Inland Revenue
Te Tari Taake

POLICY AND STRATEGY

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax Policy Report: Tax Working Group final report – officials' companion advice

Date:	1 February 2019	**Report No:**	T2019/113 IR2019/041
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Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Grant Robertson)	**Note** the contents of this report.	7 February 2019
Minister of Revenue (Hon Stuart Nash)	**Note** the contents of this report.	7 February 2019

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
Matthew Gan	Tax Specialist, The Treasury	s9(2)(a)	N/A (mob)	
Mark Vink	Manager, The Treasury		s9(2)(a)	✓
Emma Grigg	Policy Director, Inland Revenue			

Actions for the Minister's Office Staff (if required)

Return the signed report to the Treasury

Note any feedback on the quality of the report	

Enclosure: No

Tax Policy Report: Tax Working Group final report – officials' companion advice

Executive Summary

This report has been prepared to accompany the Tax Working Group's (TWG) final report which was delivered to you today. The purpose of our report is two-fold:

1. To summarise officials' high-level views on the key recommendations of the final report; and
2. To seek your direction on how we can best assist you in delivering a package of potential tax reforms to enact legislation by mid-2020.

Officials' high-level views on the TWG final report

This report should be read in conjunction with our report of 14 December on the key reform measures being considered by the TWG (T2018/3429, IR2018/800 refers). Our views from that report still hold. Because we intend to provide you with more targeted advice on the key recommendations over the course of February, we have kept the discussion relatively brief in this report.

In summary:

	Recommendation	Officials' high-level view
Capital	The majority of the TWG (8 members) support a broad extension of the taxation of capital gains. Projected to raise revenue of $8.3 billion in first five years following introduction.	• Substantially improves the fairness, sustainability and integrity of the tax system. • Some negative impact on productivity and efficiency (unless accompanied by complementary productivity and efficiency-enhancing measures), and adds complexity to the tax system.
	A minority of the TWG (3 members) would limit the extension to residential rental property. Projected to raise revenue of $2.8 billion in first five years following introduction.	• Much less improvement to the fairness, sustainability and integrity of the tax system than the majority recommendation. • Less negative impact on productivity and efficiency, and adds less complexity, than the majority recommendation,

Environmental	The TWG has developed a policy framework for assessing when to apply environment taxes and highlighted specific areas where there is scope to use them.	• Largely supportive of the recommendations and work is already underway in a number of areas.
Business measures	Consider measures to support the productive economy, boost investment and reduce compliance costs, including: • Changes to the loss continuity rules; • Changes to the treatment of 'black hole' expenditure; • Reintroducing depreciation on buildings; and • Specific options to reduce business compliance costs.	
Retirement savings measures	Consider four potential measures to encourage people to save more for retirement through KiwiSaver.	• Measures would support lower income savers. If you wish to increase support for the lifetime welfare of lower-income households, changes to tax and welfare settings are likely to be more effective.
Personal income tax measures	Several options have been considered. The TWG only considered changes to personal tax settings, as welfare changes were beyond its scope.	• Consider changes to transfer settings alongside changes to personal tax settings once the Welfare Expert Advisory Group (WEAG) has reported back.

The projected revenue from a broad extension of the taxation of capital gains is $8.3 billion in the first five years following its introduction. The TWG has developed four revenue-neutral tax packages with a range of complementary revenue-negative measures to illustrate the choices available to the Government depending on its priorities. The revenue-negative measures comprise a range of options covering personal tax, retirement savings, and business and housing measures.

Government decisions on the environmental and ecological recommendations of the TWG are not expected to impact the fiscal parameters of the potential tax package.

Delivering a package of potential tax reforms to enact legislation by mid-2020

In order to meet the Government's timeline for enacting any significant tax-reform by mid-2020 (to apply from 1 April 2021), you will need to make final policy decisions on key elements of proposed reforms over the next two months so that Cabinet approval can be sought in April and public consultation can begin through the release of a discussion document around May.

The work in developing a tax package can be split into two broad interconnected workstreams:

1. Choices in extending the taxation of capital gains; and
2. Choices on a tax package including which complementary revenue-negative measures to adopt.

The choices you make in extending the taxation of capital gains will determine the quantum of revenue you have to spend on any complementary revenue-negative measures. They may also impact the focus of any complementary measures you wish to adopt in seeking to improve the structure, fairness and balance of the tax system.

To assist you in developing a tax package, we propose to provide you with a series of reports over February and early March and will discuss these further with you on 7 February. The initial reports will ask a series of questions that will help us develop the key design parameters for the extension of the taxation of capital gains and the wider tax reform package.

We have also noted some initial questions in this report that the Minister of Finance may wish to discuss with officials at a scheduled meeting on 7 February (summarised in Annex A). We appreciate you may not yet be in a position to provide direction on many of these questions. However, any guidance you can provide at this stage will help us in tailoring future advice to assist you in the decision-making process.

In developing a tax package, careful consideration needs to be given to the administrative implications of the package, especially given the significant amount of change associated with Business Transformation. We will provide advice on administrative implications in our ongoing reporting.

Table of recommendations

The TWG has made many recommendations in the final report. This report only provides high-level comment on some of those recommendations. We will provide a table summarising our high-level views on all the TWG recommendations (excluding the extension of the taxation of capital gains) in the week of 4 February. We will discuss the TWG recommendations in respect of an extension of the taxation of capital gains in a separate report in advance of the Joint Ministers' meeting on 12 February.

Recommended Action

We recommend that you:

a **note** the contents of this report.

Noted/Not noted *Noted/Not noted*

b **discuss** the report with officials on 7 February.

c **indicate** any initial views on the questions in Annex A.

Mark Vink
Manager
The Treasury

Emma Grigg
Policy Director
Inland Revenue

Hon Grant Robertson
Minister of Finance
/ /2019

Hon Stuart Nash
Minister of Revenue
/ /2019

Tax Policy Report: Tax Working Group final report – officials' companion advice

Purpose of Report

1. This report provides officials' high-level advice on the key recommendations in the Tax Working Group (TWG)'s final report, and seeks your initial steers on where you would like further advice, and how you would like us to engage with you over the coming months.

2. The report is structured as follows:

Pages	**Topic**	**What is covered**
6 to 7	**Update on TWG's Recommendations**	Update on TWG's recommendations since our initial advice provided to you on 14 December 2018
7 to 11	**Overview of TWG's Key Recommendations**	Overview of TWG's key recommendations and officials' high-level views
12 and Annex A	**Next steps**	Summarises the questions for Ministers in the report into a draft agenda for the meeting with the Minister of Finance on 7 February

3. This report accompanies the following documents also provided to you on 1 February:
   - The TWG's final report; and
   - The draft Cabinet paper for the TWG's final report and related briefing material.

4. We are currently preparing separate reports on:
   - s9(2)(f)(iv)
   - Options to reduce compliance costs for businesses to be delivered in the week of 4 February;
   - A table summarising our high-level views on all the TWG recommendations (excluding the extension of the taxation of capital gains) to be delivered in the week of 4 February;
   - Advice commissioned by the Minister of Revenue, including a comparison of capital gains tax regimes across countries, the economic performance in countries that have introduced a capital gains tax, and the distributional impact of taxing capital gains; and
   - The TWG recommendations in respect of an extension of the taxation of capital gains in advance of the Joint Ministers' meeting scheduled for 12 February.

5. We propose to discuss this report with the Minister of Finance on 7 February. Questions for Ministers are noted throughout this report for discussion at that meeting and summarised in a draft agenda at Annex A.

Update on TWG's Recommendations

6. We reported to you on 14 December 2018 on the key reforms being considered by the TWG. Since then, there have been two major developments that have affected the TWG's overall recommendations in its Final Report:

   - Revenue from a broad extension of the taxation of capital gains is now projected to be $8.3 billion in the first five years following introduction, down from $10 billion in the 14 December report. This revision was made because of additional information received by officials and refinement of the modelling approach.[1] In response, the TWG has reduced the size of personal income tax reductions in its illustrative revenue-neutral packages.

- A minority of the TWG (three members) has recommended that the extension of the taxation of capital gains be limited to residential rental property. This is discussed further on page 8 below.

Overview of TWG's Key Recommendations

Majority recommendation – broad extension of the taxation of capital gains

7. The majority of the TWG's members have recommended a broad extension of the taxation of capital gains, as part of a package including complementary revenue-negative measures to be determined by the Government depending on its priorities.

8. Officials consider that a broad extension of the taxation of capital gains is the most effective way to meet the Government's objectives to improve the fairness, sustainability and integrity of the tax system, within the scope of the TWG's terms of reference. In particular, it would:
   - Improve fairness, by raising taxes on income that is currently under-taxed and increasing the progressivity of the tax system;
   - Improve sustainability, by broadening the tax base and ensuring the revenue base remains resilient to future structural changes; and
   - Improve integrity, by reducing opportunities for tax planning and tax avoidance stemming from the capital/revenue boundary and the difference in the company tax rate and top personal tax rate.

9. A broad extension of the taxation of capital gains should also increase the neutrality of investment decisions by reducing the extent to which tax settings bias investment decisions. This will lead to a more efficient allocation of capital in the economy which by itself would improve productivity.

10. On the other hand, there are some costs associated with a broad extension of the taxation of capital gains. These stem from the resulting lock-in effects[2], additional compliance costs, and higher levels of taxation of savings and investment. These costs mean that, on its own, an extension of the taxation of capital gains will have some negative impact on efficiency and productivity, and add complexity to the tax system. We would not expect the negative impact on efficiency and productivity to be large in aggregate, but some sectors will be more affected than others.

11. The extent to which a broad extension of the taxation of capital gains contributes to each of the Government's different objectives will depend on its design and how the revenue raised is used. There will be important trade-offs between objectives. For example, if the Government's overriding priority were for changes in the tax system to:
   - Reduce inequality – revenue-negative measures could be focussed on supporting lower-income individuals;
   - Enhance efficiency and productivity – revenue-negative measures could be focussed on improving business taxation to offset any negative effects on productivity from a broad extension of the taxation of capital gains.

[1] The revenue from a broad extension of the taxation of capital gains is based on the TWG's design of a capital gains tax and will therefore change depending on the final design of the extension. The revenue may also change if newer information comes to light or through further quality assurance.

[2] For assets that have increased in value, the tax liability is triggered when the assets are sold (or deemed to be sold). This may tend to lock taxpayers into existing assets instead of them selling to acquire preferred new assets.

Minority recommendation – limit extension of taxation to residential rental property

12. A minority of the TWG's members have recommended that the extension of the taxation of capital gains be limited to residential rental property (with no further extension at this point).

13. Officials consider that the minority recommendation would achieve the Government's objectives of improving the fairness, sustainability and integrity of the tax system to a significantly lesser extent than the broad extension of the taxation of capital gains recommended by the majority of the TWG's members. In particular, it would:
    - Do much less to improve fairness and reduce inequality, as it would leave capital gains from non-residential capital assets – whose ownership is highly concentrated among higher-wealth households – untaxed;
    - Do less to improve sustainability, as it would extend the tax base to a lesser extent, and therefore do less to ensure the revenue base remains resilient to future structural changes and
    - Do much less to improve integrity, as there would still be significant opportunity for tax planning and tax avoidance to benefit from the capital/revenue boundary and the difference in the company tax rate and top personal tax rate.

14. The minority recommendation would also raise less revenue than the majority recommendation ($2.8 billion rather than $8.3 billion over five years). This means that there would be less revenue to fund complementary revenue-negative measures to help meet the Government's objectives.

15. However, the minority recommendation would have a less negative impact on productivity than a broad extension of the taxation of capital gains, unless a substantial part of the additional revenue raised under a broad extension of the taxation of capital gains is used to finance productivity enhancing measures. This is because it would have a smaller impact on the returns to saving, investment and entrepreneurship. Taxing capital gains earned through land, as opposed to other forms of capital assets, is also likely to create less economic distortions as land is in fixed supply.

16. We will provide you with additional comment on the majority and minority recommendations in our report on designing an extension of the taxation of capital gains (in advance of the Joint Ministers' meeting on 12 February).

Phasing in or partial extensions

17. The TWG has noted that the Government could consider phasing-in a broad extension of the taxation of capital gains, or extending the taxation of capital gains to some assets but not others.

18. With regards to partial extensions, officials consider this would be generally less effective than a broad extension in achieving the Government's objectives for the reasons noted above on the minority recommendation.

19. With regards to phasing, officials note that, as previously advised, the timeline for implementing the broad extension of the taxation of capital gains by 1 April 2021 is very tight. Officials can meet the timeline, but it brings implementation risks of needing to make further legislative changes in future, which would impose higher uncertainty and compliance costs on taxpayers. As we have previously advised, the introduction of legislation until mid-2020 with effect from 1 April 2022 would substantially reduce these risks.

20. However, we have also given further consideration to whether phasing-in a broad extension of the taxation of capital gains would be an alternate way to reduce these implementation risks while still extending taxation to some assets from 1 April 2021. The most feasible phasing option would be to extend taxation to residential rental property (or residential property) from 1 April 2021, and to other asset classes (such as rural, commercial and industrial property, shares, business assets and managed funds) from 1 April 2022 or 1 April 2023 onwards. Other phasing options are unlikely to reduce risks compared with a broad extension of the taxation of capital gains from 1 April 2021.

21. We will provide you with additional comment on phasing in our report on designing an extension of the taxation of capital gains (in advance of the Joint Ministers' meeting on 12 February).

Question for Ministers

- What are Ministers' initial thoughts on the timing of introduction of a tax reform package (including the extension of the taxation of capital gains)?
  a. Implement a tax reform package from 1 April 2021
  or
  b. Implement a tax reform package from 1 April 2022
  or
  c. Implement the extension to residential rental property from 1 April 2021, and to any other asset classes from 1 April 2022 or 1 April 2023.

Environmental and ecological outcomes

22. The TWG has developed a policy framework for assessing when environmental taxes could be usefully applied, and has highlighted specific areas where there is greater scope to use environmental taxes.

23. Officials are largely supportive of these conclusions, and note that work that addresses the TWG's specific recommendations is already underway in a number of areas.

The taxation of business

24. The TWG has made several recommendations on the taxation of business. Some of these were included in the TWG's interim report – such as recommendations against reducing the company tax rate, or introducing a progressive company tax. Since then, the TWG has made further recommendations to support the productive economy, boost investment, and reduce compliance costs. These include:
    - Making changes to the loss continuity rules;
    - Making changes to the treatment of 'black-hole' expenditure;
    - Considering the reintroduction of depreciation deductions for buildings; and
    - Examining specific options to reduce business compliance costs.

25. s9(2)(f)(iv)

26. We are preparing a report on options to reduce business compliance costs to be delivered to you in the week of 4 February.

Questions for Ministers

- Do Ministers wish to commission any particular advice on any of the business measures? Is there anything else Ministers would like to consider?

Retirement savings

27. The TWG has recommended the Government consider increasing tax benefits for low- and middle-income earners (or those on parental leave) provided through KiwiSaver to encourage people to save more for their retirement, and has proposed four potential measures to do so (summarised in Annex A).

28. The suggested measures would support savers, especially those on lower incomes, and could be used to offset any additional taxes on savings brought about by a broad extension of the taxation of capital gains. However, officials consider that none of these measures are likely to significantly increase the amounts that individuals contribute to their KiwiSaver funds. If the Government's objective is to increase support for the lifetime welfare of lower-income households more generally, we consider that changes to tax and transfer settings would be more effective than these KiwiSaver measures.

Question for Ministers

- Do Ministers wish to commission any particular advice on any of the KiwiSaver measures? Is there anything else Ministers would like to consider?

Personal income tax

29. The TWG noted that any changes to personal income taxation would need to reflect the objectives of the Government:
    - If the Government wishes to improve incomes for very low income households, the TWG considers that the best means of doing so is through welfare transfers.
    - If the Government wishes to improve incomes for certain groups of lower-to-middle-income earners, such as full-time workers on the minimum wage, the TWG considers that changes to personal income taxation may be a better option.

30. The TWG also considered a range of options to increase the progressivity of the personal tax system (summarised in Annex A). The TWG has a preference for increasing the bottom tax threshold – potentially combined with an increase in the second marginal tax rate – over introducing a tax-free zone.

31. Officials consider that the appropriate design of any changes to personal income tax settings depends on the Government's objectives.

32. The TWG has not focused on personal income tax settings at middle-to-upper-income levels, but the Government could consider investigating changes in all marginal rates and thresholds to increase efficiency and productivity.

33. Officials recommend you consider changes to transfer settings (i.e., benefits and credits) alongside changes to personal tax, and that you defer any decisions in this regard until after Budget 2019. This would allow time to take account of the WEAG's recommendations and to develop an integrated personal tax and welfare reform package.

34. s9(2)(f)(iv) [redacted]

> **Question for Ministers**
>
> s9(2)(f)(iv) [redacted]
>
> - Are Ministers supportive of the option of deferring decisions in this regard until after Budget 2019 to account of the WEAG's recommendations?

Timelines

35. If Ministers want to enact legislation for a potential tax reform package before the 2020 General Election, legislation would need to be introduced by November 2019. Before this, there would need to be consultation on detailed design decisions, which would need to start around May with the release of a Government discussion document.

36. An indicative timeline to achieve this is set out below:

February	• TWG Final Report published
	• Discussions with Joint Ministers on:
	    o Design details for extending the taxation of capital gains
	    o Overall package of measures

March	• Joint Ministers decisions on:
	    o Design details for extending the taxation of capital gains
	    o Overall package of measures

April	• Cabinet decisions on:
	    o Design details for extending the taxation of capital gains
	    o Overall package of measures

May	• Government announces overall package of measures • Discussion document released
August	• Cabinet decisions on final design details • Legislative drafting instructions issued

37. This timeline requires you to take a series of decisions on a large number of complex issues over the course of February and early March, in time for papers to be prepared to be taken to Cabinet in April. We propose to send you a series of reports throughout February to facilitate these decisions and to discuss this suggested process at the meeting with the Minister of Finance on 7 February.

> **Question for Ministers**
>
> - Are Ministers comfortable with the proposed timeline at paragraph 36?
> - How best can officials can best engage with Ministers and Cabinet over the coming months?

Next steps

38. Officials are scheduled to meet with the Minister of Finance on 7 February to discuss this report. To help guide the discussion at the meeting, we have prepared the draft agenda in Annex A summarising the questions in this report. We appreciate you may not yet be in a position to provide direction on many of these questions. However, any guidance you can provide at this stage will help us in tailoring further advice to asset you in the decision-making process.

ANNEX A:

Draft agenda for discussion
Meeting with Minister of Finance – 7 February 2019

Early guidance on tax packages

1. What are Ministers' current views on the balance of potential objectives for a tax reform package? Is there any particular advice or information that we could provide to assist Ministers in considering the options to achieve these objectives?

2. What are Ministers' initial thoughts on the timing of introduction of a tax reform package (including the extension of the taxation of capital gains)?
    a. Implement a tax reform package from 1 April 2021
    or
    b. Implement a tax reform package from 1 April 2022
    or
    c. Implement the extension of the taxation of capital gains to residential rental property from 1 April 2021, and to any other asset classes from 1 April 2022 or 1 April 2023.

Revenue-negative measures

3. Do Ministers wish to commission any particular advice on any of the following revenue-negative measures? Is there anything else Ministers would like to consider?

Revenue measures	Rationale	Further work
Business and housing measures		
a. Allow businesses to claim depreciation expenses on buildings	Encourage business investment and improve efficiency of investment	
b. Allow businesses to deduct expenses for 'black hole' expenditure	Encourage innovation and entrepreneurship	
c. Allow businesses to keep losses when the owner changes	Make it easier for small companies to expand	
d. Options to reduce business compliance costs	Reduce compliance costs or businesses	Advice in preparation
e. Remove residential rental loss ring-fencing	Reduce upward pressure on rents and increase efficiency	
KiwiSaver measures		
f. Decrease lower KiwiSaver PIE rates	Encourage saving by lower-income earners	
g. Provide the maximum level of Member Tax Credits for those on parental leave	Provide support through KiwiSaver for those on parental leave	
h. Remove tax on employer contributions to lower-income KiwiSavers	Encourage saving by lower-income earners	
i. Increase the Member Tax Credit	Encourage saving through KiwiSaver	
Personal income measures		
s9(2)(f)(iv) [redacted]		

Revenue measures	Rationale	Further work
s9(2)(f)(iv) [redacted]		

Interface with the welfare system

4. s9(2)(f)(iv) [redacted]
5. Are Ministers supportive of the option of deferring decisions in this regard until after Budget 2019 to take account of the WEAG's recommendations?

Timelines and process

6. Are Ministers comfortable with the following timeline?

February	• TWG final report published
	• Discussions with Joint Ministers on:
	    ○ Design details for extending the taxation of capital gains
	    ○ Overall package of measures

March	• Joint Ministers decisions on:
	    ○ Design details for extending the taxation of capital gains
	    ○ Overall package of measures

April	• Cabinet decisions on:
	    ○ Design details for extending the taxation of capital gains
	    ○ Overall package of measures

May	• Government announces overall package of measures • Discussion document released
August	• Cabinet decisions on final design details • Legislative drafting instructions issued

7. How best can officials engage with Ministers and Cabinet over the coming months?