ORIGINAL

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REGULATORY IMPACT STATEMENT

Tax Reform Package for Budget 2010

Agency Disclosure Statement

This Regulatory Impact Statement (RIS) has been prepared by the Treasury and Inland Revenue. It provides analysis on policy options for a tax reform package to be included in Budget 2010. This is the second RIS prepared on this tax reform package; this RIS builds on the analysis and context set out in the previous statement (*Options for tax reform for inclusion in Budget 2010*).

The tax reform package seeks to:

- achieve a step up in economic growth by improving incentives to work, save and invest;
- improve the fairness, coherence and integrity of the tax system by reducing opportunities to avoid tax (and/or unduly gain access to social assistance); and
- have a tax system that supports New Zealand's competitiveness globally in a sustainable manner.

The analysis undertaken includes, in relation to each of the tax changes and to the tax reform package as a whole:

- modelling of revenue, expenditure, and distributional impacts (revenue estimates are based on Treasury preliminary BEFU forecast data);
- consideration of fairness impacts and horizontal equity, as well as tax system integrity and coherence;
- analysis of growth impacts (including impacts on savings, labour supply, and investment);
- consideration of compliance and administrative impacts; and
- detailed implementation and design work.

This analysis is detailed in a number of papers on tax reform, outlined in appendix 1 attached to this RIS.

As noted in the previous RIS (*Options for tax reform for inclusion in Budget 2010*), the options analysed were those that could feasibly be considered (from a policy, fiscal, and operational perspective) for inclusion in the 2010 Budget, with implementation possible within the dates specified by Cabinet. Areas of tax reform requiring more detailed analysis, design or implementation have not been considered, but could still be considered in the longer-term as part of the normal tax policy work programme.

These key parameters were set out by Cabinet on 1 February 2010 (Cab Min (10) 3/2 refers). In addition, Cabinet agreed that the reform should be broadly revenue neutral; asked for further advice on a number of broad options; and agreed that no further advice would be sought on others.

Within the broad options on which further advice was sought, officials, in conjunction with Ministers and their advisers, narrowed these options by reference to the tradeoffs between a number of interrelated factors (derived by reference to the objectives of the tax reform package). These included:

- the impact of the measure on efficiency and growth;
- the distributional impact of a particular measure, particularly at low to middle income levels;
- minimising distortions from tax settings on taxpayer behaviour;
- integrity concerns; and
- the fiscal implications of the measure.

Public comments made by Ministers about the tax reform package – particularly the Prime Minister's statement to Parliament on 9 February 2010 – also guided the narrower options considered.

A key constraint in the process was the need for Budget secrecy, which made extensive consultation on options impossible. However, most of the key tax reforms noted in this paper were considered by the Tax Working Group (TWG) in its review of the key medium-term tax policy challenges facing New Zealand. The TWG's findings were outlined in their 2010 report entitled *A Tax System for New Zealand's Future*.[1] Accordingly, many of the reform options considered have been in the public domain for some time with the ability for the public to contribute thereon within the constraints of Budget secrecy. This is broadly consistent with the Generic Tax Policy Process.

As far as possible, officials have attempted to minimise the impact of the Budget secrecy constraint by consulting on limited aspects of the package, and by deferring more technical implementation decisions until after the Budget so that detailed consultation can occur. Examples of this include the changes to the GST regime for property transactions, Working for Families integrity issues, and implementation of a flow-through regime with respect to Loss Attributing Qualifying Companies (LAQCs).

Further constraints related to the timeframe for analysis and the availability of data. The timeframe for providing advice was often extremely short: the TWG report was released on 20 January 2010; Cabinet agreed to seek advice from officials on a number of tax issues on 1 February 2010; and decisions on the tax reform package were taken by Ministers in early April 2010. A lack of comprehensive data constrained analysis of the revenue, distribution, and efficiency impacts of the package as a whole, although such analysis on aspects of the package was provided wherever data was available. The data constraints differed for different areas of tax reform, and are set out in detail in each of the papers on the different areas of tax reform considered.

Further work would have been desirable on building depreciation rates in New Zealand over a longer time period (ideally using data for 50 years or more); on the impact of behavioural changes as a result of some of the measures; and on the drivers of foreign direct investment.

1 Victoria University of Wellington Tax Working Group (2010), *A tax system for New Zealand's future*, available at http://www.victoria.ac.nz/sacl/cagtr/twg.

The policy options discussed in this RIS affect areas that the government has stated require a strong case before regulation is considered. The tax changes will alter incentives for businesses and individuals to save, innovate and invest, and will impose initial compliance costs on business. Officials consider that regulation is appropriate as it is the only means to achieve the desired objectives; particularly given the aims of the tax reform package to improve personal and business incentives, and thus improve New Zealand's economic growth and competitiveness; and to improve the fairness of the tax system.

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Status Quo and Problem definition

The first 2010 Budget tax reform RIS (*Options for tax reform for inclusion in Budget 2010*), set out New Zealand's current tax settings; the broad problems with these settings; and the expected outcomes in the absence of any further government action. It noted concerns with the current tax system in relation to:

- changes over time to the tax system that were inconsistent with a broad-base, low-rate tax framework;
- reliance on taxes most harmful to growth (personal income and company taxes);
- high effective marginal and average personal income tax rates;
- inconsistent treatment of different forms of income applying to entities and investment forms; and
- lack of international competitiveness of personal income and company tax rates.

On 1 February 2010, Cabinet agreed to limit the scope of the issues that Ministers were to receive advice on in relation to forming a tax reform package for Budget 2010 (Cabinet Minute (10) 3/2 refers). Accordingly, advice was specifically sought from officials on the following main tax issues:

- changes to personal, corporate, portfolio investment entity and trust tax rates;
- increasing the GST rate;
- changes to the depreciation rules in respect of buildings;
- changes to the rules in respect of depreciation loading;
- changes to the thin capitalisation rules;
- non-structural changes to Working for Families;
- clarifying the capital/revenue boundary;
- introduction of loss ring fencing rules for property investment;
- capital contribution payments; and
- considering the tax status of loss attributing qualifying companies.

Advice was specifically **not** sought, for the purposes of a tax reform package in Budget 2010, on the following structural tax issues:

- changing the fundamental structure of the current company tax framework in New Zealand;
- introduction of a capital gains tax;
- introduction of a land tax; and
- introduction of a risk free rate of return method of taxing rental housing.

Cabinet also agreed that tax reforms should be implemented on 1 October 2010, 1 April 2011, or the 2011/12 income year as appropriate; and that the tax reform package should be broadly revenue neutral. A subgroup of Ministers was established to develop a tax reform package for consideration by Cabinet in early April 2010.

The options considered in this RIS seek to address the concerns noted above within the framework agreed by Cabinet in terms of the options considered, feasibility for Budget 2010, implementation dates, and revenue neutrality.

Objectives

The first RIS (*Options for tax reform for inclusion in Budget 2010*) set out the broad objectives for the tax reform package. In short, the main objectives of tax reform in Budget 2010 were to:

- achieve a step up in economic growth by improving incentives to work, save and invest;
- improve the fairness, coherence and integrity of the tax system by reducing opportunities to avoid tax (and/or unduly gain access to social assistance); and
- have a tax system that supports New Zealand's competitiveness globally in a sustainable manner.

The primary aim of the analysis undertaken since the first RIS (*Options for tax reform for inclusion in Budget 2010*) is to identify and analyse whether tax reform within the Cabinet directives discussed above (relating to the type of reform sought, and the revenue neutrality requirement: Cab Min (10) 3/2) refers) can deliver these broad objectives.

An objective of these changes is to be consistent with the Government's equity objectives. Further information on these objectives was provided in the Prime Minister's statement to Parliament on 9 February 2010 (see http://www.beehive.govt.nz/speech/statement+parliament+0):

> "Furthermore, we need a tax system which is not difficult to comply with or administer, which is regarded as fair, and which limits opportunities to divert income and reduce tax liabilities....if [a GST] increase were to occur it would have to be accompanied by across-the-board reductions in personal taxes, as well as up-front increases in benefits, New Zealand Superannuation, and Working for Families payments...Suffice to say, the Government would not embark on a policy of increasing GST unless it would benefit the New Zealand economy in the long term and unless it saw the vast bulk of New Zealanders better off... Higher income families will benefit more from personal income tax cuts, simply because they pay more tax. The Government does not want to magnify this effect by taking money from low to middle income families through a reduction in Working for Families...Our main concern with Working for Families is the possibility that people can earn a lot of income, but do so in a way that means they are still eligible for Working for Families payments. That is contrary to the intent of the policy, which is aimed at supporting genuine low to middle income earners. The Government is therefore looking at how to make Working for Families fairer in this regard."

Therefore, the Government's equity objectives for the tax reform package are:

- to ensure the majority of New Zealanders are better off if GST is increased, through lowering the personal tax rates for all income levels, and providing up-front increases in benefits, New Zealand Superannuation, and Working for Families payments;
- to limit opportunities for individuals and households to divert income, reduce tax liabilities, and artificially lower taxable income to qualify for social assistance, particularly through the use of residential rental property;
- to make the tax system fairer by removing distortions in the treatment of income from different income sources or entities; and
- to ensure that low to middle income earners benefit from the tax reform package.

Regulatory impact analysis

As noted previously, the scope of the issues that Ministers were to receive advice on in relation to forming a tax reform package for Budget 2010 was limited to certain key areas of tax reform. The main options considered by Ministers did not therefore contain any material tax issues outside these agreed key areas.

Appendix 1 attached to this RIS outlines all tax policy reports received by Ministers from officials in relation to the tax reform package for Budget 2010. Where appropriate, issues have been discussed in these papers in terms of their potential, both individually and as part of an overall tax reform package, to help meet the objectives of tax reform.

Given the large number of key areas of tax reform that could be considered for inclusion in the tax reform package, and also the many sub-variations within some of these areas (for example, the multitude of different tax rates and structures that could be considered), there were many potential options for reform that could be considered. These potential options were narrowed by officials, Ministers, and their advisers, by reference to a number of factors as set out in the Agency Disclosure Statement.

Following this, the Ministerial subgroup established by Cabinet considered a number of these options for inclusion in the preferred tax reform package. Instead of discussing all the potential options considered by the subgroup, this RIS summarises officials' advice on the development of a preferred tax reform package for Budget 2010.

The key policy issues and tradeoffs that informed this advice were:

- whether to change the tax mix away from personal income tax towards greater reliance on GST (and subsequently decide on an appropriate GST and income tax rate structure);
- the extent to which additional compensation measures should be provided to certain vulnerable groups for an increase in GST;
- whether a rebalancing of the tax reform package should occur in order to provide relief to companies;
- if relief is to be provided to companies, whether this should be done by way of:
  - a reduction in the company tax rate to 28%; or
  - scaling back of certain base-broadening measures affecting companies or providing some other form of relief;
- if the company tax rate is to be reduced, what the appropriate top Portfolio Investment Entity (PIE) tax rate and the tax rate for other savings vehicles should be; and
- what sort of base-broadening measures should be introduced.

Effects of the tax reform package options considered

Change in the tax mix

The cornerstone of all the tax reform packages considered is the shift in the balance of government tax revenues from income taxes to GST. This shift is expected to improve incentives to save, increasing growth, efficiency, and global competitiveness.

Distributional analysis on the 10.5%/17.5%/30%/33% personal income tax rate structure included in the preferred tax reform package shows that households across total income bands over $10,000 are on average better off in terms of real disposable income[2] i.e. after the price effect of GST is taken into account. This modelling does not take account of the compensatory increases to non-taxable retirement and social welfare income (see T2010/191; PAD2010/16). Therefore the slight reduction that is apparent below $10,000 is likely to be an overestimate.

The reduction in the top personal rate will improve the integrity of the tax system by reducing opportunities for arbitrage and improve incentives for individuals to work by lowering effective marginal tax rates.

These personal tax reductions can be implemented from either 1 October 2010; or by phasing the reduction in the top rate (reducing it to 36% from 1 October 2010, and to 33% from 1 April 2011; with all other rates reducing on 1 October 2010). Deferral of the reduction in the top personal rate would reduce the cost of the package in the first year, as many of the base broadening measures needed to fund the reduction in the top rates will not be implemented until the 2011/12 income year. Phasing only the top personal rate will also ensure that low to middle income earners are not disadvantaged by an increase to the rate of GST.

More detailed analysis and discussion of the major implications of shifting the balance of tax revenues from personal income taxes to GST is provided in the tax policy reports T2010/191;PAD2010/16 and T2010/362;PAD2010/44.[3]

Compensation measures for a rise in GST

An increase in GST from 12.5% to 15% is expected to increase the price of goods and services by, on average, 2.02%. Without additional support, this would result in certain groups (particularly those receiving financial support from the Government, including beneficiaries, and New Zealand Superannuation and Working for Families recipients) facing adverse financial effects even after the personal income tax changes. Options to compensate these groups included consideration of changes to the level, timing, or delivery of government assistance. The resulting compensation package that is included in the preferred tax reform package is comprehensive and compares favourably with the package that accompanied the introduction of GST. It aims to prevent people being worse off on average.

To that end, the proposed measures meet their equity objectives. That said, it is not possible to guarantee that no people will be worse off. Some individuals may be worse off, for example, if they spend more than they earn or where non-taxable income comprises a significant proportion of total income.

The dynamic effect of the proposed tax reform package (and the other alternative packages), together with the *Future Focus* benefit reforms, will also incentivise many people to try to earn more income.

More detailed analysis and discussion of the GST compensation package is provided in the policy reports T2010/339;REP10/03/095;IRD2010/042 and T2010/515;PAD2010/059.[4]

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2 Note total income excludes WFF tax credits, whereas these are included in the calculation of disposable income.

3 See Appendix 1 for a full list of tax policy reports.

4 See Appendix 1 for a full list of tax policy reports.

Relief for companies, PIEs and other savings vehicles

To meet the broad revenue neutrality requirement, base-broadening is required as the changes to personal income taxes and compensation proposed cannot be entirely funded from an increase in the GST rate. Many of the base-broadening options considered have an impact on businesses; which do not benefit directly from the changes to personal income taxes or compensation measures.[5]

The extent to which the tax reform package should incorporate a rebalancing of the burden of taxation on companies and, if so, how this should be achieved, is the major point of difference between the proposed tax reform package and the alternative packages considered by officials.

Variations to the tax reform package considered by officials were:

- to not provide any rebalancing to companies; or
- to provide relief to companies by way of a cut to the company tax rate to 28%; or
- to provide relief to companies by scaling back certain base-broadening measures affecting companies (in particular, by not removing depreciation on industrial buildings) or by providing some other form of targeted relief.

Treasury is of the view that, in order to meet the objectives of the tax reform and to rebalance the package, the preferred approach is to reduce the company tax rate to 28%. Inland Revenue, on the other hand, believes that reducing the company tax rate may be inconsistent with a number of the objectives of the tax reform.

More detailed analysis and discussion of the company tax rate is provided in the tax policy reports T2010/373;PAD2010/043, T2010/362;PAD2010/44 and T2010/119;PAD2010/07.[6]

With respect to the tax rates for PIEs and other savings vehicles, two broad options were considered if the company tax rate was reduced:

- to allow the tax rate on savings vehicles to fall to 28%; or
- maintain the tax rates on savings vehicles at 30% on Budget day, and announce a review of what the tax rate on these vehicles should be.

Reducing the rate to 28% would maintain the status quo alignment of tax on savings vehicles with the company tax rate, and it would reduce the tax on savings. However, it would mean tax on savings made through savings vehicles is lower than the tax on savings made directly by an individual.

The disadvantage of maintaining the tax rates on savings vehicles at 30% on Budget day, with the expectation that the rate be changed either up to the top personal rate or down to the company rate before the commencement of the next income year, is that it may appear more incoherent than having the savings rate fall on Budget day, because the savings tax rate would not align with either rate and would essentially create a new tax rate. It could also create uncertainty as taxpayers will be aware that it is not the final rate for savings vehicles.

The proposed tax reform package opts to reduce the tax rate on savings vehicles to 28% on Budget day, on the basis that it would reduce the tax rate on savings and preserves the current policy intention behind aligning PIE, superannuation, and company tax rates.

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[5] See Appendix 2 for more details on these base broadening options.

[6] See Appendix 1 for a full list of tax policy reports.

Other analysis and discussion of the tax rate for savings vehicles is provided in the tax policy report T2010/296;PAD2010/035.[7]

Base-broadening and integrity measures

As the changes to personal income taxes and compensation proposed cannot be entirely funded from an increase in the GST rate, revenue neutrality requires other base-broadening measures to fund the above noted tax rate reductions and other compensatory measures (in all the tax reform packages considered).

Base-broadening can also be efficiency and integrity enhancing in its own right to the extent that it brings taxation of particular activities more in line with their underlying economic returns and broadens the tax base, enabling lower tax rates (consistent with a broad-base low-rate approach to tax policy). For example, increasing taxation of income from property, through reductions in depreciation and other measures, is intended to reduce existing tax preferences and to improve the allocation of resources. Base-broadening therefore improves the fairness and integrity of the system, by reducing opportunities for some individuals to minimise their taxable income.

Targeted integrity measures also contribute to the fairness of the system.

By financing reductions in personal tax rates, the base-broadening measures will have a second important impact on efficiency. This will increase the incentives for New Zealanders to work, save and invest and encourage productive skilled workers to locate or remain in New Zealand.

A summary of the individual base-broadening and integrity measures adopted, highlighting taxpayers affected and their likely impact, is attached at Appendix 2. Key base broadening reports include changes to the thin capitalisation rules (T2010/202;PAD2010/21), property tax changes (T2010/225;PAD2010/28), changes to depreciation (T2010/299;PAD2010/32), Working for Families issues (T2010/300;PAD2010/36) and other base broadening issues (T2010/422;PAD2010/51).[8]

Tax reform package developed by Ministerial subgroup

After consideration of all these issues, the tax reform package developed by the Ministerial subgroup for inclusion in Budget 2010, subject to Cabinet agreement, consists of the following main changes:

Change in the tax mix: increase in GST and new personal tax rate structure

- GST to be increased to 15% (from 1 October 2010).
- Personal income tax rates to be either:[9]
  - reduced to 10.5%, 17.5%, 30% and 33%, from 1 October 2010; or
  - reduced initially to 10.5%, 17.5%, 30% and 36% from 1 October 2010, with the top personal rate reducing further to 33% on 1 April 2011.

[7] See Appendix 1 for a full list of tax policy reports.

[8] See Appendix 1 for a full list of tax policy reports.

[9] In either case, a 1 October 2010 change would be effected by having a blended personal tax rate apply for the 2010/11 income year, with PAYE rates being changed on 1 October 2010.

Compensation measures for a rise in GST • The main benefits (e.g. Student Allowances, Family Tax Credit, Minimum Family Tax Credit, NZ Superannuation and Veterans Pensions) to be increased by a payment equivalent to 2.02% to provide additional compensation for the rise in GST (from 1 October 2010). • Compensation measures in respect of other benefits are also to be introduced.
Relief for companies, PIEs and other savings vehicles • The company tax rate to be reduced to 28% (from the 2011/12 income year). • The top PIE tax rate and the tax rate for other savings vehicles to be reduced to 28% (generally from the 2011/12 income year). • A two year transitional period be introduced during which pre-existing imputation credits can be attached to dividends at the current maximum 30:70 imputation ratio. • Provisional tax be reduced for taxpayers who pay provisional tax on the earlier year basis, to reflect reductions in the personal income tax rates and the company tax rate.
Base-broadening and integrity measures[10] • Tax depreciation to be removed from all buildings with an estimated useful life of 50 years or more (from the 2011/12 income year). • The 20% depreciation loading to be removed on new assets (from the current income year for purchases made after Budget day). • The 75% safe harbour in the inbound thin capitalisation (interest allocation) rules applying to the New Zealand operations of foreign multinationals to be reduced to 60% (from the 2011/12 income year). • An announcement to be made in the Budget that LAQCs will become flow-through entities for income tax purposes (similar to limited partnerships), with the intention of providing subsequent legislation to this effect (from income years commencing on or after 1 April 2011). • The cost of a depreciable asset to be reduced by an amount that is funded by a capital contribution, so that taxpayers are not able to claim depreciation for costs that they have not in fact incurred (with respect to capital contributions made on or after Budget day). • GST base changes, including measures addressing certain risks to the tax base such as phoenix scheme fraud, to be introduced from 1 April 2011. • Indexation of the Working for Families tax credits abatement threshold to be removed (from the date of enactment). • Changes to be introduced to prevent people offsetting investment losses (such as losses from rental properties) from their taxable income for the purposes of increasing their Working for Families entitlements (from 1 April 2011). • An announcement to be made in the Budget that a post-Budget review addressing integrity concerns relating to social assistance programmes (covering Working for Families tax credits, student allowances and health entitlement cards, including review of trust distributions, income from non-locked in funds such as PIEs, income from non-resident spouses, and fringe benefits), with the intention of providing subsequent legislation addressing these integrity concerns (from 1 April 2011). • The redundancy tax credit to be removed (from 1 October 2010). • Additional funding to be provided to Inland Revenue for compliance and enforcement purposes.

10 See Appendix 2 for further details of the base broadening and integrity measures.

The fiscal cost of this package has been estimated, over the forecast period, to be:

$ million	Increase (decrease) in operating balance				
	2010/11	**2011/12**	**2012/13**	**2013/14**	**4yr total**
Personal Tax (10.5, 17.5, 30, 33)	(2,455)	(3,685)	(3,935)	(4,255)	(14,330)
Net NZS compensation	(255)	(360)	(385)	(390)	(1,390)
Net main benefits compensation	(75)	(100)	(100)	(105)	(380)
WFF compensation	(45)	(65)	(65)	(65)	(240)
Other compensation	(45)	(60)	(60)	(60)	(225)
Company tax cut to 28%	(20)	(340)	(450)	(305)	(1,115)
PIES & savings vehicles capped at 28%	(15)	(40)	(55)	(60)	(170)
Inland revenue admin costs	(10)	-	-	-	(10)
GST (including clawback)	2,040	2,840	2,985	3,160	11,025
WFF de-indexation	-	15	50	40	105
WFF Integrity Measures	5	25	25	25	80
Building Depreciation (all > 50yrs)	-	685	685	690	2,060
Depreciation Loading (grandfathered)	135	245	310	345	1,035
LAQCs (incl. remission loophole)	-	70	65	55	190
Thin Capitalisation 60%	-	200	200	200	600
Depreciation - capital contributions	5	5	5	10	25
GST maintenance	15	60	60	60	195
Tobacco excise[1]	130	160	170	150	610
Tobacco excise - remove CPI flow-through[2]	5	20	40	40	105
Audit activity (incl. admin)	120	210	210	205	745
Sub-total of estimated static impact	**(465)**	**(115)**	**(245)**	**(260)**	**(1,085)**
adjustment for macroeconomic effects	5	25	205	435	670
Impact on operating balance	**(460)**	**(90)**	**(40)**	**175**	**(415)**

*all figures rounded to nearest $5m
[1] Tobacco excise policy as agreed per EGI Min (10) 6/7
[2] Policy to exclude tobacco excise increase-induced CPI flow-through to welfare assistance included.

If the reduction in the top personal rate is phased, the impact on the package is:

$ million	Increase (decrease) in operating balance				
	2010/11	**2011/12**	**2012/13**	**2013/14**	**4-yr total**
Impact of base package	(460)	(90)	(40)	175	(415)
savings from phasing top rate reduction[1]	280	(30)	(40)	-	210
Impact on operating balance	**(180)**	**(120)**	**(80)**	**175**	**(205)**

Other variations of tax reform packages considered

Alternative variations to the proposed tax reform package that were considered mainly centred round whether a rebalancing of the tax mix should occur in order to provide relief to companies and, if so, alternative ways in which this could be achieved.

As noted above, the other two main variations considered were:

- as per the proposed tax reform package (described above), but with no rebalancing to provide any relief to companies; and
- as per the proposed tax reform package, but with relief provided to companies by either:
  - scaling back certain base-broadening measures affecting companies (in particular, not removing depreciation on industrial buildings); or
  - providing another form of targeted relief.

Consultation

Due to the need for Budget secrecy, and the short timeframes involved in developing a tax reform package for Budget 2010, the ability to consult in the usual manner has been severely constrained.

As was noted in the previous 2010 Budget tax reform RIS (*Options for tax reform for inclusion in Budget 2010*), however, many of the key tax reform issues noted in this paper have already been considered by the TWG in its review of the key medium-term tax policy challenges facing New Zealand. Accordingly, many of the reform options considered have been in the public domain for some time, with the ability for the public to contribute thereon. This is broadly consistent with the Generic Tax Policy Process (which includes a consultation process that most tax reform proposals are subject to).

In addition, a limited amount of external pre-Budget confidential consultation has been undertaken by officials with a small number of key stakeholders, including representatives from the property industry, business groups, and tax practitioners. This consultation was conducted in relation to a number of specific technical issues only (for example, legislative issues in relation to a potential transition to an increase in the rate of GST, specific depreciation issues, and in respect of GST base changes).

Officials have also listened to, but not actively consulted on, specific concerns raised by these interested groups in respect of their expectations of what the tax reform may entail; and of the impact of the expected changes on that group.

Some other implementation decisions have been deferred until after the Budget so that detailed consultation can occur. Examples of this include Working for Families integrity issues and implementation of the flow-through regime with respect to LAQCs. This consultation will form part of the post-Budget reviews on these issues.

Conclusions and recommendations

The tax reform options considered by officials that have been discussed in the preceding sections are all considered to be consistent with the stated objectives for tax reform in Budget 2010, and also meet the Government's equity considerations.

Officials consider that the options identified in this RIS, and the preferred tax reform package as a whole, will improve the efficiency, growth, integrity and fairness of the tax system. The switch from personal income taxes to GST, in particular, will reduce biases between different forms of savings and encourage saving.

The main area for debate between the variations to the tax reform package is effectively around a trade off between further improvements to the coherence and equity of the tax system against the benefits of cutting the tax rates on companies and savings vehicles.

Inland Revenue do have some concerns about reducing the company tax rate, believing that, whilst it will boost investment, this may be able to be done more efficiently by either continuing to allow depreciation to owners of industrial buildings or by providing other, more targeted relief to companies. Inland Revenue also considers that a significant amount of the company tax reductions will accrue to non-residents deriving location-specific rents. Moreover, Inland Revenue believes that the empirical evidence for removing depreciation deductions on industrial buildings is not conclusive and may be seen by owners as unfair. Reducing the company tax rate (and the tax rate for savings vehicles) to below 30% may also, in Inland Revenue's view, lessen some of the coherency gains created by greater alignment between these rates and the top personal tax rate.

On the other hand, Treasury consider that the changes to the depreciation rules and the other base-broadening measures are consistent with fundamental tax policy principles as they better align taxable income with economic income. This reduces tax-induced distortions in investors' behaviour, improving the allocation of investment in the economy over time. Devoting some of the resulting revenues to reducing the company tax rate further reduces the effect of taxes on investor behaviour, resulting in a further improvement in the match between investor's assessments of investment opportunities, and the benefits to the country as a whole from an investment. This improvement in the allocation of investment can be expected to boost national productivity over time. As noted in the first RIS (*Options for tax reform for inclusion in Budget 2010),* Treasury is not convinced that there is reliable evidence of significant economic rents being earned in the New Zealand corporate sector, nor that the potential to tax such rents, where they exist, outweighs the strong case for lower corporate tax rates.

The direction of the final package is therefore shaped by the relative importance placed on these policy drivers, and is a question of judgement. However, officials from Inland Revenue and Treasury both agree that all of the options considered, and the preferred tax reform package as a whole, will do the following, relative to the status quo:

- achieve a step up in economic growth by improving incentives to work, save and invest;
- improve the fairness, coherence and integrity of the tax system by reducing opportunities to avoid tax (and/or unduly gain access to social assistance); and
- result in a tax system that supports New Zealand's competitiveness globally in a sustainable manner.

Implementation

The reform options proposed in Budget 2010 will, generally, be implemented by either 1 October 2010, 1 April 2011, or from the 2011/12 income year, depending on the specific measure. Implementation dates are detailed in the description of the main elements of the tax reform package being proposed by Ministers (per the Regulatory Impact Analysis section above).

It is critical for the success of the implementation of the tax reform package that businesses are able to prepare well for the proposed changes, in particular in relation to an increase in GST.

An increase in GST will represent a significant change for businesses, having an impact on their systems, processes, pricing structures and relationships with suppliers, clients and customers. It is therefore vital that taxpayers, and businesses in particular, are provided regular and timely information that explains what they need to do, when and how. To that end, Treasury and Inland Revenue will report back to Ministers by early June 2010 (post Budget day, once officials are able to consult with key stakeholders) to recommend firm options for an effective public information campaign that raises awareness, helps enable taxpayers to better understand how they may be affected, and allows them to take any necessary action.

More detailed analysis and discussion of the options for communicating Budget 2010 tax changes is provided in reports T2010/421;PAD2010/22 and IRD2010/28.[11]

Monitoring, evaluation and review

There are no plans to specifically and separately monitor, evaluate or review the proposed tax reform package for Budget 2010.. The post-implementation phase of the generic tax policy process will help in identifying and addressing any remedial issues post-Budget.

As part of the proposed tax reform package for Budget 2010, there are to be post Budget day reviews on certain issues. These will take place in respect of Working for Families integrity issues and when implementing the flow-through regime for LAQCs.

[11] See Appendix 1 for a full list of tax policy reports.

Appendix 1 – list of tax policy reports received by Ministers in relation to the tax reform package for Budget 2010

Report title	Date	Reference
Cabinet Paper – Options for tax reform in Budget 2010	20/01/2010	T2010/36;PAD2010/02
Implementation of tax reform package	29/01/2010	T2010/73;PAD2010/08
Tax system integrity and the alignment of tax rates	11/02/2010	T2010/119;PAD2010/07
Personal tax rate reductions and an increase in the GST rate	15/02/2010	T2010/191;PAD2010/16
Budget 2010: Thin capitalisation rules	16/02/2010	T2010/202;PAD2010/21
Property-related tax issues	22/02/2010	T2010/225;PAD2010/28
Tax rate for savings vehicles – including PIEs	22/02/2010	T2010/296;PAD2010/35
Working for Families – integrity issues and removing indexation of the abatement threshold	26/02/2010	T2010/300;PAD2010/36
Changes to depreciation – Budget 2010	1/03/2010	T2010/299;PAD2010/32
Implications of changing the tax mix and possible additional support for certain groups	11/03/2010	T2010/339;REP10/03/095;IRD2010/42
The company tax rate	12/03/2010	T2010/373;PAD2010/43
Options for communicating proposed Budget 2010 tax changes	18/03/2010	T2010/421;IRD2010/22
Tax reform – Budget 2010	18/03/2010	T2010/362;PAD2010/44
Additional base broadening measures – Budget 2010	19/03/2010	T2010/422;PAD2010/51
Tax cut transitional measures	26/03/2010	T2010/473;PAD2010/52
Budget tax package – outstanding issues	31/03/2010	T2010/515;PAD2010/59
GST – accounting for land and other high-value assets	1/04/2010	T2010/486;PAD2010/57

Appendix 2 – summary of base-broadening and integrity measures

Base Broadening Option	Description	Affected Taxpayers	Efficiency	Equity	Integrity	Compliance & Admin
Removing Depreciation on all Buildings	Removing tax depreciation from all buildings with an estimated useful life of 50 years or more. Effective from the 2011/12 income year. This will reduce the amount of depreciation deductions claimed.	Owners of building assets (including rental property owners, investors, businesses owning buildings)	Improvement where buildings are not depreciating (as the data suggests)	Improvement generally but building intensive industries disadvantaged compared to status quo	N/A	Reduction in compliance and admin
Removing Depreciation Loading	Removing accelerated depreciation in respect of plant and equipment assets (meaning these assets will only be depreciated at their core economic depreciation rates). Effective from the current income year for purchases made after Budget day	Owners of plant and equipment assets (including rental property owners, investors, businesses)	Significant improvement	Significant improvement	N/A	None
60% Thin Capitalisation Threshold	Reducing to 60% the current 75% safe harbour in the inbound thin capitalisation (interest allocation) rules applying to the NZ operations of foreign multinationals. Effective from the 2011/12 income year. This will reduce interest deductions claimed.	NZ companies owned by non-residents	Improvement where it reduces tax bias for debt. Reducing where it raises cost of capital for NZ	Little or no impact expected for NZers	Significant improvement	Increase in compliance
Loss Attributing Qualifying Companies (LAQCs)	LAQCs will become flow-through entities for income tax purposes, similar to limited partnerships. Effective from income years commencing on or after 1 April 2011	LAQC shareholders	Improvement	Improvement	Significant improvement	Marginal increase in compliance
Capital contributions	Reducing the cost base of a depreciable asset by the amount that is funded by a capital contribution. Effective with respect to capital contributions made on or after Budget day	NZ companies (e.g. in the utilities sector)	Improvement	Improvement	Improvement	Marginal increase in compliance
GST base maintenance	Addressing various GST tax base threats – particularly phoenix-scheme fraud that involves Inland Revenue refunding GST with no corresponding output tax payments being made by suppliers. Effective from 1 April 2011	Largely fraudulent taxpayers	Improvement	Significant improvement	Significant improvement	Marginal increase in compliance
WFF de-indexation	Removal of the Indexation of the WFF tax credits abatement threshold. This will reduce the level of WFF payments claimed.	WFF recipients below the $36,827 abatement threshold	Minor reduction as a higher number of people will face abatement (high MTRs)	Mixed. Low & high income families abate sooner than if indexed	No change	Marginal reduction in compliance and admin (fewer recipients over time)

Working for Families (WFF) integrity	Amendments to prevent people offsetting investment losses (such as losses from rental properties) from their taxable income for the purposes of increasing their WFF entitlements. Effective from 1 April 2011. A review will also be performed to address other social assistance integrity issues (e.g. by including income from trusts for social assistance purposes), with changes effective from 1 April 2011. This will reduce the amount of WFF payments claimed.	WFF recipients claiming rental property losses	Improvement	Improvement	Improvement	Marginal increase in compliance
Increased audit activity	Increased audit activity in respect of property to ensure compliance with tax laws. Also increased debt collection activity	An array of taxpayers such as real property-owners; debtors	Minor – reinforcement of how existing laws are supposed to apply	Significant improvement	Significant improvement	Increase through compliance costs of audit activity

General Notes

Estimates are produced on a static basis & do not take into account behavioural changes (due to information constraints). Estimates are produced on a "best-endeavours" basis given information constraints

Amounts are expressed in $NZ millions and based on fiscal years (year ending 30 June). Amounts are rounded to the nearest $5 million

Estimates are based on Preliminary 2010 BEFU forecasts

Comments on impacts are indicative only. Most impacts are critically dependent on design issues