 2020 income year, the conversion of excess imputation credits by local authorities to tax losses had a tax effect of approximately \$10.6m.

Although maintaining the status quo will have no direct fiscal impact, imputation credit conversion in this context can be considered as lost revenue for the government and gained funding for local government.

Stakeholder support: Officials undertook targeted consultation with the local government sector in early 2021. The sector did not argue to retain the status quo in regard to imputation. The proposals outlined in Option Two received support.

Option Two – Preventing excess imputation credit conversion to tax losses

This option would prevent local authorities from converting excess imputation credits to tax losses and would ensure that a credit does not arise to a consolidated group's imputation credit account for imputation credits attached to dividends derived by a local authority.

Integrity of the tax system: This option reduces significant integrity risks in local government tax settings. It largely reduces the ability of local authorities to transfer the benefit of their tax-exempt status to their CCOs. This option would help maintain the government's tax revenues.

Fairness and equity: Preventing local authorities from converting excess imputation credits to a loss ensures that local authorities are treated similarly to other generally exempt entities (such as charities).

Ensuring that a credit does not arise to a consolidated group's imputation credit account for imputation credits attached to dividends derived by a local authority would improve the fairness of the tax rules by ensuring that local authorities have the same imputation treatment regardless of whether they are in a consolidated group or not.

Impact on local government: This option would have an uneven funding impact on councils. Inland Revenue data shows that 44 councils converted excess imputation credits to losses in the 2020 income year. 10 councils accounted for 91% of the total amount converted. This option will be a funding impact for councils to the extent that they were taking advantage of these rules.

Preventing local authorities from converting excess imputation credits to losses would reduce the ability for councils to reduce the taxable income of their CCOs. This will likely lead to smaller dividends from CCOs to local authorities.

The cost of this proposal to local government is expected to be \$10.6m per year. For context, the surplus for all council groups in the 2020 financial year was \$2,322m. Since the impact of this proposal is relatively small, the flow-on economic impacts are expected to be relatively small.

Fiscal impact: In the 2020 income year, the conversion of excess imputation credits by local authorities to tax losses had a tax effect of approximately \$10.6m. This option would be a revenue gain for the government and would reduce the amount of income of local government.

Stakeholder support: Officials undertook targeted consultation with the local government sector in early 2021. The sector did not have strong views on the imputation problem, but these proposals received support.

Dividends: How do the options compare to the status quo?

	Option One: Status Quo	Option Two: Exempting dividends derived from wholly-owned CCOs
Integrity of the tax system	0	0 No impact on the integrity of the tax system.
Fairness and equity	0 The status quo reduces the coherence of the tax system	+ This option would improve fairness and equity by allowing local authorities to access the inter-corporate dividend exclusion, similar to wholly-owned companies.
Impact on local government	0 The status quo is unfair as it treats similar entities differently.	+ This would ensure that tax is no longer an impediment for the movement of surpluses from a wholly-owned CCO to its local authority.
Fiscal cost	0	0 No fiscal impact.
Stakeholder support	0	+ The local government sector supports exempting dividends.
Overall assessment	0	+ Officials prefer this option to the status quo as it improves the fairness, equity, and coherence of the tax rules and it is supported by the local government sector.

Key for qualitative judgements:

- ++ 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

Deductions: How do the options compare to the status quo?

	Option One: Status Quo	Option Two: Denying loss grouping	Option Three: Denying certain deductions
Integrity of the tax system	0	++ This option would prevent the current integrity risks from eroding tax revenues.	++ This option would prevent the current integrity risks from reducing tax revenues.
Fairness and equity	0	- Denying loss grouping would prevent local authorities from grouping <i>any</i> losses. This would be unfair considering they can incur deductible expenditure in deriving assessable income in their CCOs	+ This option would improve the fairness of the tax settings for taxpayers by reducing the ability for local authorities to shelter CCOs from tax.
Impact on local government	0	-- Preventing local authorities from grouping any losses would increase the costs of most councils carrying on their functions and services.	- Preventing local authorities from accessing the corporate gift deduction and limiting certain interest deductions would increase the costs of some councils carrying on their functions and services.
Fiscal impact	0	+ This option would raise tax revenues for central government.	+ The option would raise tax revenues for central government.
Stakeholder support	0	-- The local government sector strongly opposed denying loss grouping.	- Officials expect that this option would not be supported by the sector but would be preferred to Option Two.
Overall assessment	0	0 This option achieves the primary objectives of limiting erosion of tax revenues but comes with significant adverse impacts to fairness, equity, and local government.	+ This option resolves the integrity risks to tax revenues by focusing on the inappropriate deductions.

Imputation: How do the options compare to the status quo?

	Option One: Status Quo	Option Two: Preventing local authorities from converting excess imputation credits to losses
Integrity of the tax system	0	++ This option reduces significant integrity risks for local government taxation.
Fairness and equity	0	+ This option would treat councils similarly to other exempt entities and would ensure local authorities receive the same tax treatment for imputation regardless of whether they are in a consolidated group or not.
Impact on local government	0	- This option would have a funding impact on local government by likely resulting in smaller dividends from CCOs to councils.
Fiscal impact	0	+ This option would raise tax revenues for central government.
Stakeholder support	0	+ The sector supported the proposed changes to imputation during consultation in early 2021.
Overall assessment	0	+ This option achieves the primary objective of resolving integrity risks with local government taxation and maintaining tax revenues.

Conclusion: What options are likely to best address the problem, meet the policy objectives, and deliver the highest net benefits?

Officials consider that the following options will best address the problem:

- **Dividends:** Option Two – Exempting dividends derived by local authorities from wholly-owned CCOs
- **Deductions:** Option Three – Denying certain deductions
- **Imputation:** Option Two – Preventing local authorities from converting excess imputation credits to a tax loss.

What are the marginal costs and benefits of the options?

Affected groups <i>(identify)</i>	Comment <i>nature of cost or benefit (e.g. ongoing, one-off), evidence and assumption (e.g. compliance rates), risks.</i>	Impact <i>\$m present value where appropriate, for monetised impacts; high, medium or low for non-monetised impacts.</i>	Evidence Certainty <i>High, medium, or low, and explain reasoning in comment column.</i>
Additional costs of the preferred options compared to taking no action			
Regulated groups: local authorities, CCOs	The proposed changes will result in a funding impact for local authorities.	Approx. \$23.8m per year	Medium
Regulator: Inland Revenue	The administration costs for Inland Revenue are expected to be negligible.	Very low	High
Other groups: donee organisations	The proposed changes may result in fewer or smaller donations from local authorities to donee organisations. Although the changes will remove a tax concession for making these donations, officials consider that councils will likely continue to donate because they have a commitment to improve the social, economic, environmental, and cultural well-being of their communities, and donee organisations often play a key role in fulfilling these objectives.	Low	Medium
Total monetised costs	Funding impact for local government	Approx. \$23.8m per year	Medium
Non-monetised costs	n/a	n/a	n/a
Additional benefits of the preferred options compared to taking no action			
Regulated groups: local authorities, CCOs	n/a	n/a	n/a
Regulator: Inland Revenue	n/a	n/a	n/a
Other groups: central Government	Increased tax revenue for the Government	Revenue gain of approx. \$23.8 per year	Medium
Total monetised benefits	Increased tax revenue	Approx. \$23.8m per year	Medium
Non-monetised benefits	n/a	n/a	n/a

Section 3: Delivering an option

How will the new arrangements be implemented?

If approved by Cabinet, amendments to the Income Tax Act 2007 will be included in the next omnibus tax bill, scheduled for introduction in August 2021. The changes will apply from the start of the 2022-23 income year.

Inland Revenue will be responsible for administering the changes. This will have no impact on Inland Revenue's systems and will largely involve communicating the changes with the local government sector and rewording some guides and forms. This will have negligible ongoing administration costs.

Officials will provide guidance on the changes to local government taxation in a *Tax Information Bulletin* item.

How will the new arrangements be monitored, evaluated, and reviewed?

Inland Revenue policy officials will work with operational Inland Revenue officials to monitor the implementation and any ongoing impacts to confirm that they match the policy objectives.

Policy officials will also analyse Inland Revenue data from the 2022-23 income year to monitor whether the measures have met the policy objectives of improving the integrity of local government taxation.

Inland Revenue will undertake post-implementation consultation engagement with the local government sector and its tax advisors, pursuant to the Generic Tax Policy Process (GTPP) and the Tax Policy Work Programme, to ensure the rules are working as intended.

Inland Revenue has strong networks in the tax community (including tax advisors to the local government sector) that will provide opportunities for stakeholders to raise any concerns as they arise.