Hon Grant Robertson, Minister of Finance

Hon David Parker, Minister of Revenue

Information Release

Introducing a new top personal income tax rate

December 2020

Availability

This information release is available on Inland Revenue's tax policy website at https://taxpolicy.ird.govt.nz/publications/2020/2020-ir-cab-20-sub-0484

Documents in this information release

#	Reference	Type	Title	Date
1	IR2020/449	Tax policy report	Possible Cabinet and legislative processes before the end of 2020	6 November 2020
2	IR2020/454 T2020/3412	Tax policy report	Introducing a new top personal income tax rate	13 November 2020
3	CAB-20-SUB-0484	Cabinet paper	Introducing a new top personal income tax rate	23 November 2020
4	CAB-20-SUB-0484	Regulatory impact assessment	Introducing a new top personal income tax rate	18 November 2020
5	CAB-20-MIN-0484	Minute	Introducing a new top personal income tax rate	23 November 2020

Additional information

The Cabinet paper was considered and confirmed by Cabinet on 23 November 2020.

Information withheld

Some parts of this information release would not be appropriate to release and, if requested, would be withheld under the Official Information Act 1982 (the Act). Where this is the case, the relevant sections of the Act that would apply are identified. Where information is withheld, no public interest was identified that would outweigh the reasons for withholding it.

Sections of the Act under which information was withheld:

9(2)(a) to protect the privacy of natural persons, including deceased people

9(2)(f)(iv) to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials

Inland Revenue
Te Tari Taake

POLICY AND STRATEGY

Tax policy report: **Possible Cabinet and legislative processes before the end of 2020**

Date:	6 November 2020	**Priority:**	High
Security level:	In Confidence	**Report number:**	IR2020/449

Action sought

	Action sought	Deadline
Minister of Revenue	**Note** the contents of this report **Refer** a copy to the Minister of Finance	10 November 2020

Contact for telephone discussion (if required)

Name	Position	Telephone
Peter Frawley	Policy Lead	s 9(2)(a) [redacted]
Melissa Siegel	Senior Policy Advisor	

6 November 2020

Minister of Revenue

Possible Cabinet and legislative processes before the end of 2020

Introduction

1. Inland Revenue is ready and well placed to implement the new Government's priorities. This report briefs you on possible Cabinet and legislative processes for certain tax policy proposals to be progressed before the end of 2020. These proposals relate to:

   1.1 the introduction of a new top personal tax rate of 39%;

   1.2 changes to the small business cashflow scheme (SBCS);

   1.3 s 9(2)(f)(iv) [redacted]

Top personal tax rate of 39%

2. In the lead-up to the 2020 General Election the Labour Party manifesto included the introduction of a new top personal income tax rate of 39% for income exceeding $180,000 and changes to the SBCS.

3. The new top personal rate would need to be legislated. We have prepared this report on the basis that the new top personal rate would apply from the start of the 2021-22 income year (1 April 2021 for most taxpayers).

4. Treasury and Inland Revenue intend to provide a joint report to you and the Minister of Finance on 12 November 2020 providing further detail and seeking policy approval for the introduction of a new top personal income tax rate of 39%.

Changes to the small business cashflow scheme

5. We have provided you a Cabinet paper on your manifesto changes to the SBCS to be considered by Cabinet on Monday 9 November 2020. These changes do not require legislation. We will provide you advice on 12 November on additional changes to the scheme and whether legislative changes would be required.

Setting the minimum family tax credit

6. In response to COVID-19, the previous Government increased benefits by $25 per week and temporarily doubled the Winter Energy Payment. This has implications for the minimum family tax credit (MFTC), which Ministers may choose to retrospectively adjust for the 2020-21 year. s 9(2)(f)(iv) [redacted]

7. A retrospective amendment to the 2020-21 MFTC rate would need to be made by a change to primary legislation. s 9(2)(f)(iv) [redacted]

8. Treasury, Inland Revenue and the Ministry for Social Development will provide a separate joint report on 12 November 2020 to you, the Minister of Finance, and Minister for Social Development and Employment on options to retrospectively adjust the MFTC for 2020-21 s 9(2)(f)(iv) [redacted].

Options for legislation

9. Options for legislating these changes include:

   9.1 a tax bill focusing on the new 39% tax rate, and possible changes to the MFTC rate and the SBCS if required, could be introduced and passed through all stages under urgency in December 2020;

   9.2 for the new 39% tax rate, a Supplementary Order Paper (SOP) to the Taxation (Annual Rates for 2020-21, Feasibility Expenditure, and Remedial Matters) Bill ("the ARFERM Bill") at the Finance and Expenditure Committee (FEC) stage of that bill. The ARFERM Bill is currently being considered by FEC and the report back to the House is scheduled for early March 2021 with enactment by the end of March 2021.

10. s 9(2)(f)(iv) [redacted]

Timing considerations

11. One relevant consideration is the amount of time between enactment of legislation and the application date of the change, and the extent of any changes that need to be implemented.

39% top personal rate

12. For the introduction of a new top personal rate, there needs to be sufficient time for Inland Revenue, payroll software providers and financial institutions to make the required systems changes and develop the necessary guidance. Employers who do not use off-the-shelf payroll software would also need time to adjust their systems and processes. Enactment of the new 39% rate in December 2020 would best ensure this.

MFTC

13. The MFTC is a payment available to working families with annual family income of $27,768 or less after tax. The MFTC tops up the family's income to $534 in each week that they work the required hours and do not receive a main benefit. To get this payment they must work for salary or wages.

14. A report will be provided to you on 12 November that will discuss whether the MFTC for 2020-21 should be retrospectively adjusted. Under existing policy settings, the MFTC is set relative to the maximum amount of income a family on benefit could receive. The MFTC rate for 2020-21 has not been adjusted to account for the increase to main benefits and the temporary doubling of the Winter Energy Payment made in response to COVID-19.

15. As noted, a retrospective change to the MFTC can only be done by a change to primary legislation. While customers would receive the same final entitlement, the timing of payments to customers would vary depending on when legislation is enacted. The 12 November report will cover this issue in further detail.

16. s 9(2)(f)(iv) [redacted]

s 9(2)(f)(iv) [redacted]

SBCS

17. Treasury, Inland Revenue and MBIE have provided you with a Cabinet paper on your manifesto changes to the SBCS to be considered by Cabinet on Monday 9 November 2020. Based on the current proposals in that report, no legislative amendments are required.

18. s 9(2)(f)(iv) [redacted]

19. Officials will provide you with advice on 12 November on these additional changes and whether legislative changes would be required.

Potential integrity measures

20. It would be desirable to buttress the new 39% rate with a range of integrity measures.

21. Before we start the detailed design of integrity rules it would be useful to understand the intended scope of the 39% tax rate. We are assuming that the intention is to tax the investment and business income of those who earn more than $180,000 at 39%. If this is the intention, in order to be effective, the tax rules would need to be amended to prevent people sheltering income in trusts to avoid the top tax rate. The most effective and straightforward way to achieve this is to align the trustee tax rate with the new top tax rate. While we know that you are not currently proposing this, it would be good to have a discussion on the relative merits of this and alternative approaches.

22. s 9(2)(f)(iv) [redacted]

23. s 9(2)(f)(iv) [redacted]

24. s 9(2)(f)(iv) [redacted]

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[1] High wealth individuals are members of households with at least $50 million of net wealth (or $20 million in some cases if they control large businesses) as estimated by Inland Revenue from public sources.

s 9(2)(f)(iv) [redacted]

25. s 9(2)(f)(iv) [redacted]

26. We will advise you as soon as possible if there are any funding implications for Inland Revenue from administering any integrity measures and additional information collection requirements.

Cabinet process

27. Under either legislative option (bill or SOP), a paper would need to be taken direct to Cabinet on Monday 30 November 2020 seeking policy approval for the design of the new 39% top personal rate.

28. To enable the introduction of a bill shortly thereafter, the paper would seek Cabinet approval for you, in consultation with the Minister of Finance and the Leader of the House, to directly introduce the bill in the House (i.e. without obtaining separate approval for introduction from the Cabinet Legislation Committee). Following Cabinet approval, the bill would be introduced in the week beginning 30 November 2020.

29. To enable the introduction of a SOP, the paper would seek Cabinet approval for you, in consultation with the Minister of Finance and the Leader of the House, to directly introduce the SOP at the FEC stage (i.e. without obtaining separate approval for introduction from the Cabinet Legislation Committee).

30. To allow further time for consideration, it may be possible for the paper to instead be taken to Cabinet on Monday 7 December 2020 and for the corresponding bill or SOP to be introduced that week. This would be the last possible opportunity before Christmas assuming the House were to rise on Thursday 10 December 2020.

31. s 9(2)(f)(iv) [redacted]

Next steps

32. We will discuss the contents of this report with you at a meeting on Tuesday 10 November 2020, in particular, the legislative options for enacting the new top personal rate and possible changes to the SBCS and MFTC.

33. s 9(2)(f)(iv) [redacted]

34. On 12 November 2020, officials intend to report to you and the Minister of Finance in further detail on key policy design issues relating to:

    34.1 the introduction of a new top personal income tax rate of 39%;

34.2 options to retrospectively reset the MFTC for 2020-21 s 9(2)(f)(iv) [redacted];

34.3 s 9(2)(f)(iv) [redacted]

35. We recommend that you meet with the Minister of Finance and officials on Monday 16 November 2020 to discuss the 12 November reports and associated proposals.

36. Following agreement on the key design issues relating to the 39% top personal tax rate, we will report to you and the Minister of Finance on Monday 23 November 2020 with a draft Cabinet paper for your joint approval, for consideration at the Cabinet meeting on Monday 30 November 2020. The Cabinet paper would need to be lodged with Cabinet office by 10am Thursday 26 November 2020.

37. Regarding the MFTC, if Ministers choose to amend primary legislation, the process would be as above. s 9(2)(f)(iv) [redacted]

Other work on information collection

38. Regarding information collection more broadly, access to good quality, accurate information is essential to the smooth running of the tax system. s 9(2)(f)(iv) [redacted]

Consultation

39. The Treasury has been consulted on the content of this report. The Treasury supports the development of integrity measures to buttress the new top rate. The Treasury recommends the development of additional integrity measures post enactment of the rate change, s 9(2)(f)(iv) [redacted], to ensure the 39% rate applies effectively to income over $180,000.

Recommended action

We recommend that you:

1. **note** that the Labour Party manifesto for the 2020 General Election included the introduction of a top personal tax rate of 39% on income exceeding $180,000 and changes to the small business cashflow scheme (SBCS);

   Noted

2. s 9(2)(f)(iv) [redacted]

3. **note** that legislative amendment would be required to implement the new personal tax rate and may be required for the MFTC rate and SBCS changes;

   Noted

4. **note** that two options for legislating these changes include:

   4.1 a bill introduced and passed through all stages under urgency in December 2020;

   4.2 inclusion in a Supplementary Order Paper to the Taxation (Annual Rates for 2020-21, Feasibility Expenditure, and Remedial Matters) Bill at the Finance and Expenditure Committee stage of this bill.

   Noted

5. **note** that you will meet with officials on Tuesday 10 November 2020 to discuss the contents of this report.

   Noted

6. **note** that officials will report to you and the Minister of Finance (and in the case of MFTC, the Minister for Social Development and Employment) on Thursday 12 November 2020 seeking approval on key design features of the new top personal tax rate and possible retrospective changes to the MFTC rate for 2020-21 [redacted] s 9(2)(f)(iv) [redacted];

   Noted

7. **note** that you and the Minister of Finance will meet with officials on Monday 16 November 2020 to discuss the contents of the 12 November reports. We will subsequently provide Ministers with draft Cabinet papers;

   Noted

8. **refer** a copy of this report to the Minister of Finance for their information.

   Referred/Not referred

s 9(2)(a) [redacted]

Peter Frawley
Policy Lead
Policy and Strategy

Hon David Parker
Minister of Revenue
/ /2020

Annex A

s 9(2)(f)(iv)

[redacted]

s 9(2)(f)(iv)

s 9(2)(f)(iv)

s 9(2)(f)(iv)

[redacted]

s 9(2)(f)(iv)

[redacted]

Inland Revenue
Te Tari Taake

POLICY AND STRATEGY

TE TAI ŌHANGA
THE TREASURY

Tax policy report: Introducing a new top personal income tax rate

Date:	13 November 2020	**Priority:**	High
Security level:	Sensitive	**Report number:**	IR2020/454 T2020/3412

Action sought

	Action sought	Deadline
Minister of Finance	**Discuss** this report with officials **Agree** to recommendations **Note** the contents of this report	16 November 2020
Minister of Revenue	**Discuss** this report with officials **Agree** to recommendations **Note** the contents of this report	16 November 2020

Contact for telephone discussion (if required)

Name	Position	Telephone
Phil Whittington	Chief Economist, Policy and Strategy, Inland Revenue	s 9(2)(a)
Jess Rowe	Acting Manager, Tax Strategy, The Treasury	
Steve Mack	Principal Policy Advisor, Policy and Strategy, Inland Revenue	

Sensitive

13 November 2020

Minister of Finance
Minister of Revenue

Introducing a new top personal income tax rate

Executive summary

Purpose of report

1. During the 2020 election, the Labour Party announced an intention to establish a new personal tax rate of 39% for income over $180,000. Much of the economic and distributional analysis in this report has been prepared on the basis of an increase to the top personal rate only, not coupled with an increase to the trustee rate. However, we have also provided advice on increasing the trustee rate as well, which is officials' recommended option.

2. Inland Revenue has previously reported to the Minister of Revenue on 6 November on possible options for legislating the new top personal tax rate in order for the new rate to apply from the start of the 2021-22 income year[1] (IR2020/449 refers). That report also briefly discussed possible integrity measures to buttress the rate change.

3. This report:

   - seeks your agreement to introduce a new top personal rate of 39% (and consequential rate[2] changes) for annual income over $180,000, with application from the start of the 2021-22 income year;
   - advises you on the economic, distributional, and fiscal implications of the proposed reform;
   - seeks your agreement to increase the trustee tax rate to 39%;
   - seeks your agreement for Inland Revenue to collect further information on trusts;
   - recommends you direct officials to provide further advice on other measures to support integrity; and
   - briefs you for discussions on the content of a Cabinet paper seeking approval to implement the new top personal tax rate.

Objectives of the new tax rate

4. We understand the motivation for this reform is to raise extra revenue to reduce the fiscal impact of higher operating allowances proposed in the fiscal strategy (**revenue objective**). We also infer that you want to raise the extra revenue in a way that has as little as possible impact on low- to middle- income earners and that is progressive (**distributional objective**).

[1] The year 1 April 2021–31 March 2022 for most taxpayers.
[2] Including resident withholding tax (RWT) on interest, fringe benefit tax (FBT), employer superannuation contribution tax (ESCT) and residential land withholding tax.

Likely impacts

Fiscal impact

5. We estimate that the proposed new top personal rate will raise approximately $2.2 billion over the forecast period, although this estimate is highly uncertain. This uncertainty arises because we are unable to accurately predict the level of restructuring or avoidance that would occur. This estimate assumes that the trustee rate is not aligned with the top personal rate. If the trustee rate were increased to 39% our preliminary estimate is that revenue would be approximately $300 million higher per annum.[3] This is also very uncertain.

Distributional impact

6. The new top personal tax rate, without an increase in the trustee rate, will raise additional revenue from some high-income earners and increase the progressivity of the tax system. We estimate it will have a small impact on reducing measured income inequality. However, Inland Revenue's data shows many high wealth individuals earn income through company or trust structures, which would limit the impact of this measure on this cohort unless the trustee rate, in particular, is aligned with the top personal rate.

Economic impact

7. There will also be economic costs of raising the top personal rate through increasing biases in labour supply, investment and savings decisions. However, the limited population to which the rate change would apply would mitigate these impacts. Additionally, possible alternative measures to increase tax at a lower economic cost may not meet your distributional objectives.

System design impact

8. The introduction of a new top personal income tax rate will have consequential implications for the rest of the tax system. There will be stronger incentives for taxpayers to avoid the top rate by structuring their affairs or diverting income into other entities, such as trusts, companies and portfolio investment entities (PIEs). The ability to avoid the new top tax rate will have implications for the amount of revenue raised and affect distributional and economic outcomes. Aligning the trustee rate with the new top personal rate will mitigate system design issues.

Integrity measures

9. High-income individuals generally have the flexibility to earn their income through companies and trusts. This would allow them to reduce income subject to the 39% tax rate unless integrity measures to counter this are adopted.

Trustee tax rate

10. Among entities and structures that can be used to reduce tax, trusts represent the most significant integrity risk.

11. The trustee tax rate of 33% is a final tax and there is no further tax if the income is subsequently distributed to a higher tax-rate beneficiary. In the case of companies, shareholders are taxed on dividends they receive with imputation credits for any company income tax paid. The top PIE tax rate is capped at 28% and while it is a final tax, PIEs are not generally used to shelter very large amounts of income because they cannot hold investor-controlled businesses. The trustee tax rate therefore presents the largest single integrity (and revenue) risk from people

[3] This estimate is subject to further quality assurance processes but is indicative of the magnitude.

earning income in a way in which they do not pay tax at what should be their personal tax rate.

12. If a trust earns income and has lower tax-rate beneficiaries, the trustees may classify the income as beneficiary income and it would be taxed at the beneficiaries' tax rates. This mitigates the risk of over-taxation at the trustee tax rate. However, the income must be paid to the beneficiaries within about a year of the trust's year-end or there may be some practical issues for the trust.

13. For these reasons, we recommend that you agree to raise the trustee tax rate to 39% effective for the 2021-22 income year onwards, in line with the application date of the higher personal tax rate.

Other integrity issues

14. This report recommends that you also direct officials to provide further advice on integrity measures s 9(2)(f)(iv) [redacted]. These integrity issues currently exist but become more acute with the increase in the top rate.

15. If you wish to receive advice on wider integrity measures, officials will provide an initial report on the options, process and timetable for integrity measures in February 2021. s 9(2)(f)(iv) [redacted]

16. Depending on the design of any integrity measures, Inland Revenue is likely to require further information from taxpayers. Using this information to monitor systemic issues will be important to assess the success of the reform. We recommend that new trust information reporting for the 2021-22 income year onwards be required in legislation. This will match the application date of the 39% rate, but the information will not be available until trustees file their tax returns after the end of the income year (being 31 March 2022 for most trustees).

Process for implementing rate change

17. As previously reported to the Minister of Revenue, it is feasible to implement a new personal tax rate and consequential amendments by 1 April 2021 (IR2020/449 refers). The costs that arise from the implementation and administration activity of the changes to the 39% rate can be reprioritised within Inland Revenue's existing baseline. This may need to be reassessed if Ministers decide to collect significantly different information from trusts or change other integrity measures over and above increasing the trustee rate. Inland Revenue is also monitoring the cumulative impact of this and other initiatives it may be asked to deliver in the post-election period and may seek funding where costs can no longer be managed within existing baselines.

Next steps

18. We recommend you discuss this report with officials at the joint Ministers' meeting on 16 November. These discussions will inform the content of a paper that we can provide you to take directly to Cabinet on 23 November seeking Cabinet agreement to the rate change and possible alignment of the trustee rate. A second draft Cabinet paper will be provided for you to take directly to Cabinet on 30 November regarding final policy design and seeking delegated authority for the Minister of Revenue (in consultation with the Minister of Finance and Leader of the House) to introduce a bill to implement the proposals.

Recommended action

We recommend that you:

a. **agree** to implement a new personal income tax rate of 39% for annual income over $180,000;

Agreed/Not Agreed Agreed/Not Agreed

b. **agree** that the new rate will apply for the 2021-22 and later income years (beginning 1 April 2021 for most taxpayers);

Agreed/Not Agreed Agreed/Not Agreed

c. **agree** that consequential changes connected to the introduction of the new top personal income tax rate be made to other tax rates, including:

(i) PAYE rates;

(ii) fringe benefit tax;

(iii) resident withholding tax (RWT) on interest;

(iv) employer superannuation contribution tax; and

(v) residential land withholding tax.

Agreed/Not Agreed Agreed/Not Agreed

d. **agree** to increase the trustee tax rate to 39%, effective for the 2021-22 and later income years;

Agreed/Not Agreed Agreed/Not Agreed

e. **agree** that legislative amendments be made to require trusts to provide additional information to Inland Revenue, including distributions to beneficiaries (and their IRD numbers) and balance sheet information on trust assets and liabilities and other information requested by the Commissioner of Inland Revenue;

Agreed/Not Agreed Agreed/Not Agreed

f. **agree** that a new RWT rate on interest should apply from 1 October 2021 to ensure that financial institutions have sufficient time to implement the required systems changes;

Agreed/Not Agreed Agreed/Not Agreed

g. **note** that we estimate that the new personal tax rate (without a change to the trustee rate) will generate around $2.2 billion over the forecast period, but that this estimate is highly uncertain:

Table 1. Estimated revenue from a 39% tax rate on income above $180,000[4]

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

Source: The Treasury

h. **note** that our preliminary estimate is that the revenue increase would be approximately $300 million per annum higher if the trustee rate were also increased (this estimate is highly uncertain and subject to further quality assurance processes);

i. **note** that the additional revenue from increasing the top personal tax rate and any change to the trustee rate can be included in the HYEFU forecasts provided that decisions are made by 23 November;

j. **direct** officials to report back to you in February 2021 with advice on measures to mitigate integrity risks associated with the new top personal tax rate;

Directed Directed

k. **agree** that changes arising from recommendations in a. to f. be included in a bill to be introduced and passed through all stages under urgency in December 2020;

Agreed/Not Agreed Agreed/Not Agreed

l. **note** that Inland Revenue is able to reprioritise to manage the costs that arise from implementation and administration of this initiative within existing baselines, but will need to reassess whether further funding is needed if any new integrity measures (other than raising the trustee tax rate) are progressed;

m. **discuss** this report at a joint Ministers' meeting on 16 November. This will inform the content of a paper for Cabinet on 23 November seeking approval on the new top personal rate and possible alignment of the trustee rate;

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

n. **note** that a second Cabinet paper will be drafted for you to take to Cabinet on 30 November seeking final policy approval and delegated authority for the Minister of Revenue (in consultation with the Minister of Finance and Leader of the House) to introduce a bill containing these proposals.

s 9(2)(a)

[redacted]

Jess Rowe
Acting Manager, Tax Strategy
The Treasury

Phil Whittington
Chief Economist, Policy and Strategy
Inland Revenue

Hon Grant Robertson
Minister of Finance
/ /2020

Hon David Parker
Minister of Revenue
/ /2020

Purpose of report

19. This report:

- seeks your agreement to introduce a new top personal rate of 39% (and consequential rate[5] changes) for annual income over $180,000, with application from the start of the 2021-22 income year;
- advises you on the economic, distributional, and fiscal implications of a higher top personal tax rate;
- seeks your agreement to increase the trustee tax rate to 39%;
- seeks your agreement for Inland Revenue to collect further information on trusts;
- recommends you direct officials to provide further advice on other measures to support integrity; and
- briefs you for discussions on the content of a Cabinet paper seeking approval to implement the new top personal tax rate.

Background

20. The Labour Party 2020 Manifesto announced an intention to have a new personal tax rate of 39% for income over $180,000. We understand the motivation for this reform is to raise extra revenue to reduce the fiscal impact of higher operating allowances proposed in the fiscal strategy. We also infer that you want to raise the extra revenue in a way that has as little as possible impact on low- to middle-income earners and that is progressive.

Consequential changes for proposed new top rate

21. The main consequential legislative changes flowing from the proposed new top personal income tax rate are:

- an additional rate for extra pays (for example, bonuses and retirement payments) and a new secondary code in the PAYE rules;
- a new top fringe benefit tax (FBT) bracket for non-cash benefits provided to employees;
- a new resident withholding tax (RWT) rate on payments of interest;
- a new employer superannuation contribution tax (ESCT) bracket for employer contributions to an employee's superannuation scheme (for example, KiwiSaver); and
- a new higher rate of residential land withholding tax (RLWT) that applies to sales of residential property by offshore persons made within five years of purchase.

22. Normally, the higher RWT rate for interest should apply from the beginning of the year of the change in tax rates. However, the banks have said that systems implications mean it may not be feasible for them to complete this until 1 October 2021. We recommend that the payers of interest have until 1 October 2021 to make

[5] Including resident withholding tax (RWT), fringe benefit tax (FBT), employer superannuation contribution tax (ESCT) and residential land withholding tax.

this change. We consider this is reasonable given that there are few affected taxpayers (about 2% of individuals), Inland Revenue will automatically detect and assess any underpayment of tax for interest income, and the affected taxpayers (earning more than $180,000) are unlikely to suffer hardship from paying the additional tax directly at the end of the year.

Analysis

23. An increase in the top personal tax rate by itself will raise additional revenue from some high-income earners with income over $180,000. It will, however, have limited effects on the amount of tax paid by some of New Zealand's highest income earners unless it is accompanied by additional integrity measures (see paragraph 55 on horizontal and vertical equity) or an increase in the trustee rate.

24. Increasing the top personal tax rate will increase the progressivity of the tax system, but comes with a range of ***economic*** and ***integrity*** impacts:

- A higher top personal tax rate will have economic costs through increasing biases to labour supply, investment and savings decisions. The limited population affected however mitigates these costs.
- A higher top personal rate will create incentives for high-income earners to avoid the top personal rate through restructuring. This paper discusses some possible measures to address these impacts and seeks your direction to provide further advice on these options, including increasing the trustee rate.

25. These economic and integrity impacts are related. The extent of accompanying reforms to company, trust and PIE settings, in order to address integrity risks, will impact distributional, economic and revenue outcomes.

26. The next section outlines the fiscal, distributional and economic outcomes of an increase in the top personal tax rate only, in the absence of accompanying integrity measures or an increase in the trustee rate. The following section discusses potential integrity measures.

Fiscal and economic impacts of raising the top personal rate

Revenue considerations

27. Table 1 below shows our revenue estimate for a 39% top personal rate applying to income above $180,000.

Table 1. Estimated revenue from a 39% tax rate on income above $180,000[6]

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

Source: The Treasury

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

28. Our modelling assumes:

- there is no change to the trustee, company and PIE rates;
- none of the integrity measures discussed below in paragraphs 56 to 73 are in place;
- the consequential rate changes discussed in paragraph 21 are increased; and
- taxpayers do not bring forward income to the current income year to avoid the higher rate.

29. Our revenue estimate also includes a behavioural assumption that high-income taxpayers would reduce their taxable income subject to a new top personal tax rate. This could be achieved through either reducing their total taxable income (e.g. reducing the amount they work or save in New Zealand or potentially evading their tax obligations), or restructuring (e.g. moving their income so that it is earned through companies or trusts, rather than personally).

30. This revenue estimate is highly uncertain because:

- the revenue estimates are sensitive to behavioural assumptions, which are uncertain (see paragraph 31); and
- the full impact of COVID-19 on the income distribution is not yet clear.

31. We have undertaken further modelling to illustrate the sensitivity of the revenue estimates to behavioural assumptions. With moderate changes to our behavioural assumptions the revenue raised by the new tax rate can increase or decrease by approximately $150 million per annum. These results are intended to illustrate the uncertainty in our revenue estimates and are not intended to be upper or lower bounds for potential revenue.

32. The additional revenue from increasing the top personal tax rate and any change to the trustee rate can be included in the HYEFU forecasts provided that decisions are made by 23 November.

Distributional considerations

33. The increase in the top personal rate will increase the progressivity of the tax system as it will be paid only by those with incomes over $180,000. However, the increase in progressivity will be offset to the extent very high-income earners are able to avoid the higher top tax rate (see paragraph 55).

34. Table 2 below shows the number of people potentially impacted by a higher top personal rate, and the additional tax they would pay, based on the 2018-19 income distribution and assuming no restructuring to avoid the higher rate.

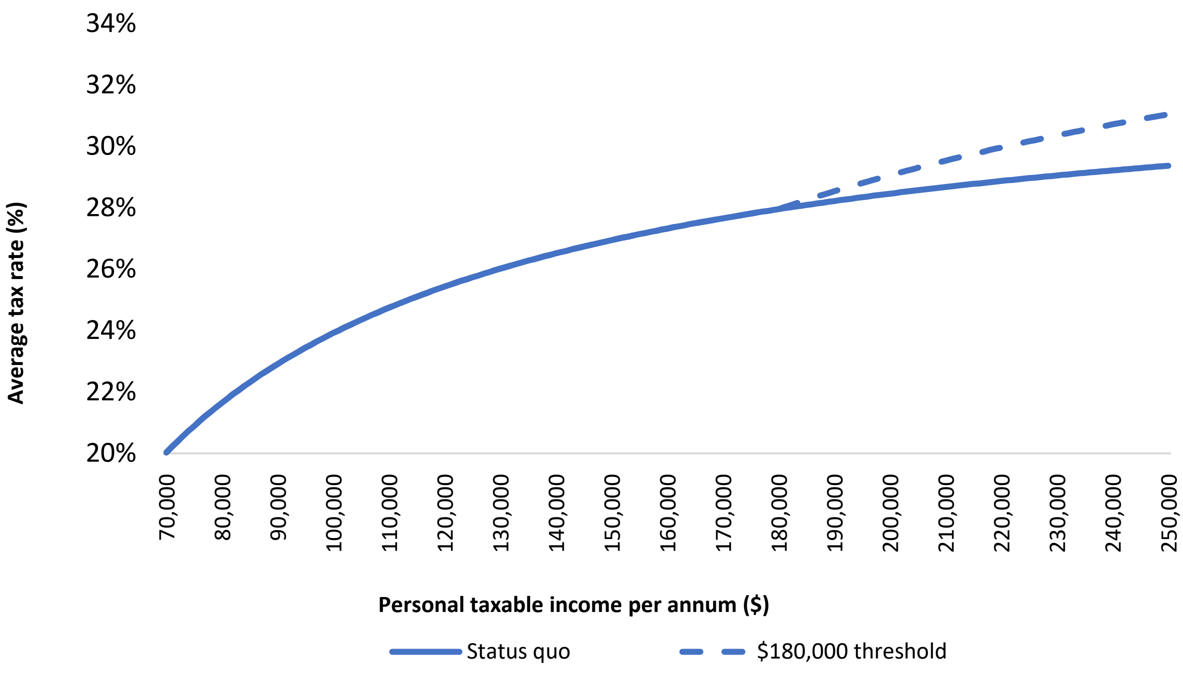
Table 2: Number of people, and additional tax to pay, with new 39% personal rate (using 2018-19 income year data)

For individuals earning between	Number of people (2018-19)	Maximum additional tax an individual would pay ($)
$180,000 - $190,000	10,500	600
$190,000 - $200,000	8,600	1,200
$200,000 - $210,000	7,000	1,800
$210,000 - $220,000	7,000	2,400
$220,000 - $230,000	5,700	3,000
$230,000 - $240,000	4,800	3,600
$240,000 - $250,000	4,200	4,200
$250,000+	38,900	>4,200
Total:	86,700	N/A

Source: Inland Revenue and The Treasury

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

Figure 1. Average personal tax rates for taxable income



Source: The Treasury

Equity

36. An increase in the top personal rate will have a small impact on measured income inequality. We estimate that a 39% top personal rate applying to income above $180,000 will reduce the Gini coefficient[7] for individual after-tax income by

[7] The Gini coefficient is a measure of income inequality. A Gini coefficient of zero expresses perfect equality of income (all people have the same income). A Gini coefficient of one (or 100%) expresses maximal inequality of income (one person has all the income and no one else has any income).

approximately 0.2 percentage points (from 0.493 to 0.491). This small impact reflects the relatively few people earning above $180,000 and, consequently, the relatively small impact this tax increase has on the overall income distribution. This is a very imprecise impact as it assumes no behavioural response, and does not account for shifting of income into other (lower taxed) entities.

37. An increase in the top personal rate will not have the same effect on all high-income earners. Depending on other decisions (e.g. the trustee rate), those earning non-wage income may have greater opportunities than salary and wage earners to structure their affairs to sidestep the new 39% rate. Very high-wealth individuals utilise structures that would allow them to avoid the high rate on much of their income (see paragraph 55, on horizontal and vertical equity). This could create horizontal inequities between wage earners paying the new top rate and high-wealth individuals who can avoid the new rate. As discussed below, there are a range of integrity measures available to reduce these avoidance opportunities.

Economic considerations

38. An increase in the top personal rate on income above $180,000 is likely to have a small negative impact on labour supply, investment and savings. It is likely to have some efficiency cost through increasing biases to labour supply, investment and savings decisions. The magnitude of the impact at a macro-economic level is likely to be small as a relatively small number of people are impacted.

39. There are other possible reforms that would have a lower efficiency cost per dollar raised relative to the current proposal, such as having a smaller increase of all income tax rates or raising GST. However, these options may not meet your distributional objectives. These efficiency costs of the current proposal would be mitigated somewhat by the possible integrity measures discussed in this report. Some of the reasons the cost per dollar raised is higher than alternative options are:

- a higher top personal rate increases existing distortions favouring investment in under-taxed assets (such as owner-occupied housing) and can create new distortions favouring investment into tax-preferred entities;
- a higher top personal rate can discourage some human capital investments, and for the highly skilled can induce migration, and favour self-employment over standard employment arrangements; and
- increasing the top personal rate increases distortions in the treatment of risk and could impact entrepreneurship and innovation.

40. However, alternative options to raise the same amount of revenue may not meet your distributional objectives. The overall welfare effects depend on value judgements, which depend on both efficiency and distributional considerations.

41. The paragraphs below provide more detail on the economic impacts of an increase in the top personal tax rate.

Individual investment/savings impact

42. New Zealand's system of personal income taxation taxes both labour and capital income (e.g. interest, dividends and rents). An increase in the top personal rate could impact both the allocation of savings and investment and the level of saving and investment.

The allocation of individuals' savings and investment

43. Taxation has economic costs when it distorts the allocation of investment due to different investments being taxed at different rates. An increase in the top personal rate would thereby impose economic costs by increasing the existing distortions in the allocation of individuals' savings under the current tax system, which favour investment into certain under-taxed assets (such as land) over fully-taxed investments (such as interest-earning assets). Furthermore, having different entities taxed at different rates may also impose economic costs if it affects the allocation of savings, for example due to rules relating to permissible investments for some entities, or imposes additional compliance costs.

44. In terms of the housing market, a higher top tax rate would be expected to place some upward pressure on the ratio of property prices to rents, although the effects are uncertain.[8] The effect will partly depend on whether the "marginal investor" in the housing market is subject to the higher top tax rate. The effect may be small owing to the small proportion of taxpayers that will be subject to the proposed new tax rate.

The level of saving

45. The impact of a higher top tax rate on the level of household saving is uncertain as there are competing effects. Affected individuals with a savings goal in mind may save more so as to save the same amount after tax, while a higher tax rate on savings income may discourage savings. Most evidence suggests that there would be a small negative impact on aggregate household saving. This will be offset to some extent by lower Crown debt, if increased Crown revenue results in lower debt than otherwise.

Business investment

46. A higher top personal rate is likely to only have relatively small impacts on the level of business investment. This is because New Zealand can access capital from foreign investors and, for foreign investors, the company tax rate is the rate that determines the amount of tax paid on investment income.

47. There may however be small impacts on business investment to the extent to which domestic savings influence domestic investment. A higher top rate will likely matter more in sectors where the ability of New Zealand firms to access foreign capital is limited (particularly small businesses, unlisted businesses and rental property investments).

Human capital and labour market impacts

48. An increase in the top personal rate above $180,000 would likely have a small negative effect on labour supply overall. There is likely to be some efficiency cost associated with the effect on hours worked and job choice. There is a risk, however, that an increase in the top personal rate would reduce the number of highly skilled workers in New Zealand and reduce the efficiency of the allocation of labour. These impacts would arise through the following channels:

- **Migration.** Personal taxes affect after-tax incomes and international evidence indicates this affects migration decisions, and that the impact is greater for mobile, high-income, and highly skilled workers.
- **Human capital accumulation.** A higher top personal tax rate would reduce the financial returns from education and upskilling, and may discourage human capital accumulation. The international evidence regarding the

[8] Because housing is favourably taxed (for capital gains), the value of housing as an investment should increase relative to other investments. This means investors are willing to accept a lower rate of return meaning the rent-to-price ratio should fall.

impact of taxation on human capital accumulation is mixed, and we would expect the impact of this change to be relatively small overall.

- **Allocation of labour.** A mismatch between the top personal rate and the tax rates for trusts and companies will allow self-employed workers to access a lower tax rate than employees. This will favour self-employment over standard employment arrangements, which may reduce the efficiency of the allocation of labour.

Economic impacts – concluding comments

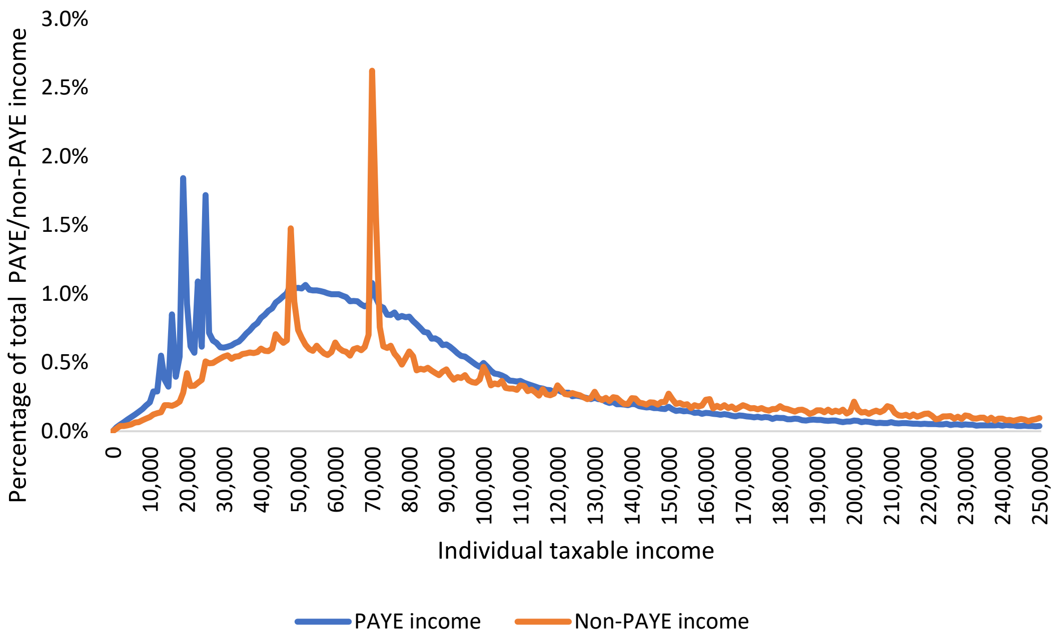
49. Increasing the top marginal tax rate will inevitably have some efficiency costs. However, a top marginal tax rate of 39% is not high compared with other OECD countries. Other countries have been willing to accept the efficiency costs of their top marginal tax rates when they have traded off efficiency costs against their distributional objectives. Nonetheless, there are other lower efficiency cost ways to raise the same amount of revenue.

Integrity concerns with raising the top personal tax rate

50. New Zealand's approach to tax system design to date has sought to support equity and economic outcomes through minimising differences between personal and entity tax rates. Ensuring similar activities are taxed at a similar rate supports economic outcomes by minimising the extent to which the tax system distorts individuals' choices as to which activities to engage in and supports equity by ensuring similar activities are taxed at the same rate.

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

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

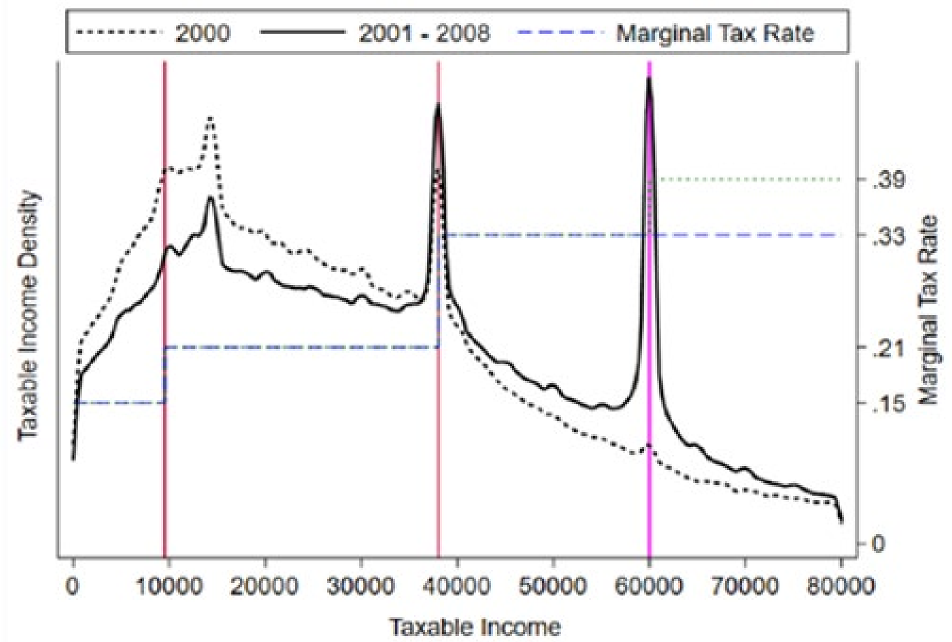


Source: Treasury analysis of Inland Revenue administrative data.

Increasing the top personal tax rate will increase the pressure

52. We consider that a higher top personal rate will increase integrity pressures and will have consequential implications for the rest of the tax system. Evidence to support that expectation comes from the increased avoidance of the top personal tax rate that occurred in response to the increase in the top personal rate in 2000:

Figure 3. Taxable income distribution: self-employed (2000 vs. 2001-2008)[9]



Source: Alinaghi, Creedy & Gemmell[10]

53. The figure shows the distributions of income from self-employment before and after the increase in the top personal rate. The bunching of self-employed people at the new threshold after 2000 shows that there was substantial movement by the self-employed to avoid the higher top personal rate. Measures were taken to mitigate the avoidance of the top rate, including court cases,[11] and new income tax rules.[12] The measures reduced the use of the relevant structures to some extent.

54. In its final report, the Victoria University of Wellington Tax Working Group of 2010 identified misalignment of rates as one of its three critical concerns with the system:

> *The tax system lacks coherence, integrity and fairness: Differences in tax rates and the treatment of entities provide opportunities to divert income and reduce tax liability. This disparity means investment decisions can be about minimising tax rather than the best business investment. For individuals, the tax burden is disproportionately borne by PAYE taxpayers since many with wealth can restructure their affairs through trusts and companies to shelter income from taxes or to enable people to receive social support.*[13]

Increased structuring could have significant impacts

55. Officials are concerned that increased structuring could have significant impacts:

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[9] Taxable income density is the amount of taxable income that is bunched above a hypothetical 'smooth' income distribution where there is no bunched income.
[10] This figure is drawn from Nazila Alinaghi, John Creedy and Norman Gemmell, *Estimating Elasticities of Taxable Income and Adjustment Costs from Tax Kink Bunching: Evidence from Register Data for New Zealand* (2019).
[11] For example, the decision in *Penny and Hooper v CIR* [2011] NZSC 95 limited the ability of taxpayers to use trusts to avoid the top personal rate in certain circumstances.
[12] An example is the personal services attribution rules.
[13] Victoria University Tax Working Group, *A Tax System for New Zealand's Future* (2010), page 9.

- **Revenue impacts:** Revenue from a higher top personal rate will be reduced due to structuring activity. This is due to the direct impact of providing means of earning income at a lower tax rate. It is also because an inconsistent rate structure makes it harder for courts to find tax avoidance when the different rates mean it is difficult to determine whether a structure undermines what Parliament contemplated (the test for applying tax avoidance provisions).

- **Social capital impacts:** Perceptions of arbitrary outcomes will erode public confidence in the integrity of the tax system and the feeling that all taxpayers are treated fairly.

- **Horizontal and vertical equity:** In the absence of other measures, more income of high-wealth individuals and others with substantial capital income is likely to flow to lower-taxed entities. In 2018, personal tax made up only 5% of 350 high-wealth individuals'[14] total income tax,[15] suggesting that an increase in the top personal tax rate in itself will have little effect on taxing the income of the very wealthiest.

- **Integrity impacts:** Substantial misalignment between the top personal rate and the rate for companies, trusts, and PIEs will raise broader questions about the coherence of New Zealand's tax policy settings. There is likely to be considerable pressure on the integrity of the tax system over the long term, in the absence of more substantive reform.

Options to mitigate the integrity issues

56. On 6 November 2020, Inland Revenue officials reported to the Minister of Revenue on possible integrity measures to buttress the proposed rate change, but noted that officials were intending to provide a report to you providing further detail and seeking policy approval for the introduction of the new top personal income tax rate (IR2020/449 refers).

57. We have provided the Minister of Revenue with a table of high-level descriptions of what some integrity measures could be. Some are very technical and could take some time for reasonable analysis and description. s 9(2)(f)(iv) [redacted] We also recommend that you increase the trustee rate.

58. Paragraphs 59-74 provide an initial overview of the main issues and possible options to resolve them. Some of the options are preliminary and would require development and consultation.

Trusts

59. The integrity risk from trusts arises because income retained in a trust is taxed as trustee income at 33% as a final tax. There is no additional tax when the income is subsequently distributed to a higher rate beneficiary, so they do not need to pay the top personal tax rate on any such distributions.

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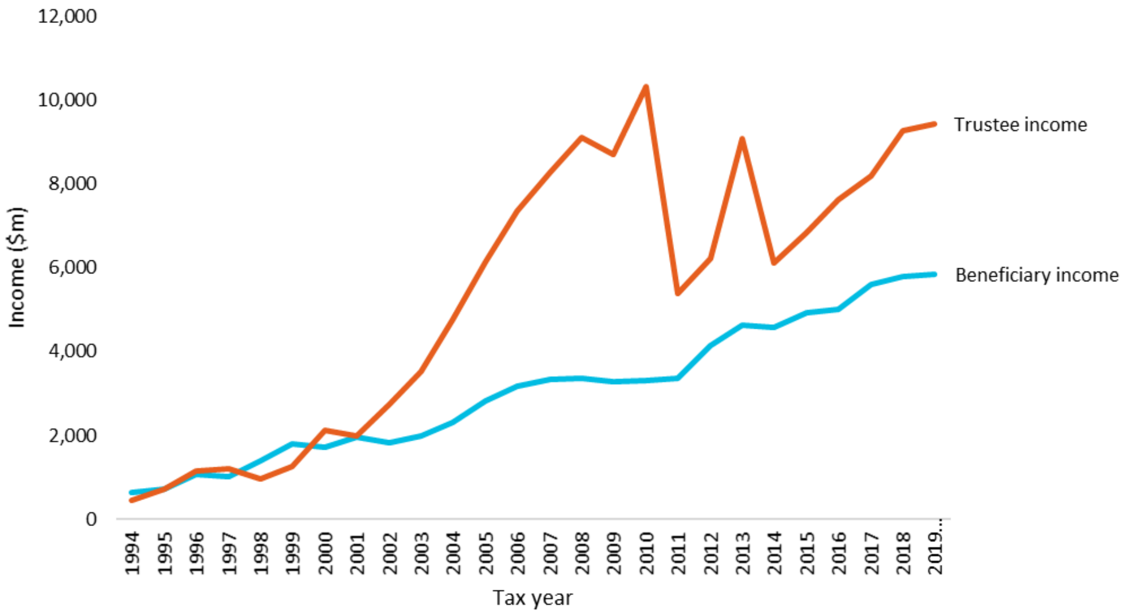
14 Individual members of households with a net wealth of more than $50 million, or more than $20 million and controlling large businesses, as estimated by Inland Revenue from public sources.
15 95% of their income tax was paid at the company or trustee tax rate. Source: Inland Revenue.

Figure 4. Trustee and beneficiary income since 1994



Source: Inland Revenue

60. Figure 4 shows how significant amounts of income were diverted into trusts when the personal income tax rate was raised to 39% in 2000 while the trustee rate remained at 33%.[16] Many of the trust structures that were set up from 2000 are still being used and provide a structure that could be used to reduce tax unless the trustee tax rate is aligned with the highest personal tax rate.

61. Addressing the integrity issue with the trustee tax rate is probably the most significant issue to make sure the 39% tax rate is imposed for high-income individuals. s 9(2)(f)(iv) [redacted]

62. International common practice is to align the trustee rate with the highest individual rate to prevent this. Officials consider that unless New Zealand aligns the trustee tax rate with the highest personal tax rate, the ability of many high-income taxpayers to circumvent the higher personal tax rate will be significant. If income is allocated to beneficiaries on lower tax rates, the income will be taxed at the beneficiaries' tax rates instead. That would mitigate risk of over-taxation compared to the tax rates of beneficiaries. However, the income must be paid to the beneficiaries within about a year of the trust's year-end or there may be some practical issues for the trust.

63. Officials recommend that you increase the trustee tax rate to 39% effective from the 2021-22 income year. If the trustee rate were increased to 39% our preliminary estimate is that revenue would be approximately $300 million higher per annum.[17] This is also very uncertain.

64. s 9(2)(f)(iv) [redacted]

[16] The spike in 2013 was due to the expiration of an imputation credit transitional rule which allowed dividends to be imputed at a higher rate. The spike is from dividends of companies owned by the trust that were distributed to the trust.

[17] This estimate is subject to further quality assurance processes but is indicative of the magnitude.

[redacted]

65. In order to monitor the use of trusts and how they could be used to reduce tax, we recommend that the tax legislation be amended to require trusts to provide additional information to Inland Revenue for the 2021-22 and later income years, such as distributions to beneficiaries and information on trust assets and liabilities, and other information requested by the Commissioner of Inland Revenue. This will match the application date of the 39% rate, but the information will not be available until trustees file their tax returns after the end of the income year (being 31 March 2022 for most trustees). It is likely that trustees and settlors will object to the additional compliance costs from such a change and object to the lack of any consultation before putting this requirement in legislation.

Companies

66. Companies pay income tax at 28%, with any dividends to shareholders taxed at their personal tax rate (with imputation credits for the company tax paid). However, shareholders of controlled companies have adopted some techniques that allow them to receive distributions from companies without paying tax at their personal rate. Any increase in the top personal tax rate would likely increase the use of these mechanisms, as the difference between the two rates would increase to 11 percentage points.

67. s 9(2)(f)(iv) [redacted]

68. We do not recommend aligning the company tax rate with the top personal tax rate, because that would negatively affect the cost of foreign capital.[18] Excessive taxes on inbound investment can decrease the attractiveness of New Zealand as an investment destination.

69. s 9(2)(f)(iv) [redacted]

70. s 9(2)(f)(iv) [redacted]

Portfolio investment entities (PIEs)

71. PIEs are vehicles that hold portfolio investments for investors. These include multi-rate PIEs (managed funds, including KiwiSaver) which pay tax on behalf of their

[18] See *New Zealand's taxation framework for inbound investment*: A draft overview of current tax policy settings (Policy and Strategy, Inland Revenue and the Treasury, June 2016).

[19] s 9(2)(f)(iv) [redacted]

investors using a progressive scale. The rates approximately follow the personal income tax scale, but the top rate is capped at 28%. There is no further tax on distribution to the investor. This means higher-rate taxpayers can obtain the benefit of the capped rate by investing in a PIE.

72. While the difference between the top PIE rate and top personal income tax rate already exists, moving from a five percentage point difference to an 11 percentage point difference could result in a significant diversion of investment into PIEs. This would result in reduced revenue collection and a small economic cost.[20]

73. There is an overlap between how we tax PIEs and savings policy, including KiwiSaver, so we would have to report in more detail on options and issues if you would like further advice on this issue.

s 9(2)(f)(iv) [redacted]

74. [redacted]

Process for implementation

75. Officials can prepare a Cabinet paper for joint Ministers to take to Cabinet on 23 November to enable Cabinet to make a decision on the new top personal tax rate and possible alignment with the trustee rate. A second Cabinet paper will be drafted for you to take to Cabinet on 30 November seeking final policy approval and delegated authority for the Minister of Revenue (in consultation with the Minister of Finance and Leader of the House) to introduce a bill containing these proposals.

76. s 9(2)(f)(iv) [redacted]

77. s 9(2)(f)(iv) [redacted]

78. s 9(2)(f)(iv) [redacted]

79. s 9(2)(f)(iv) [redacted]

Consultation

80. Due to the timeframe for providing advice, no active consultation has been undertaken with other agencies or external stakeholders. However, the proposal was subject to public consultation through the general election process. External commentary on the proposal has referred to the risks highlighted above.

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[20] For example, PIEs are often managed funds that charge fees to the investors. Some investors might normally choose to invest directly and not pay these fees, but a significant tax advantage may result in them using managed funds and paying the fees they would have otherwise saved.

81. Stakeholders are likely to raise concerns with the lack of consultation on new information requirements for trusts, and, if a decision is taken to increase the trustee rate, the lack of consultation on that issue.

82. Initial engagement with New Zealand Bankers' Association suggests that financial institutions would need more time to implement a new RWT rate for interest payments. They would prefer an application date of 1 October 2021 for a new RWT rate on interest.

Administrative impacts

83. Inland Revenue would need to make changes to its systems and work closely with payroll software providers and financial institutions as soon as possible to ensure that correct rates are able to be built into their products in time for a 1 April 2021 application date (or in the case of financial institutions, 1 October 2021). In addition to making system changes, Inland Revenue will need to communicate the changes to customers, including employers and tax agents.

84. Inland Revenue can reprioritise to manage the cost of implementing the new tax rate within existing baselines. Inland Revenue will receive additional contacts from customers about the changes and will utilise additional resources to mitigate the potential integrity concerns arising from the introduction of a higher top tax rate.

85. s 9(2)(f)(iv) [redacted] Inland Revenue may also be asked to deliver multiple initiatives in the post-election period, through Budget 2021, and to support the response and recovery from COVID-19. The cumulative impact of these initiatives means that further funding to cover enduring administration costs may be required. Inland Revenue will monitor the cumulative impact of each initiative and seek funding where costs can no longer be managed within existing baselines. Further administrative impact advice will be provided on each initiative.

Sensitive

Minister of Finance

Minister of Revenue

Cabinet

INTRODUCING A NEW TOP PERSONAL INCOME TAX RATE

Proposal

1. The Labour Party's manifesto for the 2020 general election included a commitment to raising the top personal income tax rate to 39% on income that exceeds $180,000. This paper proposes to implement that policy.

2. We have included analysis of the benefits and drawbacks of aligning the trustee income tax rate with a top personal income tax rate of 39% in this paper. If a decision is made to increase the trustee income tax rate to 39%, we have proposed two alternative application dates.

3. We further propose two information-gathering measures. First, a power for the Commissioner of Inland Revenue to collect information for tax policy purposes. Second, a requirement for trustees to provide additional information to the Commissioner of Inland Revenue. We have included three options on the nature of the information to be provided.

4. If the proposals in this paper are approved, we suggest including the necessary legislative amendments in a bill to be introduced as soon as practicable. Officials will also report back to us in February on other integrity measures to buttress these reforms.

Executive Summary

5. Our objective for this policy is to raise revenue to allow the Government to continue providing public services and manage debt while supporting New Zealand's economic recovery (a revenue objective), in a way that is targeted towards high-income earners (a distributional objective).

Top personal income tax rate

6. Increasing the top personal income tax rate to 39% on income in excess of $180,000 (without changing the trustee income tax rate) is estimated to generate around $2.22 billion in revenue over the next five years. This figure is, of course, an estimate and includes an assumption that some people may structure their affairs to avoid the new rate, for example, by diverting income through other vehicles like companies or trusts.

The number of people who will do so is uncertain, and could be greater than that already assumed in the estimate.

Trustee income tax rate

7. Aligning the trustee income tax rate with the top personal tax rate and implementing further measures to buttress this new rate and minimise opportunities for avoidance would increase the revenue from the measure, and ensure that taxpayers with similar income levels pay similar levels of tax. On the other hand, Labour campaigned explicitly that we would not increase the trustee income tax rate, but would monitor behaviour around avoidance and the success of enforcement measures.

8. This paper accordingly sets out three options for consideration and discusses the benefits and drawbacks of each. The options are:

   8.1 **Option A:** Increase the trustee income tax rate to 39% from **1 April 2021** for the 2021-22 income year onwards and work on over-taxation concerns[1] during 2021 (with any resulting measures having retrospective effect from 1 April 2021).

   8.2 **Option B:** Increase the trustee income tax rate to 39% from **1 April 2022** for the 2022-23 income year onwards and work on over-taxation concerns during 2021 (with any resulting measures having effect from 1 April 2022).

   8.3 **Option C:** Defer the decision on whether to increase the trustee income tax rate to 39% to a later date pending information on whether there is a behavioural response to avoid paying the new personal income tax rate.

Integrity and information gathering

9. We have also directed officials to provide advice to us in February 2021 on additional measures to support the integrity of this reform. s 9(2)(f)(iv) [redacted]

10. We also propose two information-gathering measures. The first measure would provide the Commissioner with the power to collect information for tax policy purposes. The second measure would increase information gathering from trustees.

Background

11. The measures in this paper implement the proposals contained in our tax policy released in the lead up to the 2020 General Election. Our objective for this policy is to raise revenue to allow the Government to continue providing public services and manage debt while supporting New Zealand's economic recovery, in a way that is progressive and is targeted towards high-income earners.

[1] Over-taxation may occur where, for example, trustee income is taxed at 39%, but all beneficiaries of the trust are on a lower personal income tax rate.

Raising the top personal income tax rate to 39%

Current tax rates

12. New Zealand's personal income tax rates are progressive. The greater a person's taxable income, the higher the proportion that is taxed. New Zealand's current personal income tax rates are set out below:

Taxable income	Tax rate
$0 – $14,000	10.5%
$14,001 – $48,000	17.5%
$48,001 – $70,000	30%
$70,001 upwards	33%

13. These rates apply to personal income. Tax rates for some structures (such as companies or trusts) are flat and the rate does not increase as income increases. PIEs (which includes KiwiSaver funds) are subject to a progressive tax scale, but at rates different to those set out above.

Specific rules that need to be changed

14. Our proposal is to introduce a personal income tax rate of 39% for income exceeding $180,000. To implement this change consistently across different kinds of personal income, a number of tax rules will also need to be amended to incorporate the new 39% personal income tax rate, including:

    14.1 PAYE rules (new secondary earnings and extra pay codes would be required).

    14.2 Fringe benefit tax (which generally seeks to tax non-cash benefits provided to employees).

    14.3 Resident withholding tax (RWT) on interest.

    14.4 Employer superannuation contribution tax (which generally seeks to tax an employer's superannuation cash contribution made on an employee's behalf).

    14.5 Residential land withholding tax (which generally seeks to tax amounts received by an offshore person who sells residential land within five years of acquisition).

Application date

15. The new 39% personal income tax rate and consequential changes listed above would apply for the 2021-22 income year onwards (beginning 1 April 2021 for most taxpayers).

16. However, we recommend that the higher RWT rate on interest take effect from 1 October 2021 in order to accommodate difficulties in changing systems for large interest payers, for example financial institutions. As the higher tax rate on interest income will take effect from the beginning of the income year, this would have only a small timing effect on Crown revenue in the first year.

This reform will raise revenue and increase the tax system's progressivity

17. The new personal income tax rate will support our revenue objective, giving us more flexibility to manage debt while protecting public services. Introducing a new 39% personal income tax rate applying to income above $180,000[2] (without any change to the trustee income tax rate) is expected to raise $2.22 billion over the forecast period, as shown in **Table 1**:

Table 1: Estimates of revenue collected from introducing a new top personal income tax rate

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

18. The revenue is likely to continue to increase in the outyears beyond 2024/25.

19. This revenue estimate is highly uncertain as estimates are sensitive to behavioural assumptions. For instance, it depends on the extent to which people restructure their affairs to avoid the top tax rate. Some restructuring effect is built into the model already, but the actual behaviour could be greater than that. The full impact of COVID-19 on the income distribution is not yet clear. Moreover, revenue estimates will increase if other tax settings are changed at the same time (discussed further below).

20. The 39% personal income tax rate will also support our distributional objective by increasing the progressivity of the tax system. It is a way of raising additional tax revenue that is targeted towards high-income earners. Table 2 below shows the number of people potentially impacted by a higher top rate and the additional tax they would pay, based on data from 2018–19. This represents approximately 2% of taxpayers.

Table 2. Number of people and additional tax to pay with new top personal rate (using 2018–19 tax year data)

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

**Approximately 2% of individual taxpayers.*

[2] As set out in paragraph 14, to implement an increase of the top personal income tax rate consistently across different kinds of personal income, a number of tax rules will also need to be amended to incorporate the new 39% rate, including the PAYE rules, fringe benefit tax, RWT on interest, ESCT and RLWT.

21. The new 39% personal income tax rate will cause a small reduction in measured income inequality. The Treasury estimates that the new income tax rate will reduce the 'Gini' measure of inequality[3] by approximately 0.2 percentage points (from 0.493 to 0.491). However, this is a very imprecise measure and the total impact will depend on how individuals respond to the increase in tax.

The new 39% personal income tax rate carries economic costs and integrity risks

22. An increase in tax rates may, theoretically, have economic costs. For example, it may reduce incentives to work or save and may alter the allocation of investment. The magnitude of the impact is very small in the case of this change given the relatively small number of people impacted by the tax increase (around 87,000 in the 2018-19 year).

23. A top personal tax rate of 39% is not high compared with other OECD countries. New Zealand's top personal income tax rate will still be in the bottom third within the OECD and will be lower than many of the countries we compare ourselves to, including Australia. While there are other revenue raising options that might have a lower cost per dollar raised, these do not meet our distributional objectives. Furthermore, the total impact on wellbeing will depend on how the revenue is used as it will allow us to manage debt, while protecting public services like education and health.

24. Without supporting integrity measures or other rate changes, some types of taxpayers will find it easier than others to structure their affairs so as not to pay the higher rate. Those earning non-wage income have greater opportunities to structure their affairs around the increase than those earning wage income. This could undermine both our distributional objective (as some high-income taxpayers could avoid the new rate) and our revenue objective (if more taxpayers than expected shift their income into other structures and entities to avoid the new rate). Taxpayers will be less able to do this if the trustee income tax rate increases to 39%.

25. The extent of these impacts will depend on the opportunities available to avoid the new income tax rate through structures and entities (such as trusts and companies). Set out below are possible measures to reduce opportunities for taxpayers to avoid the new 39% personal income tax rate.

Options regarding the trustee income tax rate

26. Our campaign position was that, for 98% of New Zealanders, there will be no income tax changes. Our campaign material said we were not going to increase the trustee income tax rate because there are legitimate reasons for people to use trusts. However, we said that if we see trusts being used to avoid the 39% personal rate, then we will move to crack down on those people who are exploiting trusts in this way.

27. At present, the top personal tax rate and the trustee income tax rate are aligned at 33%.[4] Therefore in response to an increase of the top personal income tax rate, we

[3] The Gini coefficient is a measure of inequality. An income Gini coefficient of zero expresses perfect equality of income (all people have the same income). A Gini coefficient of one (or 100%) expresses maximal inequality of income (one person has all the income and no one else has any income).

[4] The trustee income tax rate (currently 33%) applies to income that is retained in a trust and not allocated to beneficiaries. When income is allocated to beneficiaries within specified time limits, it is subject to the personal tax rate of the beneficiary according to the personal income tax scale set out in paragraph 12.

set out below three options for consideration. The options are (in addition to increasing the personal tax rate):

27.1 **Option A:** Increase the trustee income tax rate to 39% from **1 April 2021** for the 2021-22 income year onwards and work on over-taxation concerns during 2021 (with any resulting measures having retrospective effect from 1 April 2021).

27.2 **Option B:** Increase the trustee income tax rate to 39% from **1 April 2022** for the 2022-23 income year onwards and work on over-taxation concerns during 2021 (with any resulting measures having effect from 1 April 2022).

27.3 **Option C**: Defer the decision on whether to increase the trustee income tax rate to 39% to a later date pending information on whether there is a behavioural response to avoid paying the new personal income tax rate.

28. Paragraphs 29 to 44 compare increasing the trustee income tax rate (Option A or B) with not increasing the trustee income tax rate (Option C). If Cabinet decides to increase the trustee income tax rate, paragraphs 45 to 48 then compare Option A and B. If it decides not to increase the trustee income tax rate, paragraphs 49 to 51 provide analysis of Option C.

Alignment of rates (Options A and B) supports our revenue objective

29. Alignment of the trustee income tax rate with the top personal income tax rate under Option A or B will generate further revenue.

30. **Option A**: We estimate that setting both the trustee income tax rate and top personal tax rate at 39% from 1 April 2021 will raise $3.705 billion over the forecast period, as shown in **Table 3**:

Table 3: Estimates of revenue collected from Option A (39% top personal income tax rate <u>and</u> trustee income tax rate from 1 April 2021)

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

31. **Option B**: We estimate that setting the top personal tax rate at 39% from 1 April 2021 and setting the trustee income tax rate at 39% from 1 April 2022 will raise $3.440 billion over the forecast period, as shown in **Table 4**:

Table 4: Estimates of revenue collected from Option B (39% top personal income tax rate from 1 April 2021 <u>and</u> 39% trustee income tax rate from 1 April 2022)

Fiscal year	2020/21	2021/22	2022/23	2023/24	2024/25	Total over forecast period
Estimated tax revenue ($m)	95	260	950	1,160	975	3,440

32. **Option C**: As discussed above at paragraph 17 that a new 39% personal income tax rate that applies to income above $180,000[5] (without any change to the trustee income tax rate as provided by Option C[6]) will raise $2.220 billion over the forecast period, as shown in **Table 5**:

Table 5: Estimates of revenue collected from Option C (39% top personal tax rate from 1 April 2021, but no change to the trustee income tax rate)

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

33. Under all three estimates, the revenue is likely to continue to increase in the outyears.

34. The increased revenue under the estimates for Option A ($3.705 billion) and Option B ($3.440 billion) compared to Option C ($2.220 billion) is generated not only from taxing trust income at a higher rate, but also obtaining a revenue gain from reduced avoidance of the personal tax rate.

35. All figures above are highly uncertain and sensitive to assumptions about taxpayer behaviour.

Alignment of rates (Options A and B) would enhance our distributional objective and the tax system's integrity

36. Aligning the trustee and top personal income tax rate under either Option A or B will be perceived to be fairer from a horizontal equity perspective. Inland Revenue's data shows many high-wealth individuals earn income through company or trust structures. Alignment of the top personal and trustee tax rates reduces the opportunity for those earners to structure their income through trusts to avoid the 39% personal income tax rate.

37. Reducing the opportunity for structuring to avoid tax enhances trust in the tax system. If structuring to avoid the 39% personal income tax rate is seen as widespread, it could undermine the culture of voluntary compliance that underpins our tax system. Such avoidance also undermines social cohesion more generally.

38. High-wealth individuals will, however, still have opportunities to structure their income through companies. That said, unlike trusts, when company income is distributed to shareholders it is taxed at the personal rate of the shareholder, so is ultimately taxed under the personal income tax scale. s 9(2)(f)(iv) [redacted]

[5] To note, as set out in paragraph 14, to implement an increase of the top personal income tax rate consistently across different kinds of personal income a number of tax rules will also need to be amended to add the new 39% rate, including the PAYE rules, fringe benefit tax, RWT on interest, ESCT and RLWT.

[6] There is insufficient certainty to forecast any revenue from a potential future increase in the trustee income tax rate under Option C.

Alignment of rates (Options A and B) carries several risks

39. Alongside these benefits, aligning the trustee income tax rate with the top personal rate under Option A or B carries several risks and downsides.

40. As noted above, there is a small risk that the personal income tax rate increase may have economic costs by reducing incentives to work and save. While increasing the trustee income tax rate to 39% will mean more income is taxed at a higher rate, it will support our revenue objective by raising more revenue and support economic and fairness objectives by providing fewer opportunities for tax-driven behaviour.

41. Secondly, a 39% trustee income tax rate will alter the incentives of trustees. When a trust earns income, trustees can choose to retain the income as “trustee income” or allocate it as “beneficiary income”. Trustee income is taxed at the trustee income tax rate (currently 33%) irrespective of the amount of income earned. Beneficiary income is taxed at the beneficiary’s personal income tax rate, which depends on their total income.

42. At present, where a beneficiary’s personal tax rate is less than 33%, there is an incentive for trustees to allocate income as beneficiary income so that it is subject to that lower rate, rather than retain it in the trust. However, there are valid reasons to retain income in the trust and distributing income to beneficiaries may not always be in the best interests of the beneficiaries. Further, there are existing rules that prevent income-splitting by taxing allocations to “minor beneficiaries” (those aged under 16) at the trustee income tax rate.

43. By raising the trustee income tax rate to 39%, we would increase the incentive for trustees to allocate income to beneficiaries where the beneficiaries’ personal tax rate is less than 39%, where those beneficiaries are aged 16 or over. Alternatively, if income is not allocated to beneficiaries, it will be taxed at a rate higher than their personal income tax rate. This change could therefore impact individual beneficiaries of trusts across all income levels.

44. Finally, increasing the tax rate on trustees to 39% will raise tax rates across all kinds of trusts. Although trusts could be used to avoid the 39% personal rate, they have a variety of legitimate purposes. Officials can provide us with advice on how these impacts could be ameliorated for specific types of trusts. This is especially important where there are over-taxation concerns.

Comparison of Options A and B

45. If Cabinet agrees to increase the trustee income tax rate, Options A and B provide two alternative application dates for that increase. To support the integrity of the tax system, officials would work on over-taxation concerns during 2021.

    45.1 Option A applies from 1 April 2021 (2021-22 income year onwards). Any measures produced from work to address over-taxation concerns should apply from 1 April 2021 and have retrospective effect (if necessary).

    45.2 Option B applies from 1 April 2022 (2022-23 income year onwards). Any measures produced from the work to address over-taxation concerns should apply from 1 April 2022.

46. Option A would more closely align with our revenue and distributional objectives. Option A would provide greater revenue over the forecast period, but Options A and B would have the same revenue effect over the long term. The simultaneous alignment of the tax rates under Option A would further support the tax system's integrity and would be perceived to be fairer from a horizontal equity perspective.

47. Over-taxation concerns would likely be addressed through measures with retrospective effect. While these measures would likely be to the benefit of those affected, they could (depending on design) produce complex compliance obligations for trustees and lead to inefficiency (where knowledge of measures to address over-taxation concerns would have impacted decision making).

48. Option B would be easier for taxpayers to comply with and avoid complex retrospective law-making. Taxpayers would be aware of any measures to address over-taxation concerns from the time the increased tax rate is in force, and therefore be more certain of the tax consequences of income derived and actions taken in respect of trusts. However, Option B provides a misalignment of the trustee income tax rate and the personal income tax rate for the 2020-21 income year. This would make it easier to avoid the new top personal income tax rate through the use of trusts in the interim year.

Option C

49. Option C is the most accurate implementation of what Labour campaigned on during the election. We said that we would not change the trustee income tax rate, but rather monitor behaviour and move to change that if we thought there was an increase in avoidance. We took this approach for two main reasons. First, there are legitimate uses for trusts (such as being established on behalf of children who have lost parents or who are disabled). It is questionable whether increasing tax on these kinds of trusts aligns with the distributional goal of the policy. Second, there have been significant improvements in enforcement of tax obligations over recent years, including court decisions that give Inland Revenue more ability to crack down on avoidance behaviour.[7]

50. The downside risks of not moving the trustee income tax rate are outlined in the paragraphs above. There is evidence from the last time the top rate of income tax was increased to 39% that there was an increase in avoidance behaviour. There is also a basic question of fairness around the treatment of different types of income, particularly by high-income earners.

51. Option C provides that the decision whether to increase the trustee income tax rate could be deferred until a later time. Deferral would allow officials to analyse any behaviour undertaken by taxpayers to avoid the new top personal income tax rate, and then inform any future decision whether to increase the trustee income tax rate. However, the misalignment of tax rates until a decision is made could allow some avoidance to occur, and the government would forego the revenue that would otherwise be generated from an increase in the trustee income tax rate.

[7] *Penny v Commissioner of Inland Revenue* [2011] NZSC 95, [2012] 1 NZLR 433.

We have commissioned further work to buttress these reforms

52. Among entities and structures that can be used to reduce tax, trusts represent the most significant integrity risk. Addressing the integrity issue with the trustee income tax rate is probably the most significant issue to ensure the 39% tax rate is imposed for high-income individuals. However, it is not a cure-all because companies and PIEs would still be potential vehicles for obtaining a lower tax rate.

53. To support the option chosen by Cabinet regarding the trustee income tax rate, we have directed officials to provide us with advice on additional measures to support the integrity of this reform.

54. s 9(2)(f)(iv) [redacted]

55. s 9(2)(f)(iv) [redacted]

56. These options are complex and are likely to require substantial consultation. Officials will report to us in February 2021 on potential integrity measures and a proposed timeframe for consultation.

Strengthening information-gathering rules

57. We recommend a clarifying amendment to the Commissioner's current information-gathering powers. There is some uncertainty about the ability of the Commissioner to require persons to provide information solely for tax policy development purposes. This uncertainty could limit the Commissioner of Inland Revenue from fully exercising her current powers, which could reduce the range of information available for developing tax policy. We propose an amendment to remove any such uncertainty as having access to information is critical to providing good tax policy advice.

58. We also recommend the introduction of a new information-gathering measure to collect further information from trusts. This measure could be used to evaluate whether the top personal rate of 39% is working effectively, and gain insight into the use of structures and entities by trustees in New Zealand. Furthermore, information could be collected for future periods (which would likely be available to trustees) or for past periods (to the extent the information exists).

59. This paper accordingly sets out three options for this information-gathering measure in relation to trusts, from least information collected to most information collected. The options are:

59.1 **Option 1**: Collect information from trustees relating to the 2021-22 and later income years to test compliance and effective operation of the 39% rate.

59.2 **Option 2**: Collect information from trustees relating to the 2021-22 and later income years to test compliance and effective operation of the 39% rate, and provide better information to understand and monitor the use of structures and entities by trustees.

59.3 **Option 3**: Collect information from trustees relating to any income year (including prior years) to test compliance and effective operation of the 39% rate, and provide better information to understand and monitor the use of structures and entities by trustees.

60. While Option 1 would not prevent the Commissioner of Inland Revenue from using information for wider purposes (including general analysis of the use of structures and entities by trustees), it would influence the nature and range of information collected.

Consultation

61. Given tax rate changes are often in response to election commitments and passed under urgency, no external consultation has been conducted regarding the new tax rate proposal.

62. The Privacy Commissioner was consulted on the proposal to collect more information from trusts in relation to the introduction of the new 39% tax rate. At this stage he considers that the proposed collection of personal information of beneficiaries poses a low privacy risk. The Privacy Commissioner welcomes the opportunity to work with officials to better understand the specific information to be collected and the drafting of the proposal.

63. Due to the insufficient information available on the proposals to collect information from trusts from past periods and to collect information for tax policy purposes, the Privacy Commissioner is unable to assess the privacy risks associated with the proposals. However, as the proposals progress the Privacy Commissioner welcomes the opportunity to work with officials.

64. We have informed the Ministry of Justice of the information-gathering proposals (to collect information for tax policy purposes and specific information from trusts), and are consulting them on further design detail.

65. Stakeholders are likely to raise concerns with the lack of consultation on new information requirements for trusts, and, if a decision is taken to increase the trustee income tax rate, the lack of consultation on that issue.

66. If the measure to gather information from trustees is agreed to, Inland Revenue will consult with interested parties on the compliance costs it may create.

Implementation

67. The introduction of a higher top tax rate will require systems changes for Inland Revenue, including the creation of new tax codes. Payroll software providers will also need to factor the changes into their systems and products and need lead-in time to

do so. Implementing these changes (including consequential amendments) by 1 April 2021 is feasible if they are legislated before the end of the year. Financial institutions paying interest have indicated they would need until 1 October 2021 to make the necessary systems change to implement the higher RWT rate.

68. The proposal to gather new information from trustees may have administrative impacts and administrative costs not yet identified. Once the requirements for the new reporting are settled, Inland Revenue may look to seek further funding to cover administration costs.

69. Inland Revenue will need to communicate the changes to customers, including employers and tax agents.

70. Inland Revenue will have to divert existing limited compliance resource to mitigate the potential integrity concerns arising from the proposals.

71. For a very small number of taxpayers the rate change may apply retrospectively.[8]

Next steps

72. Implementing the proposals recommended in this paper requires changes to the Income Tax Act 2007 and the Tax Administration Act 1994.

73. The necessary legislative changes to implement any adopted recommendations will need to be included in a bill to be introduced as soon as practicable. It is envisaged that a bill would be introduced in the week beginning 30 November 2020 and pass through all stages under urgency.

74. To ensure that a bill can be introduced as soon as practicable, we recommend that Cabinet delegates authority to the Minister of Revenue and Minister of Finance to make decisions on the detailed design of the agreed proposals, and invite the Minister of Revenue to instruct Inland Revenue to draft the necessary amendments to give effect to the agreed proposals.

75. Final policy approval and delegated authority for the Minister of Revenue (in consultation with the Minister of Finance and Leader of the House) to introduce a bill containing the agreed proposals will be sought at the Cabinet meeting scheduled on 30 November 2020.

Impact Analysis

Regulatory Impact Assessment

76. The Quality Assurance Panel with representatives from Inland Revenue and the Treasury have reviewed the Introducing a new top personal income tax rate regulatory impact statement (RIS) prepared by Inland Revenue and considers that the information and analysis summarised in the RIS **partially meets** the quality

[8] For a very small number of taxpayers earning over $180,000, the 2021-22 income year starts earlier than 1 April 2021. The higher top personal rate will apply to those taxpayers from the start of their income year.

assurance criteria. This is because some key elements of the proposals have not been consulted on and will not be consulted on prior to being implemented.

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

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

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

80. The RIS also notes that Inland Revenue intends to consult with stakeholders on the other proposed integrity measures including potential changes to PIE tax rates over the first half of 2021 so that they can be legislated for 1 April 2022.

Climate Implications of Policy Assessment

81. In respect of the proposal to introduce a personal income tax rate of 39%, the Climate Implications of Policy Assessment (CIPA) team at the Ministry for the Environment has been consulted and confirms that the CIPA requirements do not apply to this proposal as the threshold for significance is not met.

Human Rights

82. The proposals in this paper do not impinge on rights and freedoms under the Human Rights Act 1993. As stated above, the Ministry of Justice has been informed of the information-gathering proposals, and are considering them in light of the New Zealand Bill of Rights Act 1990.

Gender Implications

83. There are no gender implications arising from these proposals.

Disability Perspective

84. Some trusts are established on behalf of people who are disabled. If the trustee income tax rate is increased, we will work on over-taxation concerns that could negatively impact such trusts.

Publicity

85. Subject to Cabinet's agreement to the recommendations in this paper, we intend to issue a media statement when the related tax bill is introduced.

Proactive Release

86. We propose to proactively release this Cabinet paper, associated minutes, and key advice papers with appropriate redactions when the related tax bill is introduced.

Recommendations

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

1. **Agree** to implement a new personal income tax rate of 39% for income over $180,000.

2. **Agree** that the new rate will apply for the 2021-22 and later income years (beginning 1 April 2021 for most taxpayers).

3. **Agree** that consequential changes connected to the introduction of the new top personal income tax rate be made to other tax rates, including:

    3.1 PAYE rates.

    3.2 Fringe benefit tax.

    3.3 Resident withholding tax on interest (from 1 October 2021).

    3.4 Employer superannuation contribution tax.

    3.5 Residential land withholding tax.

4. **EITHER:**

    4.1 **Agree** that the tax rate for trustee income be increased to 39% for the 2021-22 and later income years (beginning 1 April 2021 for most taxpayers) (**Option A**);

    OR

    4.2 **Agree** that the tax rate for trustee income be increased to 39% for the 2022-23 and later income years (beginning 1 April 2022 for most taxpayers) (**Option B**);

    OR

    4.3 **Agree** that the decision on whether to increase the trustee income tax rate to 39% be deferred to a later date pending information on whether there is a behavioural response to avoid paying the new personal income tax rate (**Option C**).

5. **Note** that if recommendation 4.1 or 4.2 is agreed to, officials will work on over-taxation concerns in relation to the trustee income tax rate during 2021.

6. **EITHER:**

6.1 **Note** the following changes as a result of the decisions in recommendations 1 and 4.1 (**Option A**), with a corresponding impact on the operating balance and/or net core Crown debt:

	$m – increase/(decrease)				
Vote Revenue Minister of Revenue	**2020/21**	**2021/22**	**2022/23**	**2023/24**	**2024/25**
Tax revenue	95.000	355.000	1,390.000	890.000	975.000
Total Operating	(95.000)	(355.000)	(1,390.000)	(890.000)	(975.000)

OR

6.2 **Note** the following changes as a result of the decisions in recommendations 1 and 4.2 (**Option B**), with a corresponding impact on the operating balance and/or net core Crown debt:

	$m – increase/(decrease)				
Vote Revenue Minister of Revenue	**2020/21**	**2021/22**	**2022/23**	**2023/24**	**2024/25**
Tax revenue	95.000	260.000	950.000	1,160.000	975.000
Total Operating	(95.000)	(260.000)	(950.000)	(1,160.000)	(975.000)

OR

6.3 **Note** the following changes as a result of the decisions in recommendations 1 and 4.3 (**Option C**), with a corresponding impact on the operating balance and/or net core Crown debt:

	$m – increase/(decrease)				
Vote Revenue Minister of Revenue	**2020/21**	**2021/22**	**2022/23**	**2023/24**	**2024/25**
Tax revenue	95.000	160.000	830.000	540.000	595.000
Total Operating	(95.000)	(160.000)	(830.000)	(540.000)	(595.000)

7. **Note** that the revenue from all options will continue to increase in the outyears.

8. **Note** that we have directed officials to undertake further work investigating measures to support the integrity of the new personal income tax rate.

9. **Agree** that the Commissioner of Inland Revenue should have the power to collect information for tax policy purposes.

10. **EITHER**

10.1 **Agree** to collect information from trustees relating to the 2021-22 and later income years to test compliance and effective operation of the 39% top personal income tax rate (**Option 1**);

OR

10.2 **Agree** to collect information from trustees relating to the 2021-22 and later income years to test compliance and effective operation of the 39% top personal income tax rate, and provide better information to understand and monitor the use of structures and entities by trustees (**Option 2**);

OR

10.3 **Agree** to collect information from trustees relating to any income year (including prior years) to test compliance and effective operation of the 39% top personal income tax rate, and provide better information to understand and monitor the use of structures and entities by trustees (**Option 3**).

11. **Note** that the proposal to gather new information from trustees may have administrative impacts and costs not yet identified. Once the requirements for the new reporting are settled, Inland Revenue may seek further funding to cover administration costs.

12. **Note** that once the measure is in place, Inland Revenue will consult with interested parties on the compliance costs it creates.

13. **Agree** to delegate authority to the Minister of Revenue and Minister of Finance to make decisions on the detailed design of the proposals described in this paper and agreed to by Cabinet.

14. **Invite** the Minister of Revenue to instruct Inland Revenue to draft the necessary amendments to give effect to the proposals described in this paper and agreed to by Cabinet.

15. **Agree** to proactively release this Cabinet paper, associated minutes, and key advice papers with appropriate redactions when the Bill is introduced in late 2020.

Authorised for lodgement

Hon Grant Robertson
Minister of Finance

Hon David Parker
Minister of Revenue

Coversheet: Introducing a new top personal income tax rate

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

Summary: Problem and Proposed Approach

Problem Definition **What problem or opportunity does this proposal seek to address? Why is Government intervention required?**
As signalled in the Labour party's 2020 Election Manifesto, the Government has committed to introducing a new top personal income tax rate of 39 percent on income over $180,000. This is to meet two objectives: • A **revenue objective**: The Government is raising extra revenue to reduce the fiscal impact of higher operating allowances proposed in its fiscal strategy. • A **distributional objective**: The Government is seeking to raise this additional revenue in a way which has as little as possible impact on low- and middle-income earners and thus increases the progressivity[1] of the tax system. This Impact Statement analyses how to implement the new rate in a way that best meets the Government's **revenue** and **distributional** objectives while minimising unintended impacts.

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

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

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

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

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

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

s 9(2)(f)(iv)

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

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

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

Section B: Summary Impacts: Benefits and costs

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

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

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

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

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

Table 1: Estimated revenue from a 39 percent tax rate on income above $180,000[2]

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

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

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

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

The Treasury estimates that a 39 percent top personal rate applying to income above $180,000 (without any other changes to tax settings) will reduce the Gini coefficient[3] for individual after-tax income by an estimated 0.2 percentage points (from 0.493 to 0.491). This small impact reflects the relatively few people earning above $180,000 and, consequently, the relatively small impact this tax increase has on the overall income distribution. This is a very imprecise impact as it assumes no behavioural response and does not account for shifting of income into other (lower-taxed) entities.[4]

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

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

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

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

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

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

Where do the costs fall?

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

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

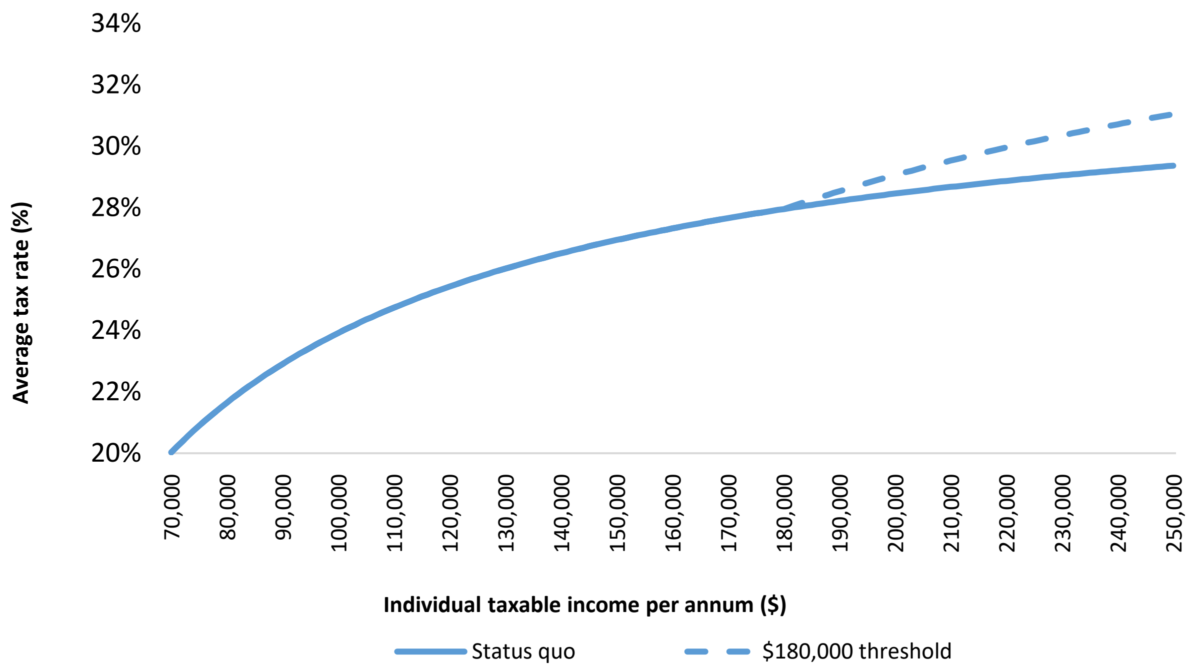
Table 3: Number of people and additional tax to pay with new top personal rate of 39 percent (using 2018/2019 income year data)

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

Source: Inland Revenue and The Treasury.

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

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



Source: The Treasury.

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

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

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

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

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

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

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

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

A more substantial discussion of these impacts is included later.

Section C: Evidence certainty and quality assurance

Agency rating of evidence certainty?

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

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

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

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

To be completed by quality assurers:

Quality Assurance Reviewing Agency:
Quality Assurance Panel with representatives from Inland Revenue and the Treasury.
Quality Assurance Assessment:
The Quality Assurance Panel considers that the information and analysis summarised in the RIS **partially meets** the quality assurance criteria. This is because some key elements of the proposals have not been consulted on and will not be consulted on prior to being implemented. As noted in section 2.4, stakeholders are likely to raise concerns with the lack of consultation on proposed changes to increase the trustee tax rate and to introduce new information reporting requirements for trusts. Under these proposals additional tax and compliance costs would be imposed on a large number of trustees – Inland Revenue receives approximately 245,000 income tax returns from trustees per year. The absence of consultation means Inland Revenue currently has a limited understanding of the compliance costs that trusts will face with the proposed new information requirements and how large these costs are. The RIS was therefore unable to determine whether the potential integrity benefits from the proposed trust information disclosure outweighed the compliance costs it would impose. However, as noted in section 7.2, Inland Revenue will conduct a post-implementation review of the proposed information requirements for trusts in 2021 which will include consultation with the affected trustees to determine the compliance costs associated with the new requirements and to identify if any changes could be made to reduce these compliance costs. In addition, the lack of consultation was a constraint imposed on the policy process in order to implement the proposal for the 2021/22 tax year, and the risks caused by this lack of consultation are clearly spelt out in the RIS. The RIS does not consider the options presented in the Cabinet paper for collecting past-year information from trusts and for collecting trust information for purposes other than the proposed 39% personal tax rate. If these options are taken by Cabinet, the compliance costs imposed by these options should be included in the post-implementation review of the trust information measure. Section 2.4 also notes that Inland Revenue intends to consult with stakeholders on the other proposed integrity measures s 9(2)(f)(iv) over the first half of 2021 so that they can be legislated for 1 April 2022.
Reviewer Comments and Recommendations:

Impact Statement: Introducing a new top personal income tax rate

Section 1: General information

1.1 Purpose

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

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

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

1.2 Key Limitations or Constraints on Analysis

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

- **Restricted range of options considered**: The Government has already announced its intention to introduce a new top personal income tax rate of 39 percent on income over $180,000 as part of the Labour party's 2020 Election Manifesto. The approaches considered in this Impact Statement are limited to options that could better ensure (based on traditional tax policy criteria) that this proposed top rate applies to taxpayers as broadly as intended while minimising negative impacts. It does not consider any other ways of achieving the Government's objectives given the pre-election announcement.

- **Time constraints**: Ministers have decided to plan for the introduction of the new top personal income tax rate from the 2021–22 income year onward (1 April 2021 for most taxpayers). With that commencement date in mind, the proposals must be included in legislation introduced before 31 December 2020 to allow payroll software providers and employers enough time to update their systems. That leaves a significantly shortened amount of time to undertake sufficient analysis of this proposal.

- **Uncertainty surrounding magnitude of impacts**: Inland Revenue has a strong evidence base to determine the expected qualitative effects of a higher top personal income tax rate but cannot easily quantify the magnitudes of these effects. Revenue estimates throughout this Impact Statement are sensitive to assumptions about how much people change their behaviour in response to the new rate (e.g., reducing hours, diverting income into another entity). One assumption underlying the estimates is that there is no change in the income distribution because of current and future COVID-19-related shocks. There is significant uncertainty in these assumptions and changing them results in substantial changes in revenue. Hence, some estimates provided in this Impact Statement are subject to a wide margin of error, while other impacts are unable to be estimated at all.

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

1.3 Responsible Manager:

P J Whittington

Phil Whittington
Chief Economist
Policy and Strategy
Inland Revenue

18 November 2020

Section 2: Problem definition and objectives

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

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

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

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

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

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

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

New Zealand's tax system taxes trustee income at a rate of 33 percent, and distributions of trustee income from complying trusts to beneficiaries are non-taxable. Beneficiary income is taxed at the beneficiary's marginal rates[6] (subject to the minor beneficiary rule).

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

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

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

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

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

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

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

2.3 What is the policy problem or opportunity?

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

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

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

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

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

2.4 What do stakeholders think about the problem?

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

A July 2020 Newshub-Reid Research poll found that 50 percent of those polled[7] supported an additional higher income tax bracket.[8] In contrast, an August 2020 *BusinessNZ* survey found that only 9 percent of the 1,193 business respondents supported increases in personal tax rates to address the fiscal challenges of COVID-19.[9]

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Section 3: Option identification

3.1 What options are available to address the problem?

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

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

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

The analysis investigates each of the following options:

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

These options are assessed against five criteria:

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

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

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

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

Option 1: Status quo.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Efficiency: There will be some efficiency costs, which are an inevitable part of raising the top marginal tax rate. By raising more revenue, the total efficiency costs are likely to be higher than **Option 2**. However, the efficiency costs per dollar of revenue raised are likely to be lower than **Option 2** because it will mean that the higher top marginal tax rate is less able to be circumvented[17]. This is because trusts are one of the key vehicles for high-income individuals to use when a gap between the top personal rate and the trustee rate exists, which is nullified under this option.

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

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

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

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

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

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

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

brought in until 1 April 2022 to allow for sufficient consultation. s 9(2)(f)(iv) [redacted]

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

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

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

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

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

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

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

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

s 9(2)(f)(iv)

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

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

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

Integrity: This option reduces avoidance opportunities the most for the 39 percent rate. Alignment of the trustee rate with the top personal rate ensures that trusts cannot be used to avoid the new top personal rate, s 9(2)(f)(iv) This option will result in the least long-term pressure on the tax system regarding rate alignment and anti-avoidance rules, resulting in the best tax integrity outcomes.

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

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

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

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

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

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

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

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

s 9(2)(f)(iv) [redacted]

s 9(2)(f)(iv)

Section 4: Impact Analysis

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

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

					Inland Revenue's recommended option

Key:

+ + + very much better than doing nothing/the status quo

+ + much better than doing nothing/the status quo

+ better than doing nothing/the status quo

0 about the same as doing nothing/the status quo

- worse than doing nothing/the status quo

- - much worse than doing nothing/the status quo

- - - very much worse than doing nothing/the status quo

Section 5: Conclusions

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

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

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

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

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

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

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

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

5.2 Summary table of costs and benefits of the preferred approach (Option 5)			
Affected parties	**Comment**	**Impact**	**Evidence certainty**
Additional costs of proposed approach compared to taking no action			
Regulated parties: Taxpayers earning over $180,000 and trustees	Trustees, and individual taxpayers earning more than $180,000, will be taxed at 39 percent on that income.	$3.7 billion over the forecast period[18] Refer to **Table 3** for breakdown of income distribution of individuals earning above $180,000.	Medium
Regulated parties: Taxpayers earning under $180,000	N/A		
Regulated parties: Trustees and beneficiaries	As part of integrity measures, the Commissioner of Inland Revenue will collect more information on trust assets, liabilities, and distributions. This will impose compliance costs on trustees. Inland Revenue receives approximately 245,000 income tax returns from trustees per year.	Medium	Medium
Regulators: Inland Revenue	Further policy development required to progress the integrity measures. There is also likely to be increased work associated with enforcing those measures.	Medium	Medium
Wider Government	N/A		
Other parties: Payroll software providers and related parties	Any person who is required to make technical/software changes to accommodate the introduction of a new top personal tax rate will face some administrative costs.	Low	Medium
Total monetised cost		**$3.7 billion over the forecast period**	**Low**

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

Total non-monetised cost		**Medium**	**Medium**

Expected benefits of proposed approach compared to taking no action			
Regulated parties: Taxpayers earning over $180,000	N/A		
Regulated parties: Taxpayers earning under $180,000	These taxpayers do not face the new top personal income tax rate and so stand to gain from government spending or lower future taxes resulting from increased progressivity of the income tax scale	Low	Low
Regulated parties: Trustees and beneficiaries	N/A		
Regulators: Inland Revenue	N/A		
Wider Government	The revenue collected under this option will reduce the fiscal impact of higher operating allowances proposed in the Government's fiscal strategy. Over the longer term, the Government may have more flexibility in spending this extra revenue. The Government also moves toward achieving its vertical equity objectives with this change.	$3.7 billion Medium	Medium Medium
Other parties: Payroll software providers and related parties	N/A		
Total monetised benefit		**$3.7 billion over the forecast period**	**Low**
Total non-monetised benefit		**Medium**	**Medium**

5.3 What other impacts is this approach likely to have?

This section provides more detail on the unintended impacts of the proposal, which can generally be categorised as **economic impacts** or **integrity impacts**. The main risk of the proposal is that the tax revenue collected from the proposal may be less than expected due to avoidance arrangements. This might be the case because of a greater-than-expected behavioural response to a new tax rate (noting that the behavioural response is highly uncertain). These economic and integrity impacts are considered in turn.

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

Individual investment and savings impact

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

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

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

Business investment

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

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

Human capital and labour market impacts

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

- Migration. Personal taxes affect after-tax incomes, and international evidence indicates this affects migration decisions.[20] The impact is greater for mobile, high-income, and highly skilled workers.

- Human capital accumulation. A higher top personal tax rate would reduce the financial returns from education and upskilling, and may discourage human capital accumulation. The international evidence regarding the impact of taxation on human capital accumulation is mixed, and Inland Revenue expects the impact of this channel to be relatively small overall.

- Allocation of labour. A potential mismatch between the top personal rate and the tax rate for trusts and companies will lead to many self-employed workers being able to access a lower tax rate than employees. This will favour self-employment over standard employment arrangements which may reduce the efficiency of the allocation of labour.

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

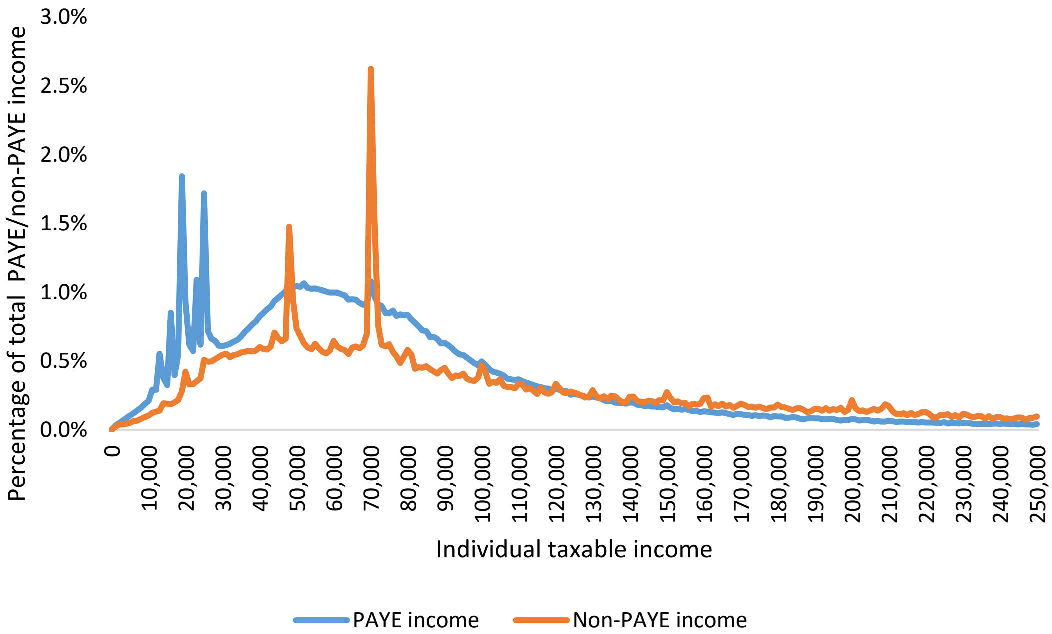
There are other possible reforms that would have a lower efficiency cost per dollar raised relative to the current proposal, such as having a smaller increase in all income tax rates or raising GST. However, these options may not meet the Government's distributional objectives. The efficiency costs of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

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

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

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

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

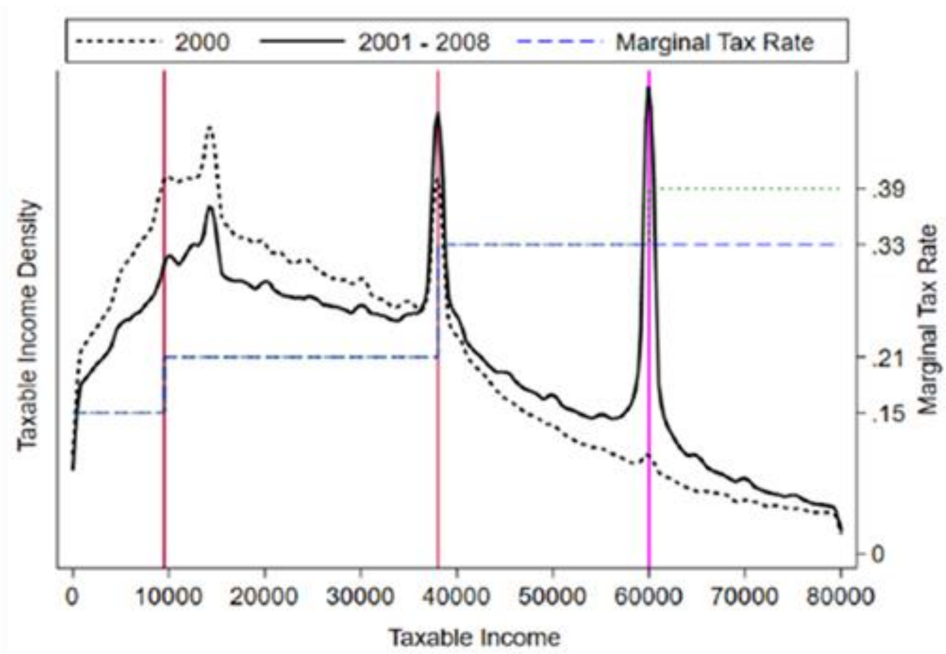


Source: The Treasury's analysis of Inland Revenue administrative data.

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

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

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



Source: Alinaghi, Creedy, & Gemmell.[21]

Figure 3 shows the distributions of income from self-employment before and after the increase in the top personal rate. The bunching of self-employed people at the new threshold after 2000 shows that there was substantial movement by the self-employed to avoid the higher top personal rate. Measures were taken to mitigate the avoidance of the top rate, including court cases[22] and new income tax rules.[23] The measures reduced the use of the relevant structures to some extent.

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

- Revenue. Tax collected from a higher top personal rate will be reduced due to structuring activity. This is due to the direct impact of taxpayers being able to earn their income through lower-taxed entities, such as trusts and companies. It is also because an inconsistent rate structure makes it harder for courts to find tax avoidance when the different rates mean it is difficult to determine whether a structure undermines what Parliament contemplated.

- Social capital: Perceptions of arbitrary outcomes, such as when some taxpayers can structure to avoid the 39 percent rate, will erode public confidence in the integrity of the tax systems and the feeling that all taxpayers are treated fairly.

- Horizontal and vertical equity: In the absence of integrity measures, more income of high-wealth individuals and others with substantial capital income is likely to

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

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

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

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

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

The integrity risks can be mitigated in two ways:

- By imposing a 39 percent rate on trustee income, since trusts are the primary vehicle that high-income taxpayers are most likely to use to divert income that would otherwise be taxed at their 39 percent personal rate.[24]
- By investigating specific integrity measures s 9(2)(f)(iv) These would necessarily be less effective than taxing the entities themselves at 39 percent.

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

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

Section 6: Implementation and operation

6.1 How will the new arrangements work in practice?

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

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

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

6.2 What are the implementation risks?

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

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

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

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

Section 7: Monitoring, evaluation, and review

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

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

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

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

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

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

7.2 When and how will the new arrangements be reviewed?

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

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

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

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

Cabinet

Minute of Decision

Introducing a New Top Personal Income Tax Rate

Portfolios **Finance / Revenue**

On 23 November 2020, Cabinet:

Top personal income tax rate

1 **agreed** to implement a new personal income tax rate of 39 percent for income over $180,000;

2 **agreed** that the new rate will apply for the 2021-22 and later income years (beginning 1 April 2021 for most taxpayers);

3 **agreed** that consequential changes connected to the introduction of the new top personal income tax rate be made to other tax rates, including:

3.1 PAYE rates;

3.2 fringe benefit tax;

3.3 resident withholding tax on interest (from 1 October 2021);

3.4 employer superannuation contribution tax;

3.5 residential land withholding tax;

4 **agreed** that a decision on whether to increase the trustee income tax rate to 39 percent be deferred to a later date pending information on whether there is a behavioural response to avoid paying the new personal income tax rate;

Financial implications

5 **noted** the following changes as a result of the decisions in paragraphs 1 and 4 above, with a corresponding impact on the operating balance and/or net core Crown debt:

	$m – increase/(decrease)				
Vote Revenue Minister of Revenue	**2020/21**	**2021/22**	**2022/23**	**2023/24**	**2024/25**
Tax revenue	95.000	160.000	830.000	540.000	595.000
Total Operating	(95.000)	(160.000)	(830.000)	(540.000)	(595.000)

6 **noted** that the revenue will continue to increase in the outyears;

7 **noted** that officials have been directed to undertake further work investigating measures to support the integrity of the new personal income tax rate;

Collecting information for tax policy purposes

8 **agreed** that the Commissioner of Inland Revenue have the power to collect information for tax policy purposes;

9 **agreed** to collect information from trustees relating to any income year (including prior years) to test compliance and effective operation of the 39 percent top personal income tax rate, and provide better information to understand and monitor the use of structures and entities by trustees;

10 **noted** that:

10.1 the proposal to gather new information from trustees may have administrative impacts and costs not yet identified;

10.2 once the requirements for the new reporting are settled, Inland Revenue may seek further funding to cover administration costs;

11 **noted** that once the measure is in place, Inland Revenue will consult with interested parties on the compliance costs it creates;

Legislative implications

12 **authorised** the Minister of Finance and the Minister of Revenue to make decisions on the detailed design of the proposals agreed to by Cabinet;

13 **invited** the Minister of Revenue to issue drafting instructions to Inland Revenue to draft the necessary amendments to give effect to the above proposals.

Michael Webster
Secretary of the Cabinet