The Treasury

Final Report of the Tax Working Group Information Release

April 2019

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Office of the Minister of Finance

Office of the Minister of Revenue

Chair, Cabinet

FINAL REPORT OF THE TAX WORKING GROUP

Proposal

1. This paper informs Cabinet of the findings of the Tax Working Group's Final Report.

Executive Summary

2. This Government established the Tax Working Group (TWG) to find ways of improving the structure, fairness and balance of the tax system. This includes whether the tax system promotes the right balance between supporting the productive and speculative economies.

3. We are pleased to advise Cabinet that the TWG has now provided us with its Final Report. The TWG intends to publicly release this report on 21 February 2019.

4. The key topics in the Final Report are:

   - extending capital income taxation – including detailed design proposal;
   - environmental taxes;
   - taxation of business and savings;
   - personal income taxation; and
   - revenue-neutral packages.

5. The Final Report also reaffirms the findings in the Interim Report on:

   - GST and financial transaction taxes;

- corrective taxes;
- the treatment of charities;
- the administration of the tax system;
- the integrity of the tax system;
- international income taxation;
- the future of work; and
- housing.

6. All members of the TWG support extending capital income taxation, although there is disagreement about the scope of the extension. A clear majority (8 members) recommends a broad extension, applying to most assets. A minority (3 members) recommends a more limited extension, applying only to residential rental properties.

7. The TWG also makes 97 other recommendations in its Final Report. Many of these are recommendations that were also made in the TWG's Interim Report. While the TWG's Interim Report covered a wide range of issues impacting the structure, fairness and balance of the tax system, the Final Report focuses on just a few specific issues.

8. Decisions on how to respond to the TWG's recommendations will need to be made by April 2019. However as stated previously, no changes from these decisions will come into effect until after the 2020 election.

Background

9. In December 2017, this Government established the TWG. The TWG was tasked with recommending changes to improve the structure, fairness and balance of the tax system.

10. The TWG provided its Interim Report to the Minister of Finance and the Minister of Revenue in September 2018. In response, we provided the TWG with a letter outlining what areas we would like it to further focus on in its Final Report.

Key findings of the Final Report

11. The TWG has identified two key issues that weaken the structure, fairness and balance of the tax system. These are the inconsistent taxation of capital income, and the treatment of natural capital. Its findings on these key areas are summarised below.

12. The TWG has also made a number of other recommendations for improving the tax system, particularly in the areas of business tax, the taxation of

savings, and personal income tax. These findings are also summarised below.

Capital income taxation

13. All members of the TWG support extending capital income taxation, although there is disagreement about the scope of the extension. A clear majority (8 members) recommends a broad extension, applying to most assets. A minority (3 members) recommends a more limited extension, applying only to residential rental properties. One member of the minority is supportive of the limited extension also applying to vacant properties and second homes.

Rationale for extending capital income taxation

14. The TWG has found that an important element of capital income – profits from the sale of capital assets – are not taxed on a consistent basis. This is one of the key issues impacting the structure, fairness and balance of the tax system.

15. New Zealand's tax system is based on a broad-base, low rate framework. A fair tax system should have two main features:

    i. A tax base that taxes a wide range of income, so that the tax paid is spread fairly – put simply, people earning the same amount of income should pay the same amount of income tax regardless of its source.
    ii. People with more capacity to pay should pay a greater share of their income in tax. This is what makes a progressive tax system.

16. The TWG believe that the current treatment of capital income fails the first test of fairness. This is illustrated in the example below.

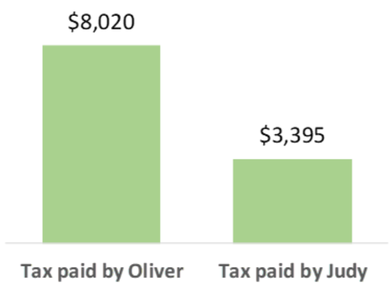
An example of unfairness in our current approach to taxing capital income

Oliver and Judy have the same income, but pay very different amounts of tax.

Oliver earned $50,000 in wages in 2018. He paid $8,020 in tax on this income.

Judy earned $25,000 from part-time work. She also sold shares in a business, and received non-taxable income from a capital gain of $25,000 (Judy bought $100,000 of shares at the start of 2018, then sold those shares for $125,000 at the end of 2018). Under current law, Judy will pay $3,395 in tax.

Judy pays $4,625 less tax than Oliver because she earns her income in different ways.



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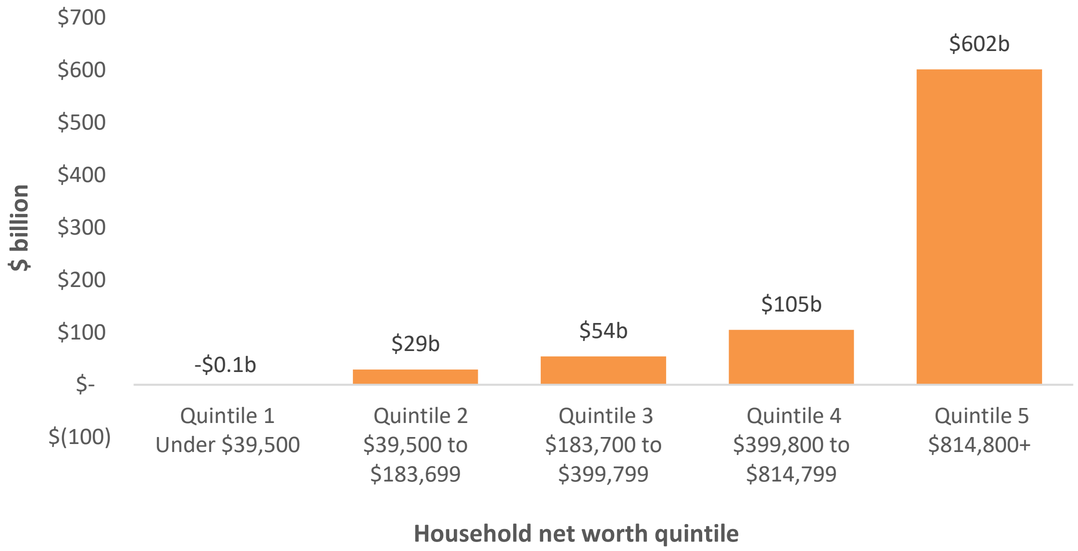
17. The TWG also finds that the current treatment of capital income undermines the second test – the progressivity of the tax system.

18. Overseas studies show that high-income earners derive a much greater share of their income from capital income than low- and middle-income earners. When capital income is not taxed, those on higher-incomes benefit the most.

19. There is evidence of this unfairness In New Zealand. Figure 1 below shows the distribution of wealth. A vast majority of wealth owned by New Zealanders is held by the wealthiest 20% of households. This suggests that a vast majority of untaxed capital income is also going to wealthy households.

Figure 1: Total net worth (excluding owner-occupied housing) by net worth quintile (2015)[1]



20. The TWG consider that extending capital income taxation will also improve the integrity of the tax system. It will prevent some high-income individuals from using complex tax planning to reduce the tax they pay.

21. Extending capital income taxation over a broad range of assets will also help level the playing field between different types of investments.

High-level design

22. The TWG has also provided some details on what a broad extension to capital income taxation would involve. These are listed below.

[1] Note: Net worth estimates exclude owner-occupied housing. Quintiles are based on household net worth, including owner-occupied housing

a. Taxing increases in value on a broad range of assets including residential, commercial and industrial property (but not the family home), shares, and business assets.

b. Only collecting tax when an asset is sold or transferred (with some exceptions e.g. managed funds).

c. Deferring tax in some circumstances (e.g. inheritance, relationship property transferred, sole trader putting business into a company).

d. Treating capital income the same as other income, which means taxing it at appropriate income tax rates (e.g. 28% for companies and marginal rates for individuals) and with no adjustment for inflation.

e. Only taxing gains that occur from after the tax is implemented (e.g. 1 April 2021).

23 [33]

Disadvantages

24. The TWG has acknowledged that extending capital income taxation will lead to compliance costs for asset owners, particularly when the tax comes into effect and asset owners need to value their assets. However, the TWG has identified a number of options which could minimise these costs.

- Some assets with clear market values (e.g. listed shares) will not need to be valued

- There will be a set of default valuation rules for asset owners that do not want a valuation

- Asset owners that do want a valuation would have up to 5 years to determine the value of their asset

25. The TWG also acknowledged that extending capital income taxation could also have some negative impacts on saving and investment. However, the TWG identified a number of complementary measures that could help offset this effect. These measures were considered as parts of a series of complementary packages of measures that could be considered alongside an extension of capital income taxation.

Potential packages

26. Extending capital income taxation on a broad range of assets using the TWG's proposed design would, according to preliminary estimates by the TWG, generate approximately $8.3 billion in its first five years (2021/22 - 2025/26).

27. The TWG has made it clear that a spectrum of choices is available when considering an extension of capital income taxation. These choices include which types of assets should be subject to the tax, and how best to stage the timing of introduction. The various choices will generate differing amounts of revenue.

28. The TWG has developed four illustrative packages for how this revenue could be allocated within the tax system. These packages include a mix of measures that focus on the following:

    - increasing progressivity in the tax system through changesto the personal income tax thresholds;
    - helping low-income taxpayers save for their retirement through changes to the taxation of KiwiSaver contributions and increasing the Government's contribution, and
    - helping to offset any negative efficiency effects arising from extending capital income taxation through targeted measures for business and housing.

Business/housing measures

29. The TWG has identified a wide range of opportunities to reduce compliance costs (especially for small businesses), remove investment distortions for New Zealand businesses, and support the Government's housing affordability goals. Some of the key measures are:

    a. **Allowing businesses to claim depreciation expenses on buildings** – encourage more business investment (range of options)

    b. **Allowing business to deduct expenses for "black hole" expenditure** – encourage innovation and entrepreneurship

c. **Allowing businesses to keep losses when the owner changes** – make it easier for small companies to expand

d. **Removing residential loss ring-fencing** – recognising that gains would be taxed and could reduce upward pressure on rents

30. The TWG also recommends maintaining the company tax at the current rate, and retaining the imputation system. The TWG recommends against moving to a progressive company tax system.

31. The TWG recommends retaining the current tax rate for Māori authorities, but also recommends that this rate should be extended to the subsidiaries of Māori authorities.

Savings measures

32. Extending capital income taxation would also result in higher taxes for people who are saving for their retirement, including people who are using KiwiSaver. The TWG has identified some measures that would help compensate for these higher taxes. These measures are:

- **A KiwiSaver tax exemption** – remove tax on employer KiwiSaver contributions to lower income KiwiSavers
- **Increase the KiwiSaver member tax credit –** increase Government contributions to all KiwiSavers
- **Reduce KiwiSaver PIE rates** – give lower income KiwiSavers the same benefit as those in the highest tax bracket

33. These measures could offset the impact of extending capital income taxation on KiwiSaver earnings.

Environmental taxes

34. The TWG was asked to consider how the tax system could sustain and enhance New Zealand's natural capital, alongside regulation and other policy measures.

35. The TWG has concluded that the environmental challenges ahead of us require profound change to existing patterns of economic activity. Taxation is one tool – alongside regulation and spending measures – that can be used to support and guide a transition to a sustainable economy.

36. The TWG has developed a framework for deciding when to apply taxes to address negative environmental externalities. By applying this framework, the Group believes there is scope for tax instruments to play a greater role in sustaining and enhancing New Zealand's natural capital. Using this framework, the TWG has identified a number of short, medium and long term uses for environmental taxes.

37. The short term uses of environmental taxes recommended by the TWG are all currently being addressed by existing Government work programmes.

Personal income taxation

38. The TWG has considered a range of options to increase the progressivity of the personal tax system, including the possibility of a tax-free threshold. The TWG's preferred option is to increase the bottom threshold of income tax, with a potential increase in the second marginal tax rate.

39. The TWG notes, however, that choices around personal income taxation should depend on the objectives of the Government. The TWG concludes that if the Government wishes to improve the incomes of the very poorest members of society, then changes to benefit rates are likely to be a more effective policy tool than changes to tax rates.

40. The TWG also suggests that the Government consider increasing net benefits to match any personal tax changes. This would provide a fairer redistribution of revenue across individuals, and have a greater impact on poverty reduction.

He Ara Waiora

41. Through the engagement process with Māori, strong support emerged for drawing on knowledge from Te Ao Māori to enhance our public policy frameworks, to improve outcomes for Māori and for all New Zealanders. This process has been named 'He Ara Waiora - A Pathway Towards Wellbeing'. The Treasury is currently considering how it might take this work forward in the context of the Living Standards Framework.

Other issues

42. The Group has commented on a wide range of other issues in its Final Report, including corrective taxes, GST, charities, and the integrity and administration of the tax system. These are all issues that the TWG addressed in its interim report. Some of the Group's recommendations on these issues are summarised below.

Corrective taxes

43. The TWG recommends that the Government review the rate structure of alcohol excise with the intention of rationalising and simplifying it.

44. The TWG also recommends that the Government prioritise other measures to help people stop smoking before considering further large increases in the tobacco excise rate (beyond those already scheduled).

GST

45. The TWG has decided not to recommend a reduction in the GST rate, or the introduction of new exceptions.

46. The TWG also recommends that the Government monitor international developments in taxation of financial services, but does not recommend at this time that the Government apply GST to financial services or introduce a financial transactions tax.

The integrity of the tax system

47. The TWG supports various measures to reduce the extent of the hidden economy (i.e. undeclared and cash-in-hand transactions). The TWG also recommends measures to improve collection and encourage compliance.

The treatment of charities

48. The TWG has considered whether the tax exemption for charitable business income confers an unfair advantage on the trading operations of charities. The TWG's view is that the underlying issue is more about whether policy settings are appropriately encouraging the distribution of funds for charitable purposes.

The administration of the tax system

49. The TWG has made a number of recommendations to ensure that Inland Revenue collects the data it needs in order to effectively administer the tax system, and provides that data to the public, where appropriate.

50. The TWG recommends a number of changes that would improve interactions between taxpayers and Inland Revenue, including the establishment of a taxpayer advocate service to assist taxpayers in disputes with Inland Revenue.

Next steps

51. After consideration by Cabinet, the Final Report will be released by the Group on 21 February 2019.

52. In order to deliver on election commitments and enact legislation before the next election, Cabinet will need to make key policy decisions in response to the Group's recommendations in April 2019. These decisions will be based on consultation between coalition and confidence and supply parties.

53. The indicative timeline for responding to the Group's findings remains as previously indicated [CAB-17-SUB-0505 refers] and is set out below:

April 2019*****	Cabinet decisions on Group's recommendations

***subject to consultation between coalition and confidence and supply parties	
April to August 2019	Consultation on government proposals (if any)
October - December 2019* *additional time to incorporate legislative package	Bill introduced
July 2020	Legislation passed and enacted
April 2021	Implementation

54. There will need to be consideration of an overall package of measures. After the TWG released its interim report, we directed it to consider measures that would result in a revenue-neutral package.

55. There are many options for the Government's final package. The TWG itself says "the Government does not face a binary choice" to extend capital income taxation. There are a spectrum of choices for the coverage of assets, timing and phasing.

56. The Government is also not limited to the proposals in the Final Report. It will be important if we do consider proposals that are not in the report that there is time available to test them.

Responding to the Final Report – key messages for Ministers.

57. The Government set up the TWG to improve the fairness and balance of the tax system, and encourage more productive investment. The final decisions will be based on an overall package that meets that goal.

58. The Government is currently considering the recommendations of the TWG. Decisions will be made in the coming months. No changes from these decisions will come into effect until after the 2020 election.

59. We propose that all requests for comment on the report be referred to the Minister of Finance and the Minister of Revenue.

Consultation

60. The Treasury and Inland Revenue were consulted.

Financial Implications

61. There are no financial implications arising directly from this paper.

Human Rights

62. There are no human rights implications arising from his paper.

Legislative Implications

63. There are no legislative implications arising directly from this paper.

Regulatory Impact Analysis

64. The regulatory impact analysis requirements do not apply to this paper.

Gender Implications

65. There are no gender implications arising from this paper.

Disability Perspective

66. There are no disability implications arising from this paper.

Publicity

67. The TWG intends to release the Final Report on 21 February 2019. This will involve a release event with some selected members of the media and tax community, in which the Chair of the TWG will provide a summary of the contents of the Final Report.

68. We propose to publish a statement at the time that the Final Report is released. This will provide a wider context in terms of the changes we have already made to the tax system and areas where more work in underway (such as multinational taxation and the proposed changes to secondary tax).

69. The TWG is also planning to proactively release all materials that it received from the Secretariat to the Group, as well as other material that was considered by the Group at its meetings. It has already proactively released most of the material it received prior to the release of its Interim Report.

Recommendations

70. The Minister of Finance and the Minister of Revenue recommend that Cabinet:

    1. **Note** the contents of the Final Report.

2. **Note** that the Tax Working Group intends to release the Final Report on 21 February 2019.

3. **Agree** that all requests for comment on the report will be referred to the Minister of Finance and the Minister of Revenue.

4. **Note** the next steps in the process after the TWG's Final Report is released.

Authorised for lodgement

Hon Grant Robertson

Minister of Finance

Hon Stuart Nash

Minister of Revenue

The Treasury

Final Report of the Tax Working Group Information Release

April 2019

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Cabinet

Minute of Decision

Final Report of the Tax Working Group

Portfolios **Finance / Revenue**

On 18 February 2019, Cabinet:

1 **noted** that:

1.1 on 20 November 2017, Cabinet agreed to establish the Tax Working Group to consider improvements to the structure, fairness and balance of the tax system [CAB-17-MIN-0505];

1.2 on 17 September 2018, Cabinet noted the findings of the Tax Working Group's interim report [CAB-18-MIN-0458];

2 **noted** the contents of the Tax Working Group's Final Report;

3 **noted** that the Tax Working Group intends to release the Final Report on 21 February 2019;

4 **agreed** that all requests for comment on the Final Report be referred to the Minister of Finance and the Minister of Revenue;

5 **noted** the next steps in the process after the Final Report is released, as outlined in the paper under CAB-19-SUB-0042.

Michael Webster
Secretary of the Cabinet

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Minister of Revenue