Taxation (Annual Rates for 2023–24, Multinational Tax, and Remedial Matters) Bill

Regulatory Impact Assessments

1. The taxation of trustee income 3
2. OECD's Pillar Two GloBE tax rules 59
3. Taxation of backdated lump sum payments 75
4. Government payment of an employer contribution to qualifying paid parental leave recipients 95
5. Extending tax exemption for non-resident oil rig and seismic vessel operators 111

Regulatory Impact Statement: The Taxation of Trustee Income

Coversheet

Purpose	
Decision sought:	Agreement to increase the trustee tax rate to 39%.
Advising agencies:	Inland Revenue
Proposing Ministers:	Minister of Finance Minister of Revenue
Date finalised:	3 April 2023

Problem Definition

The ability to raise more revenue from the personal tax base is significantly constrained because of misalignment between the 39% top personal tax rate and the 33% trustee tax rate. This misalignment allows the top personal tax rate to be circumvented and reduces the progressivity of the income tax system.

Executive Summary

Rate misalignment constrains the ability to raise revenue from personal taxes

Taxpayers can circumvent the top personal tax rate of 39% by retaining income in a trust as trustee income. This is because once income has been taxed as trustee income at 33%, distribution of that income to the beneficiaries of the trust is tax free. That is, trustee income is subject to a final tax of 33% imposed in the year the income is derived by a trust.

Misalignment between the 33% trustee tax rate and the 39% personal tax rate constrains the Government's ability to raise revenue from personal taxes. This is because having lower tax rates on income earned through certain structures, such as trusts, means those earning income through these lower-tax structures will not be affected by any increase in personal tax rates. This results in under-taxation and reduces both the progressivity and fairness of the tax system.

Aligning the trustee tax rate with the top personal tax rate would help address under-taxation…

We have explored a range of options and consider that aligning the trustee tax rate with the top personal tax rate at 39% would be the most effective way of addressing the under-taxation of trustee income within the existing regime for trusts. This would strengthen the sense of fairness in the tax system by ensuring that trusts cannot be used to shelter income from the top personal tax rate.

Increasing the trustee tax rate to 39% would raise revenue for Budget 2023 and can be designed and implemented by Inland Revenue for the 2024–25 and later income years (beginning 1 April 2024 for most trusts). This approach is expected to raise $350 million per annum. However, this is highly uncertain and largely dependent on the extent of the behavioural response of trustees.

Even if the trustee tax rate is aligned with the top personal tax rate, there will continue to be opportunities to circumvent that rate by substituting trusts with companies or portfolio investment entities ("PIEs"). However, trusts are a completely different legal structure and they are not complete substitutes for PIEs or companies. For example, some trusts have investments (such as businesses controlled by settlors or beneficiaries, like farms and small-to-medium enterprises) that could not be put into PIEs. Furthermore, trusts have certain tax advantages that companies do not, such as being able to distribute capital gains immediately to beneficiaries tax free and to stream distributions to different beneficiaries.

This reduced level of substitutability means changes to the trust taxation rules are likely to be worthwhile, even if no changes are made to the taxation of companies or PIEs. Issues relating to the taxation of companies/shareholders and PIEs are outside the scope of this RIS.

… and existing rules should be sufficient to mitigate over-taxation in most cases

Some trusts with settlors and beneficiaries on lower tax rates could be over-taxed if the trustee tax rate is increased to 39%. Existing rules can mitigate this as they allow income of a trust to be taxed at a beneficiary's marginal tax rates if the income is allocated to the beneficiary as beneficiary income. Beneficiary income can be credited or paid to a beneficiary, or it can be allocated to the beneficiary for them to receive at a future date (such as when they reach a particular age).

There will be situations where income is not allocated to beneficiaries. This includes when:

- there is a lack of information regarding the beneficiaries of a trust so income cannot be allocated;
- the trustees do not yet know which beneficiaries to allocate income to; or
- non-tax reasons for keeping income in a trust are prioritised (such as protecting income from creditors or against relationship property claims).

Where the existing mechanism is clearly insufficient, special rules can be introduced to mitigate over-taxation. However, without undertaking public consultation, there is a risk that there are barriers we have not identified which would prevent trusts from mitigating over-taxation.

Detailed design

We consider two special rules are necessary at this stage to ensure the proposal addresses the under-taxation of trustee income and mitigates over-taxation. Public consultation is needed to determine whether any additional rules are required.

Rule to buttress a 39% trustee tax rate

We recommend a rule to prevent beneficiary income allocations to corporate beneficiaries being used to circumvent the 39% rate. A company can be a beneficiary of a trust. Under current law, income allocated as beneficiary income to a corporate beneficiary is taxed at 28% (the company tax rate). Treating such allocations as trustee income for the purposes of determining the rate of tax (39%) and who pays the tax (trustees) would ensure that trustees cannot circumvent a 39% rate by sheltering income in a corporate beneficiary. We propose limiting the application of this integrity rule to certain trusts to ensure that the use of trusts in large corporate groups would not be affected.

Rule to mitigate over-taxation for estates

Estates are taxed as trusts and may not be able to mitigate over-taxation by allocating income to beneficiaries if the affairs of the deceased are still being worked through. To help mitigate over-taxation, we recommend allowing trustees of estates to have the option of trustee income derived within 12 months of the deceased's date of death being taxed at the deceased's marginal tax rates. Our initial view is that 12 months is a reasonable length of time and should be adequate for most estates.

Other situations where over-taxation may arise, but we do not have enough information to recommend special rules at this stage

We have also considered whether a 39% trustee tax rate could result in over-taxation for trusts settled for disabled people, fixed trusts, trusts with a large number of beneficiaries ("widely-held trusts"), energy consumer trusts, or superannuation funds that are taxed as trusts (the large majority of superannuation funds, like KiwiSaver, are taxed separately under the PIE rules and would not be affected). For all these types of trusts, we recommend monitoring this situation to establish whether a problem exists and, if so, undertaking consultation to determine how best to address it.

Other options for addressing misalignment issue

We also considered other options to address misalignment between the trustee tax rate and the top personal tax rate, including taxing trustee income at the principal settlor's personal tax rate, or introducing an imputation-style system for trusts (which would ultimately tax beneficiaries on distributions of trustee income at their personal tax rates). An imputation-style system, in particular, could improve the long-term robustness and sustainability of the tax system. However, both options would involve fundamental reform to the taxation of trustee income. These approaches would be significantly more complex to design, implement, and administer.

Limitations and Constraints on Analysis

Wider misalignment issues and constraints imposed by Ministers' commissioning

Misalignment across the tax system

Integrity pressures that arise from misalignment between the company, trustee, PIE and top personal tax rates make it very difficult for the Government to raise significant additional revenue in a way that is progressive and economically efficient. This is because having lower tax rates on income derived through certain entities means those earning income through these lower-tax entities will not be affected by any increase in personal tax rates, reducing the revenue gain from such a rate increase and undermining the fairness of the tax system.

While changes to the taxation of trusts, PIEs and companies/shareholders could individually raise revenue, together they can provide further, very significant long-term benefits. Combined, they would move towards a robust and sustainable tax system, giving the Government more flexibility to raise revenue from the personal tax base in a progressive way should it choose to do so in the future.

Maximising these benefits would require making compatible tax changes in all three areas – trusts, PIEs and companies/shareholders – to ensure that increases in tax rates apply as fairly as possible and to reduce income-shifting behaviour. For example, if the trustee and PIE tax rates were aligned with personal tax rates but company/shareholder taxation was unchanged, the top personal tax rate could still be circumvented by diverting income to

companies. This issue is more pronounced for PIEs than for trusts because companies are more substitutable for PIEs than for trusts.

Reduced substitutability for trusts

Ministers have decided to progress increasing the trustee tax rate to 39% for the 2024–25 and later income years (beginning 1 April 2024 for most trusts) while considering PIE and company/shareholder misalignment issues on a longer timeframe.

Even if the trustee tax rate is aligned with the top personal tax rate, there will continue to be opportunities to circumvent that rate by substituting trusts with companies or PIEs. However, trusts are a completely different legal structure from companies and PIEs, and they are not complete substitutes.

- *Substitutability with PIEs:* Some trusts have investments that earn large amounts of income that could not be put into a PIE. These are primarily businesses that settlors or beneficiaries control, such as farms and small-to-medium enterprises. While the general population may not have many of these investments, they represent a large amount of the assets of high-income investors.
- *Substitutability with companies:* Trusts have certain tax advantages that companies do not. Capital gains derived in trusts can be distributed immediately to beneficiaries tax free, whereas capital gains can only be extracted from a company upon liquidation or as a taxable dividend. Trusts can also stream distributions to different beneficiaries and can be used for asset protection in a way that companies cannot. Also, the company and dividend tax rules are relatively more comprehensive than the trust tax rules. Therefore, there are some important advantages that would counteract, to a degree, the incentive for taxpayers to shift income from trusts to companies.

This reduced level of substitutability means changes to the trust taxation rules are likely to be worthwhile, even if no changes are made to the tax treatment of PIEs or companies. Raising the trustee tax rate to 39% will still raise revenue in a relatively low compliance cost way, while better meeting the Government's distributional objectives. However, we will continue to monitor the effect of the trustee rate as well as monitoring other structures that could be used to undermine a 39% trustee tax rate. Consultation with stakeholders and through the select committee process may bring to light such structures.

Ministers' commissioning

Ministers have commissioned development of a policy proposal to address misalignment between the trustee and top personal tax rates and to raise revenue for Budget 2023. The requirement to develop policy options and detailed design in time for Budget 2023 limits the available time for policy development.

Issues relating to the taxation of PIEs and companies/shareholders are outside the scope of this RIS.

Administrative and delivery constraints

Trade-offs are required in determining whether to progress any of the options analysed in this RIS. The systems, administrative and delivery impacts on Inland Revenue need to be considered in the context of other work being progressed on the wider Tax and Social Policy Work Programme.

It is expected that a large initial system development would be required to support this proposal. In addition, it is expected that any of the options outlined in this RIS will result in

ongoing customer contacts. However, it is difficult to determine the exact impact on Inland Revenue until final policy decisions have been made on all Budget 2023 initiatives that impact on Vote Revenue.

Quality of data and evidence

Limited available data

Our ability to determine whether the proposals will have a disproportionate impact on certain groups or types of trusts is limited. New Zealand does not have a trusts register, and outside of the recently introduced trust disclosure rules or income tax returns filed by trusts with Inland Revenue, there is limited available data.

Trust disclosure rules

Increased trust disclosure requirements were introduced for the 2021–22 and later income years to help evaluate the effectiveness of the 39% top personal tax rate and gain insight into the use of structures and entities by trustees. The constraint of needing to develop policy proposals in time for Budget 2023 limits the ability to use information from the recent trust disclosure rules. This is because most trusts can file their first returns under these rules as late as 31 March 2023, after the policy development of these proposals. Since the larger, more complex trusts file close to 31 March, there would have been significant limitations in using interim data as it may not have been representative of the domestic trust population.

The Trusts Act 2019 came into force in January 2021 and introduced greater transparency and compliance requirements for trusts. With the trust disclosure rules and the Trusts Act both coming into force in 2021, Inland Revenue's most recent full year of data (the 2020–21 income year) will largely precede the current regulatory environment for trusts.

HWI research project

Inland Revenue's HWI research project is due to be completed in April 2023. Data collected as part of that project was not used in the development of these proposals.

Limitations on consultation

Inland Revenue and Treasury officials worked closely together on the development of the proposals. Due to Budget sensitivity constraints, we have not been able to consult with external stakeholders on these proposals. Without undertaking public consultation, there is a risk that there are barriers we have not identified that would prevent existing rules from being fully effective in mitigating over-taxation for some trusts.

To partially mitigate the inability to undertake public consultation during the Budget preparation period, we have:

- worked closely with internal Inland Revenue trust experts;
- researched overseas jurisdictions that have broadly similar tax regimes and trust laws to New Zealand (Australia, Canada, the United Kingdom, and the United States);
- drawn on issues arising from the previous misalignment between the trustee tax rate and top personal tax rate in the 2000s;
- undertaken targeted consultation with certain public sector agencies:
    - the Financial Markets Authority – Te Mana Tātai Hokohoko
    - the Ministry of Justice – Te Tāhū o te Ture
    - the Public Trust

    - Te Tumu Paeroa – Office of the Māori Trustee
    - Whaikaha – Ministry of Disabled People; and
- liaised with the Australian Tax Office.

These steps have partially mitigated the inability to undertake public consultation during the Budget preparation period. However, trusts are complex and there is a significant risk that external consultation with stakeholders and the select committee process could bring unexpected concerns to light.

Responsible Manager

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3 April 2023

Quality Assurance

Reviewing Agency:	Inland Revenue
Panel Assessment & Comment:	The Quality Assurance reviewers at Inland Revenue have reviewed the Regulatory Impact Statement: *The Taxation of Trustee Income* prepared by Inland Revenue, and consider that the information and analysis summarised in the Regulatory Impact Statement **partially meets** the quality assurance criteria. This is because, as disclosed in the Limitations and Constraints on Analysis section, the affected stakeholders (trustees, settlors and beneficiaries of trusts) have not had an opportunity to submit on how they would be affected by the options, and there has been no publicity about the proposal to generate any public comment. Accordingly, the analysis of how these stakeholders would be affected is limited and uncertain.

Table of Contents

Regulatory Impact Statement: The Taxation of Trustee Income 1

Coversheet 1

Purpose 1

Problem Definition 1

Executive Summary 1

Limitations and Constraints on Analysis 3

Quality Assurance 6

Table of Contents 7

Section 1: Diagnosing the policy problem 9

Current tax law 9

International comparisons 11

Tax planning using a trust 11

Other uses for trusts 12

Misalignment in the 2000s 12

2020 decision to introduce a new top personal tax rate 13

Current landscape 14

Over-taxation and under-taxation 15

What is the policy problem or opportunity? 17

What objectives are sought in relation to the policy problem? 18

Section 2: Deciding upon an option to address the policy problem 19

What criteria will be used to compare options to the status quo? 19

What scope will options be considered within? 19

What options are being considered? 19

Option analysis 20

Well-being and economic considerations 30

How do the options compare to the status quo? 33

What option is likely to best address the problem, meet the policy objectives, and deliver the highest net benefits? 36

What are the marginal costs and benefits of the preferred option? 36

Section 3: Detailed design 39

Rule needed to buttress proposed 39% rate 39

Further analysis of the risk of over-taxation ... 41

Trusts for which modifications are required ... 41

Trusts for which modifications should not be required ... 43

Section 4: Delivering an option ... 51

How will the new arrangements be implemented? ... 51

How will the new arrangements be monitored, evaluated, and reviewed? ... 51

Appendix: Consequential issues ... 53

Minor beneficiary rule ... 53

Resident withholding tax ... 53

Provisional tax ... 53

Taxable distributions from non-complying trusts ... 54

Section 1: Diagnosing the policy problem

Current tax law

1. A trust is a relationship where a person (the trustee) holds property for the benefit of another person or persons (beneficiaries). The settlor is the person who creates the trust and is the source of trust property. A settlor can also be a trustee and a beneficiary of the same trust, provided there is more than one beneficiary. The main legal feature of a trust is the separation of legal and beneficial ownership of the trust property between the trustee and beneficiaries.

2. A discretionary trust is a trust where the distributions to the beneficiaries are subject to the trustee's discretion. A fixed trust, or non-discretionary trust, is a trust where the trust deed specifies how the assets of the trust are to be distributed exactly. Tax law does not distinguish between discretionary trusts and fixed trusts, and most domestic trusts in New Zealand are discretionary trusts.

3. The annual income of a trust is taxed as it is derived, either to the trustees or to the beneficiaries of the trust. Trustees of a trust are treated as a single taxable unit and their trustee income is calculated separately from their personal income. If there is more than one trustee, each trustee is jointly and severally liable for any tax.[1]

4. **Beneficiary income** is all income earned by a trust in an income year which "vests absolutely in interest" in a beneficiary during the income year or is "paid" to a beneficiary before the trustee files the trust's tax return.[2] The definition of "pay", for an amount and a person, includes to:

   - distribute the amount to them;
   - credit them for the amount; or
   - deal with the amount in the person's interest or on their behalf in some other way.

5. That is, income does not need to be distributed to a beneficiary to be beneficiary income; the income can be allocated to a beneficiary. Provided the trustees cannot change their mind about the allocation (i.e., the income is vested absolutely in the beneficiary), the income is considered beneficiary income and is taxed at the beneficiary's marginal tax rates.

[1] Sections HC 2 and YA 5 of the Income Tax Act 2007.

[2] Section HC 6 of the Income Tax Act 2007 provides that income derived by a trustee during an income year will be taxed as beneficiary income if it vests absolutely in interest in a beneficiary of the trust in the income year, or is paid to a beneficiary by the later of:

- 6 months following the end of the income year in which the income was derived; and
- the earlier of:
  - the date on which the trustee files its tax return; and
  - the date by which the trustee is required to file its tax return under section 37 of the Tax Administration Act 1994.

Table 1: Types of beneficiary income and simplified examples

Types of beneficiary income	Simplified examples
Income distributed or paid to a beneficiary.	Cash transferred to the beneficiary.
Income allocated to a beneficiary that is credited to the beneficiary's current account. Income in a beneficiary's current account is available to be called upon at any time by that beneficiary. Trustees can allocate beneficiary income without the beneficiary having knowledge of the allocation.	Allocated amounts are available in a bank account for the beneficiary to draw upon at any time.
Income that is allocated to a beneficiary for them to possess at a future date or event ("future possession beneficiary income"). This could include where income is allocated to a beneficiary for them to possess when they reach a certain age. Provided the income will go to the beneficiary's estate if the beneficiary dies before the future date or event, the income is considered beneficiary income in the year it is derived by the trust and is taxed at the beneficiary's marginal tax rates. Unlike beneficiary income credited to a beneficiary's current account, future possession beneficiary income is not available to be called upon by the beneficiary until they become entitled to possess the income (either once the future date or event has occurred or when the income goes to their estate on their death).	Allocated amounts are held in a bank account the beneficiary cannot access until they reach the age of 21.

6. The trustee must pay tax on behalf of the beneficiary for income allocated to that beneficiary as beneficiary income. To calculate the tax liability on beneficiary income, the trustee must first calculate the tax payable on the total taxable income of the beneficiary and then determine the portion referable to just the beneficiary income.[3] Beneficiaries are required to return all beneficiary income in their own personal tax return.

7. Beneficiary income is taxed at the beneficiary's marginal tax rates unless it is subject to the minor beneficiary rule. This rule applies to beneficiary income derived by a minor (under 16 years old) from property settled on a trust by a relative or legal guardian, or an associated person of the relative or legal guardian. If the total beneficiary income derived by the minor is >$1,000, the income is taxed at the trustee tax rate (currently 33%) to prevent parents, other relatives, or guardians from splitting their income with children.[4]

8. **Trustee income** is all taxable income derived by a trust in an income year that has not been paid or allocated as beneficiary income.[5] It is taxed at a flat rate of 33%. Once income has been taxed as trustee income, subsequent distribution of that income to the beneficiaries is tax free. That is, trustee income is subject to a final tax imposed in the year the income is derived by a trust.

9. **Corpus** means property settled on a trust.[6] Corpus is used by trustees to derive income and capital gains. Distributions of any amounts other than beneficiary income, including corpus, capital gains, or trustee income from prior years, are exempt from tax to the

[3] Section HD 7 of the Income Tax Act 2007.

[4] Sections HC 35 to HC 37 of the Income Tax Act 2007.

[5] Section HC 7 of the Income Tax Act 2007.

[6] Section HC 4 of the Income Tax Act 2007.

receiving beneficiary.[7] This is the tax treatment of the majority of domestic trusts ("complying trusts"), which are the focus of this RIS. Unless otherwise specified, trusts referred to in this RIS are complying trusts.

10. For more information on the income tax rules for trusts, refer to the reference guide *IR288: Trusts and estates income tax rules*.

International comparisons

11. Australia, Canada, the United Kingdom, and the United States all have broadly comparable tax regimes and trust laws to New Zealand. New Zealand is currently an international outlier in taxing trustee income below the top personal tax rate.

Table 2: International comparison of the taxation of trustee income

	NZ	Australia	Canada	UK	US
Top personal tax rate	**39%**	45%[8]	33%	45%	37%
Top personal income threshold *(2023 tax year)*	$180,000 NZD	$180,000 AUD	$235,675 CAD	£150,000 GBP	$578,125[9] USD
Tax rate on trustee income	**33%**	45%	33%	45%	37%[10]

Tax planning using a trust

12. Trusts are often used to split income within a family unit so that tax is paid at low rates under a progressive tax scale. Trustees do not need to distribute amounts equally to the beneficiaries. This means they can allocate beneficiary income as they choose to beneficiaries on lower personal tax rates. However, the minor beneficiary rule partially limits the ability to split income in this way.

Table 3: Personal tax rates for individuals

Personal income	Marginal tax rate
Up to $14,000	10.5%
Over $14,000 and up to $48,000	17.5%
Over $48,000 and up to $70,000	30%
Over $70,000 and up to $180,000	33%
Remaining income over $180,000	39%

13. Due to the trustee tax rate being lower than the top personal tax rate, and trustee income being subject to a final tax in the year it is derived (and not subject to tax when it is eventually distributed to a beneficiary, if at all), trusts can be used to shelter income from higher personal tax rates. If a trust has a 39% tax rate beneficiary (who could also be a settlor), income may be accumulated in the trust and taxed at the 33% trustee tax rate;

[7] Sections CW 53 and HC 20 of the Income Tax Act 2007.

[8] Excludes a Medicare levy of 2%, which applies to both personal income and trustee income.

[9] This is the top tax threshold for single filers. The top tax bracket is $346,875 USD for married couples filing separately and $678,750 for married couples filing jointly.

[10] The 37% rate applies to trustee income over $13,450 derived by non-grantor trusts. Trustee income derived by grantor trusts, which are trusts effectively controlled by the settlor, is taxed at the personal tax rate of the settlor.

there is no further tax when the tax-paid trustee income is later distributed to the beneficiary.

14. These tax benefits mostly relate to income derived from capital rather than from labour. Capital income can be shifted to a trust without constraint simply by shifting ownership of the assets. However, it can be more difficult to shift labour income to a trust. Labour income is normally taxable to the person providing the labour.

Other uses for trusts

15. In 2012, the Law Commission found that trusts appear to be established for the following main reasons: for family succession planning, to protect assets from creditors, to ensure separate assets (i.e., non-relationship assets) are protected from relationship property claims, to operate businesses efficiently, to provide for family members with special needs, for investment schemes and innovative commercial arrangements, and to provide for philanthropic or charitable activities. Trusts are also used for less acceptable purposes, including to avoid income and assets tests used by the Ministry of Social Development to assess eligibility for state assistance, to defeat known creditors, and to defeat the equal sharing regime under the Property (Relationships) Act 1976.[11]

16. A settlor can retain effective control of trust property by also being a trustee. They can also retain effective control by having powers to appoint new trustees, remove existing trustees, or appoint additional beneficiaries. A settlor can also retain enjoyment of trust property by being a beneficiary or having close family members who are beneficiaries. Trusts, therefore, may allow settlors to retain the benefits of ownership of property transferred to a trust while avoiding the burdens and risks of ownership.

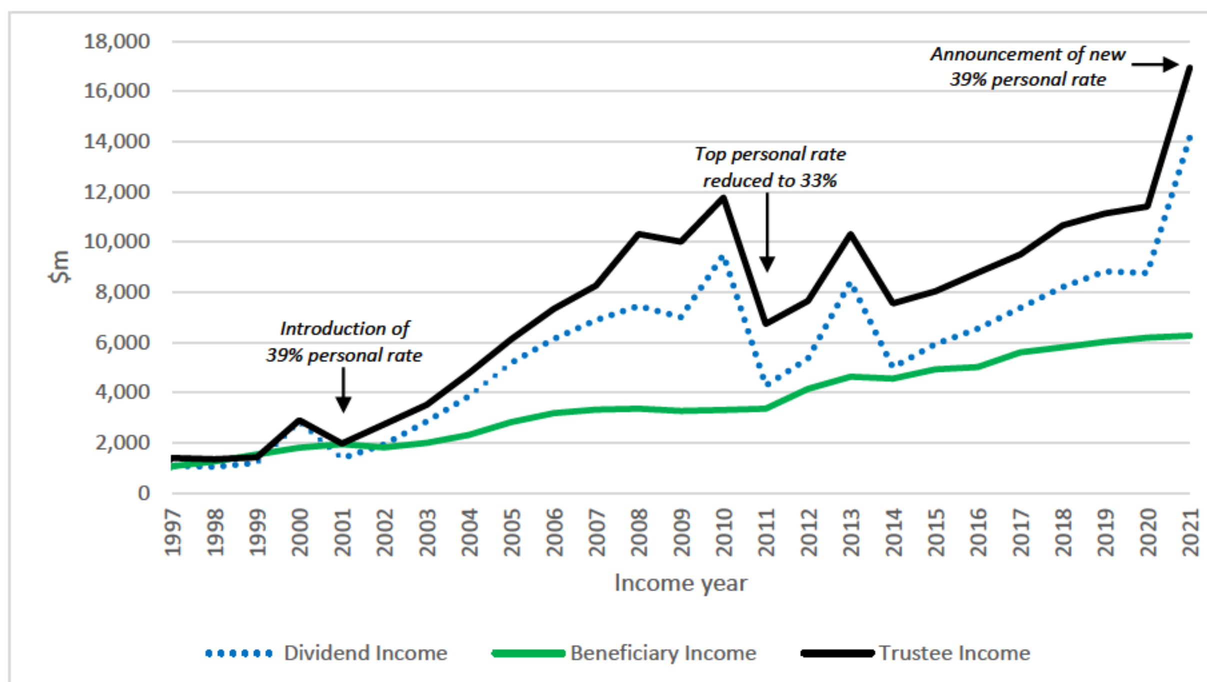
Misalignment in the 2000s

17. Since the introduction of the current tax regime for trusts in 1989, the trustee tax rate has been 33%. This rate was chosen intentionally to achieve alignment with the top personal tax rate, and it has only fallen out of alignment during the two periods since 2000 when the top personal rate was 39%.[12]

[11] Law Commission (November 2012) Review of the Law of Trusts: Preferred Approach (lawcom.govt.nz) from [1.20] to [1.22].

[12] A 39% rate on income over $60,000 was introduced for the 2000–01 and later income years; this threshold was increased to $70,000 from 1 October 2008. The top personal rate was lowered to 38% for the 2009–10 income year and then further lowered to 33% from 1 October 2010. The current 39% rate on income over $180,000 was introduced for the 2021–22 and later income years.

Figure 1: Income reported on trust tax returns 1997 – 2021



18. Figure 1 shows how significant amounts of income were diverted into trusts and taxed as trustee income when the personal tax rate was raised to 39% in 2000 and the trustee tax rate remained at 33%. Much of the growth of trustee income was in the form of dividends.[13] Many small-to-medium enterprises reorganised as companies owned by family trusts in the early 2000s to take advantage of the misalignment.

19. After the top personal tax rate was reduced to 33% in 2010, there was no longer misalignment between the trustee and top personal tax rates. This meant that there was no longer a tax advantage in passing dividends through trusts, although existing structures often remained in place.

20. Since the 2021–22 income year, the top personal tax rate has again been higher than the trustee tax rate. In advance of this taking effect, companies paid out higher than usual dividends so that trusts or individual shareholders would earn the dividends before the 39% personal tax rate took effect. This resulted in a spike in personal and trustee income.

2020 decision to introduce a new top personal tax rate

21. In November 2020, Cabinet decided to introduce a new top personal tax rate of 39% for income over $180,000 for the 2021–22 and later income years. As part of the work to introduce the new 39% rate, Inland Revenue and Treasury recommended also increasing the trustee tax rate to 39%.[14]

22. Cabinet decided to defer making "a decision on whether to increase the trustee rate to a later date pending information on whether there is a behavioural response to avoid paying the new personal income tax rate". This decision was based on concerns

[13] The 2010 and 2013 spikes in trustee income were due to the expiration of a transitional rules that allowed dividends to be imputed at a higher rate. The spikes are from dividends that were distributed to trusts by companies.

[14] IR2020/454; T2020/3412: *Introducing a new top personal tax rate*. https://www.taxpolicy.ird.govt.nz/publications/2020/2020-ir-cab-20-sub-0484

regarding the potential over-taxation of trusts settled for the care of orphans or disabled people and the improvements in enforcement of tax obligations in recent years.[15]

23. Cabinet also decided in November 2020 to introduce increased trust disclosure requirements for the 2021–22 and later income years to help evaluate the effectiveness of the 39% top personal tax rate and gain insight into the use of structures and entities by trustees.

Current landscape

24. Over 400,000 trusts are registered on Inland Revenue's systems, with approximately 180,000 filing returns reporting positive income. Table 4 shows that, in the 2021 financial year, total income derived by domestic trusts (including estates) was $23,300m, 73% of which was trustee income ($17,100m).

Table 4: Proportion of beneficiary and trustee income

	FY2020	FY2021
Number of trusts *(excl. trusts with nil income)*	182,000[16]	177,000[17]
Beneficiary income	$6,200m (35%)	$6,300m (27%)
Trustee income	$11,400m (65%)	$17,100m (**73%**)
Total income	$17,600m	$23,300m

Trustee income is concentrated in a small number of trusts

25. Table 5 shows that, for trusts with assessable income in the 2021 financial year, the top 5% of trusts in terms of trustee income (9,000 out of 177,000) accounted for 78% of all trustee income ($13.3 billion out of $17.1 billion). This does not mean that all of this income is under-taxed, as this does not take into account the number of settlors and beneficiaries of these trusts, but it is an indication of a significant amount of under-taxation.

26. Most of the largest trusts, in terms of trustee income, are linked with high-wealth individuals (individuals that have, or are in control of, net wealth in excess of $50 million) based on Inland Revenue's existing HWI information, not the HWI research project population.

[15] CAB-20-MIN-0484: *Introducing a New Top Personal Income Tax Rate*. https://www.taxpolicy.ird.govt.nz/publications/2020/2020-ir-cab-20-sub-0484

[16] Including approximately 19,000 estates and 400 foreign trusts.

[17] Including approximately 17,000 estates and 300 foreign trusts.

Table 5: Trusts with assessable income in the 2021 financial year

Percentiles based on trustee income	Number of trusts	Aggregate trustee income
Lower 24%	43,000 (24%)	Nil[18]
Lower 50%	89,000 (50%)	$30m (0.2%)
Lower 75%	**133,000 (75%)**	**$400m (2.5%)**
Lower 90%	160,000 (90%)	$1,900m (11%)
Lower 95%	169,000 (95%)	$3,800 (22%)
Top 5%	**9,000 (5%)**	**$13,300m (78%)**
Top 2%	3,500 (2%)	$10,500m (61%)
Top 1%	1,800 (1%)	$8,400m (49%)
Total	177,000 (100%)	$17,100m (100%)

Most trusts have relatively small amounts of trustee income

27. Table 5 also shows that in the 2021 financial year, the lower 75% of trusts in terms of trustee income (133,000 out of 177,000) accounted for only 2.5% of trustee income ($0.4 billion out of $17.1 billion). This includes the lower 24% of trusts (43,000) that had no trustee income (i.e., only beneficiary income) and would therefore not be affected by an increase in the trustee rate.

28. In the 2021 financial year, for trusts with some trustee income, the mean trustee income was $128,000 but the median trustee income was only $8,000. The large difference between the mean and median trustee income illustrates that the distribution of trustee income is skewed and not normally distributed.

Table 6: Trustee income reported by trusts with assessable income

	FY2020				**FY2021**			
Trustee income per trust	*Number of trusts*	*Aggregate trustee income*	*Median trustee income**	*Mean trustee income**	*Number of trusts*	*Aggregate trustee income*	*Median trustee income**	*Mean trustee income**
Nil	47,000 (27%)	Nil	Nil	Nil	43,000 (**24%**)	Nil	Nil	Nil
Up to $180,000	123,500 (66%)	$2,500m (22%)	$6,000	$20,000	120,000 (**68%**)	$2,500m (14%)	$5,000	$21,000
Over $180,000	11,500 (**6%**)	$8,900m (**78%**)	$386,000	$778,000	14,000 (**8%**)	$14,600m (86%)	$430,000	$1,017,000
Total	182,000	$11,400m	$7,000	$85,000	177,000	$17,100m	**$8,000**	**$128,000**

** Note: Trusts with nil trustee income are excluded from the median and mean calculations.*

Over-taxation and under-taxation

29. One difficulty with addressing rate misalignment between the trustee and top personal tax rates is that it is not always clear who the ultimate recipient of trustee income will be. This means different perspectives can be taken regarding to whom trustee income should be attributed when determining the appropriate rate (that is, a settlor, the trustees, or a beneficiary). A key problem, therefore, is how to determine the appropriate tax

[18] The data has been broken down into the lower 24%, rather than the lower 25%, because these trusts had exactly nil trustee income (without rounding). Above the 24th percentile, trusts start to have small amounts of trustee income.

settings for income derived by a trust and not allocated to a particular beneficiary at that time.

Existing settings, or alignment of the trustee and top personal tax rates, may over-tax some lower-rate individuals…

30. A beneficiary (who could also be a settlor) with personal income of less than $70,000 has a marginal tax rate that is below 33%. If income is retained in a trust as trustee income and later distributed to a beneficiary who has a marginal tax rate below 33%, that income would be taxed at a higher rate than their personal income. This is an existing risk in the tax system that would be exacerbated if the trustee tax rate is raised. As noted above, there are cases where it is appropriate to tax a beneficiary at a rate higher than the rate that would apply to their personal income, particularly if the beneficiary is a minor and is a relative of the settlor (the minor beneficiary rule). However, there are other cases where taxing a beneficiary at a higher rate could result in over-taxation.

31. A similar argument can be made when considering the marginal tax rate of a settlor of the trust – as many trusts are effectively a gifting mechanism used by settlors to provide property to beneficiaries over time. Attributing trustee income to the principal settlor[19] (as income from property that has not yet been completely gifted to a beneficiary) could be an option for how trustee income should be taxed. This approach is explored in more detail in Section 2 (Option 2).

32. Table 6 shows that in the 2021 financial year, the median trustee income was $8,000 and 68% of trusts (120,000 trusts) reported less than $180,000 of trustee income each ($2,500m in aggregate, or 14% of trustee income). 24% of trusts (23,000) had only beneficiary income. The majority of trusts therefore have relatively small amounts of trustee income. This illustrates that while increasing the trustee tax rate as proposed would likely be progressive, some trusts with lower-rate beneficiaries may be over-taxed.

… however, existing rules should be sufficient to mitigate over-taxation in most cases

33. Existing rules should be sufficient to mitigate over-taxation in most cases. Trustees can allocate income to a lower-rate beneficiary as beneficiary income, instead of treating it as trustee income. This allows the income to be taxed at the beneficiary's lower personal tax rate, rather than the higher trustee tax rate. However, this may result in additional compliance costs for trusts.

34. Since a settlor can also be a beneficiary of a trust, this approach can be used in situations where the settlor is alive, is a beneficiary of the trust, and has a lower personal tax rate than the trustee tax rate. Trust income can be allocated to the settlor as beneficiary income and taxed at the settlor's lower rate. If the settlor does not want to retain the income, they can settle that income back on the trust as corpus. Distributions of corpus to beneficiaries are not subject to tax. This approach effectively allows income to be taxed at the settlor's lower rate while still being retained in the trust for later distribution to beneficiaries. This is an approach available under current law – however, in Section 2, Option 2 considers whether to make this approach mandatory for income retained as trustee income when there is a living principal settlor.

35. However, there may be situations where it is not desirable or possible for income to be allocated to lower-rate beneficiaries. As a result, some level of over-taxation may not be preventable under existing settings. This issue is covered in more detail in Section 3.

[19] A "principal settlor" is the settlor who has made the greatest settlement on a trust.

Retaining income as trustee income results in under-taxation…

36. Trustee income is currently taxed at 33% but is exempt from tax on subsequent distribution to beneficiaries, even if those beneficiaries are on a 39% personal tax rate.

> ***Example 1: 39% tax rate beneficiary***
>
> Amena has personal income of over $180,000 per annum and is a beneficiary of a trust. $50,000 has been retained in the trust as trustee income (with a tax liability of $16,500 at the 33% trustee tax rate).
>
> In the following year, the tax-paid trustee income ($50,000 less $16,500 tax = $33,500) is distributed to Amena. This distribution is not subject to tax. That income has only been subject to a 33% tax rate, and Amena does not need to pay the 6% difference between the 33% trustee tax rate and the 39% personal tax rate despite earning over $180,000.
>
> If the income was earned directly by Amena as personal income, the tax liability would be $19,500 at the 39% tax rate.

… and this is a much larger problem than over-taxation in terms of total income

37. As noted in Table 5, most trustee income (78%, or $13.3 billion out of $17.1 billion, for the 2021 financial year) is concentrated in a relatively small number of trusts (5%, or 14,000 out of 177,000 trusts). That is, under-taxation is a larger problem than over-taxation in terms of total income. This does not mean that all this income is under-taxed, as it does not take into account the number of settlors or beneficiaries (or their personal tax rates), but it is an indication that there is a significant amount of under-taxation.

What is the policy problem or opportunity?

38. The Government's stated long-term revenue objective is to "ensure a progressive taxation system that is fair, balanced and promotes the long-term sustainability of the economy, consistent with the debt and operating balance objectives".

39. Medium-term fiscal pressures may require the Government to have the flexibility to raise more revenue in the future. The primary way of doing this is through adjusting rates on the Government's chosen tax bases, rather than piecemeal reforms through the base maintenance work programme.[20]

40. The Government currently raises revenue from three main tax bases: personal income tax, company tax and goods and services tax ("GST"). The personal income base is a key tax base, raising around 50% of total tax revenue. The system of personal tax rates and thresholds is designed to reflect the Government's view on how progressive the tax system should be. However, misalignment, combined with the current tax rules for companies and shareholders, makes it difficult for governments to raise revenue through the personal tax base in a way that is consistent with the Government's revenue strategy and economic strategy objectives.

41. Misalignment arises when the marginal tax rate that applies to an individual's income is higher than the tax rate that applies when income is earned through a company or a trust. The ability to raise more revenue from the personal tax base is significantly constrained because of misalignment between the 39% top personal tax rate and the

[20] The aim of a base maintenance work programme is to repair and maintain our tax rules so that existing tax bases are as fair and efficient as they can be. While base maintenance measures will sometimes raise revenue, their primary aim is to improve the efficacy of the tax system.

33% trustee tax rate. This misalignment allows the top personal tax rate to be circumvented and reduces the progressivity of the income tax system.

What objectives are sought in relation to the policy problem?

42. A key factor in considering options to address misalignment between the trustee tax rate and the top personal tax rate is whether an option moves in the direction of a robust and sustainable tax system. To help achieve this, any reform should:

    - ensure trusts cannot be used to circumvent the 39% personal tax rate;
    - minimise the over-taxation of lower-rate individuals where possible, particularly for trusts with only lower-rate settlors and beneficiaries; and
    - raise revenue for Budget 2023.

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

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

43. Options to address misalignment of the trustee tax rate and top personal tax rate have been assessed against the following criteria.

- **Under-taxation:** Does the option ensure that trusts cannot be used to circumvent the top personal tax rate?
- **Over-taxation:** Does the option result in lower-rate individuals being over-taxed?
- **Complexity:** Is the option easily understood? Does the option increase the complexity of the tax system?
- **Coherence and sustainability:** Does the option make sense in the context of the entire tax system? Is the option future-proofed?
- **Revenue impact:** How would the option impact tax revenue?
- **Administrative and delivery implications:** How would the option impact Inland Revenue? When can the option be delivered by?
- **Compliance costs:** How would this option impact taxpayers?

What scope will options be considered within?

44. Based on Ministers' commissioning, options are considered in the context of developing policy proposals in time for Budget 2023. The level of detail on some of the more complex options is limited due to time constraints.

45. The options in this RIS focus on the tax rules for trusts. Wider issues relating to misalignment between the company, PIE and top personal tax rates are outside the scope of this RIS.

46. Changes to the trust disclosure rules introduced for the 2021–22 and later income years are outside the scope of this RIS. Inland Revenue is scheduled to undertake a post-implementation review of those rules in 2023, after a full year's worth of data has been disclosed (after 31 March 2023).

What options are being considered?

47. We have considered the following options:

- **Option 1** – Increasing the trustee tax rate to 39% with modifications for certain trusts with lower-rate settlors and beneficiaries, if necessary.
- **Option 2** – Taxing trustee income at the principal settlor's personal tax rate.
- **Option 3** – Introducing an imputation-style system for trustee income, similar to what is currently in place for companies and Māori authorities.

48. We also explored the following alternative approaches. These options were ruled out in early policy development and are not covered in any detail due to their significant limitations in addressing the problem definition:

- **Retaining the 33% trustee tax rate but requiring 39% rate individuals (i.e., individuals that earn over $180,000) to pay a top-up tax at 6% on distributions of trustee income**. This would ensure trust income that is distributed to 39% rate individuals is taxed at 39%. This option was ruled out due to administrative complexity and because the additional 6% tax on trustee income could be deferred by delaying distributions of trustee income to 39% rate individuals. The additional 6% tax could also potentially be completely avoided by deferring distributions until a 39% rate individual is on a lower rate (e.g., when the individual is working part-time or has retired) or by streaming taxable distributions to lower-rate beneficiaries and tax-free distributions (corpus and capital gains) to higher-rate beneficiaries. This approach would also be a significant departure from the current trust taxation regime for a small group of individuals. Compared with other options, this option might only partially achieve the objective of ensuring trusts cannot be used to circumvent the 39% top personal tax rate and it is unclear if this approach would raise revenue for Budget 2023.
- **Introducing specific anti-avoidance provisions**. This was ruled out because it would involve high administrative costs and (depending on how well the provisions are enforced) may not meet the objectives of ensuring trusts cannot be used to circumvent the 39% top personal tax rate and raising revenue for Budget 2023.
- **Taxing trustee income on a progressive tax scale up to 39%**. While this option has the appeal of mitigating any over-taxation that might arise with a flat trustee tax rate, it was ruled out because it would create significant tax planning opportunities. Complex aggregation rules would be needed to ensure taxpayers do not settle multiple trusts to take advantage of the progressive tax scale and enforcing those aggregation rules would involve significant administrative costs. This option could result in a reduction in revenue compared with the status quo, especially if the aggregation rules are not applied consistently, and trusts would continue to be used to circumvent the 39% top personal tax rate. It is likely that none of the objectives being sought in relation to this policy problem would be satisfied.

Option analysis

Option 1 – Increasing the trustee tax rate to 39% with modifications for certain trusts with lower-rate settlors and beneficiaries, if necessary

49. This option would align the trustee tax rate with the top personal tax rate at 39%. The trustee tax rate would continue to be a final tax imposed in the year income is derived.

Under-taxation

50. Increasing the trustee tax rate to 39% would ensure that trustee income is not under-taxed when the income is accruing for the benefit of beneficiaries (who could also be settlors) whose personal income, plus their income from trusts, exceeds $180,000. A 39% trustee tax rate would improve the robustness of the tax system by increasing the likelihood that income attributable to 39% rate individuals is subject to the appropriate amount of tax. This option would also improve the sustainability of the tax system by minimising revenue leakage under existing settings.

51. As outlined above in the limitations section, even if the trustee tax rate is aligned with the top personal tax rate, there will continue to be opportunities to circumvent that rate by substituting trusts with companies or PIEs. However, trusts are a completely different legal structure from companies and PIEs, and they are not complete substitutes.

- **Substitutability with PIEs:** Some trusts have investments that earn large amounts of income that could not be put into a PIE. These are primarily businesses that settlors or beneficiaries control, such as farms and SMEs. While the general population may not have many of these investments, they represent a large amount of the assets of high-income investors.
- **Substitutability with companies:** Trusts have certain tax advantages that companies do not. Capital gains derived in trusts can be distributed immediately to beneficiaries tax free, whereas capital gains can usually only be extracted from a company upon liquidation or as a taxable dividend.[21] Trusts can stream distributions to different beneficiaries and can be used for asset protection in a way that companies cannot. Also, the company and dividend tax rules are relatively more comprehensive than the trust tax rules. Therefore, there are some important advantages that would counteract, to a degree, the incentive for taxpayers to shift income from trusts to companies.

52. This reduced level of substitutability means changes to the trust taxation rules are likely to be worthwhile, even if no changes are made to the tax treatment of PIEs or companies. Raising the trustee tax rate to 39% will still raise revenue in a relatively low-cost way, while better meeting the Government's distributional objectives.

Over-taxation

53. Aligning the trustee tax rate with the top personal tax rate may result in distributions of tax-paid trustee income to lower-rate beneficiaries being taxed above the beneficiaries' marginal tax rates. This may be appropriate, for instance in the case of a discretionary trust where the beneficiary is a minor and a relative of the settlor (the minor beneficiary rule). In cases where it is not appropriate, there are options to mitigate this.

54. An existing rule allows income earned by a trust to be taxed at a beneficiary's personal tax rate if the income is allocated or paid to the beneficiary during the income year or within an extended period following the end of the income year. There may be situations where this existing rule would not effectively prevent over-taxation. Other jurisdictions have rules to address specific situations. Modifications to address risks of over-taxation are covered in detail in Section 3, although it is important to note that the inability to undertake public consultation during the Budget preparation period means we have had to make judgements and recommendations based on limited data. We expect further information to come to light on the over-taxation risks posed by a 39% trustee tax rate once the proposals become public.

55. If a trust retains income as trustee income because the trustees have not decided which beneficiary to allocate the income to, the income should be taxed at the trustee tax rate. It is not over-taxation if the 39% rate applies in this situation, as the settlors/trustees have retained control over the income.

Complexity

56. Depending on the design of any potential modifications (Section 3), this approach is the least complex option – it fits within the existing tax regime for trusts and does not involve any significant structural reform.

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[21] Available subscribed capital can also be distributed through share repurchases, funded by capital gains, without liquidation of the company.

Coherence and sustainability

57. Aligning the trustee and top personal tax rates supports the coherence of the tax system. The trustee tax rate was intentionally aligned with the top personal tax rate when the current trust tax regime was introduced in 1989, and it has only fallen out of alignment during the two periods since 2000 when the top personal tax rate was 39%.

58. This option improves the sustainability of the tax system by reducing misalignment pressures between the trustee and top personal tax rates. In principle, this option should be robust to changes to the personal tax system provided the trustee tax rate (once it is aligned with the top personal tax rate) remains aligned with that rate. However, we have not considered the impact of any potential changes to the personal tax system in detail.

Revenue impact

59. The amount of revenue this option would raise is highly uncertain and heavily dependent on the behavioural response by trustees. If more income is diverted to other entities or is allocated as beneficiary income instead of being retained as trustee income, less revenue will be raised through the taxation of trustee income. Examples of behavioural responses by trustees include:

    - *Restructuring out of trusts:* Taxpayers could substitute trusts with PIEs or companies, however these entities are not fully substitutable, as noted above.
    - *Reducing income derived by trusts*: A large proportion of trustee income is dividend income (see Figure 1) and could be easily diverted into other entities or retained in companies.
    - *Beneficiary income allocations to individuals:* Trustees could allocate income as beneficiary income to beneficiaries of the trust on lower personal tax rates.
    - *Beneficiary income allocations to companies:* Trustees could appoint a company as a beneficiary and allocate beneficiary income to the corporate beneficiary (taxed at 28%). This matter is covered in more detail in the "Rule needed to buttress proposed 39% rate" subsection of Section 3.

60. The introduction of any modifications to this option would likely reduce the revenue raised from increasing the trustee tax rate. Furthermore, any fiscal impact would also depend on whether changes to the taxation of PIEs and companies are progressed – if they are, this option could raise more revenue.

61. With these caveats, a costing produced in 2020 for the introduction of the 39% personal tax rate indicated that increasing the trustee tax rate to 39% with no modifications was estimated to raise approximately $350m per annum (based on the income data at that time). That estimate was based on most of the relevant income being taxed at 39% and only assumed a moderate behavioural response. The timing lag relates to information flows: the first year of affected tax returns needs to be filed before the additional income tax is recognised, and the second tax year and part of the third tax year is simultaneously accrued based on that new information.

Table 7: Estimated tax revenue from increasing the trustee tax rate to 39%

Fiscal year	2022/23	2023/24	2024/25	2025/26	2026/27 & outyears	Total over forecast period
Estimated tax revenue from increasing the trustee tax rate to 39% ($m)	-	-	13	770	350	1,133

Administrative and delivery implications

62. Implementation and ongoing administrative costs are estimated to be between $5 million and $11 million over the forecast period (2022/23 to 2026/27 fiscal years). This estimate will be refined when final policy decisions have been made for all Budget 2023 initiatives that are proposed to be implemented in the same delivery timeframe.

63. At the upper-end of the cost range, over the forecast period, the estimated one-off capital build costs are $2.9 million, the one-off operating build costs are $0.7 million, the ongoing administrative costs are $5.4 million, and depreciation and capital charge are $2 million.

64. The operating costs for this initiative include additional resource capacity, one-off implementation costs, depreciation, and capital charge. The resource impact of this initiative is six FTEs in 2023/24, 25 FTEs in 2024/25 and 19 FTEs in 2025/26. This predominantly relates to responding to customer queries (both about the changes and around the auto-calculation period), enquiries from tax intermediaries, and compliance activity for return filing and non-compliant trusts. From 2026/27 these activities will reduce and be absorbed within business-as-usual activities, with no additional funding required. The ongoing funding impact from 2026/27 is for depreciation and capital charge.

Table 8: Implementation and ongoing administration costs

	$ million – increase/(decrease)					
Vote Revenue	2022/23	2023/24	2024/25	2025/26	2026/27 & outyears	Total
One-off build costs	-	0.700	-	-	-	0.700
Ongoing admin costs	-	0.600	2.700	2.100	-	5.400
Depreciation and capital charge	-	0.200	0.600	0.600	0.600	2.000
Total operating	**-**	**1.500**	**3.300**	**2.700**	**0.600**	**8.100**
Capital build costs	-	2.900	-	-	-	2.900
Total capital	**-**	**2.900**	**-**	**-**	**-**	**2.900**
Total	**-**	**4.400**	**3.300**	**2.700**	**0.600**	**11.000**
Administrative FTEs	-	6	25	19	-	-

65. To implement this option, Inland Revenue would require time to engage with its ecosystem partners, such as software providers and tax intermediaries, and this would be aligned to Inland Revenue's annual change engagement process. Additional time would be required to develop a solution for all parties. The earliest implementation date

for simply changing the trustee tax rate to 39% and implementing some simple modifications would be 1 April 2024. More complex modifications would require additional time, and the earliest implementation date for such changes would be 1 April 2025.

Compliance costs

66. Depending on the design of any modifications, this option is not expected to have a significant impact on compliance costs for trusts. Relying on paying or allocating income as beneficiary income to mitigate over-taxation could result in increased compliance costs for trustees in determining who to allocate income to each year. However, this is a decision that already needs to be made by trustees.

67. Some trusts with only lower-rate settlors and beneficiaries may consider themselves unfairly impacted by the proposed 39% trustee tax rate. Such trusts may never have a 39% rate settlor or beneficiary, yet they will be forced to decide whether to allocate income to mitigate over-taxation and may face increased compliance costs as a result. Taxpayers may consider this particularly unfair when they are using trusts for non-tax reasons, such as to protect assets from creditors or relationship property claims, and allocating income as beneficiary income could undermine those non-tax reasons.

Option 2 – Taxing trustee income at the principal settlor's personal tax rate

68. Instead of trustee income being taxed at a flat rate (as under the status quo or Option 1), such income could be taxed at the principal settlor's[22] "trust-affected" personal tax rate in the year the income is derived by the trust. This rate would be determined by taking into account both the settlor's own personal income and the trustee income of any trust for which they are a principal settlor. For trusts without a living principal settlor, trustee income would be taxed at 39% (similar to Option 1).

69. As noted above, this approach can already be voluntarily achieved by trustees under current rules. Trust income can be allocated to a settlor (as a beneficiary) as beneficiary income and taxed at the settlor's marginal tax rates. The settlor can settle that income back on the trust as corpus – distributions of corpus to beneficiaries are not subject to tax. This option would achieve the same result but would make it mandatory. This would help ensure that trusts are not over-taxed due to the trustees/settlor not knowing about this approach or applying it incorrectly.

Under-taxation

70. Applying the principal settlor's trust-affected personal tax rate to trustee income could be appropriate for many trusts, given that settlors generally retain a large degree of effective control or influence over the trusts they settle property on. Many trusts are effectively a gifting mechanism used by settlors to provide property to beneficiaries over time, so taxing trustee income (as income from property that has not yet been completely gifted to a beneficiary) at the principal settlor's trust-affected tax rate could be appropriate.

71. This option would ensure that the 39% tax rate would be paid on trustee income when, in aggregate, the trustee income and the principal settlor's personal income exceeds $180,000.

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[22] A "principal settlor" is the settlor who has made the greatest settlement on a trust.

Example 2: Taxing trustee income at the principal settlor's personal tax rate

Baru has settled property on a trust and the trust has no other settlors. In the 2024–25 income year:

- Baru derived $160,000 of personal income.
- The trust derived $300,000 of trustee income.

Under Option 2, since Baru derived $160,000 of personal income in the 2024–25 income year, $20,000 of the trustee income would be taxed at 33%. The remaining $280,000 would be taxed at the 39% trustee tax rate.

Over-taxation

72. This option would significantly mitigate risks of over-taxation by applying lower tax rates for all or some of the trustee income of trusts with lower-rate settlors – provided that the trust has a living principal settlor. A 39% trustee tax rate would apply for trusts that do not have a living principal settlor.

Example 3: Taxing trustee income at the principal settlor's personal tax rate

Gideon and Harrow have settled property on a family trust. The market value of the property settled by Gideon on the trust is $1,000,000, while the market value of the property settled by Harrow is only $500,000. Gideon is considered the principal settlor of the trust.

In the 2024–25 income year:

- Gideon derived $50,000 of personal income.
- The trust derived $50,000 of income. $25,000 is allocated as beneficiary income and $25,000 is retained as trustee income.

The $25,000 of trustee income would be taxed at Gideon's trust-affected personal tax rate. Since Gideon had $50,000 of personal income in the 2024–25 income year, $20,000 of the trustee income would be taxed at 30% (as it falls within the $48,001 to $70,000 bracket), and the remaining $5,000 would be taxed at 33%. Total income tax of $7,650 would be payable on the trustee income.

Personal income	Marginal tax rate
Up to $14,000	10.5%
Over $14,000 and up to $48,000	17.5%
Over $48,000 and up to $70,000	30%
Over $70,000 and up to $180,000	33%
Remaining income over $180,000	39%

If a 33% or 39% flat tax rate had applied to tax the trustee income instead, the total income tax payable by the trustees on the income would have been $8,250 or $9,750 respectively.

Complexity

73. This option would introduce complexity in the tax system (or alternatively would result in inequities arising from simple arbitrary rules) for situations when there are multiple settlors of a trust with the greatest-equal share or there is a new principal settlor part way through an income year.

74. The existing trust taxation rules would need to be retained in certain situations, such as when the principal settlor is no longer alive or for trusts with no natural person settlors

(such as a trust settled by a court to hold Māori land while the beneficiaries are being determined).

75. This option would be an improvement on the status quo in terms of under- and over-taxation, but it is unclear if the additional complexity (relative to Option 1) is justified. Determining the appropriate tax rate for trustee income for a year may require calculating a composite rate, based on the principal settlor's personal income and the aggregate trustee income from all other trusts where the individual is also a principal settlor. This is unlikely to be administratively straightforward.

Coherence and sustainability

76. This option could reduce the coherence of the tax system by introducing a new regime for the taxation of trusts with living principal settlors but retaining existing rules for other trusts. However, a settlor-attribution approach would help future-proof the tax system by ensuring there is no misalignment issue between the trustee and top personal tax rates, even if personal tax rates were to change in the future. Regardless of future changes to the personal tax system, this option would address under-taxation and mitigate over-taxation – albeit only for trusts with living principal settlors. Rules could potentially be developed for trusts that do not have living settlors, but these would be difficult to design and are likely to be complex.

Revenue impact

77. The fiscal impact of this option has not been estimated due to limited time and the lack of detailed design at this stage. Given the complexities involved, any estimate would be premature and highly uncertain.

Administrative and delivery implications

78. The estimated initial system development impact for Inland Revenue is small but this would depend on the detailed design of this option. Inland Revenue would need time to engage with its ecosystem partners, such as software providers, and this would be aligned to Inland Revenue's regular annual change engagement process. Additional time would be required to develop a solution for all parties. The earliest implementation date would be 1 April 2025.

79. There would likely be a medium-sized initial administrative cost in the first year to support customer enquiries about the rates at which they have been taxed and the impact on their tax assessments. Ongoing administration costs for Inland Revenue are expected to be small.

Compliance costs

80. This option would likely result in increased compliance costs for trustees of a trust with a living principal settlor. Trustees would need to know the personal income of the principal settlor of the trust. This could potentially be challenging to comply with if there are multiple trusts that need to be aggregated or if there is a new principal settlor part way through an income year.

81. There should be no compliance cost impact for trusts without a living principal settlor, as existing rules would apply.

Option 3 - Introducing an imputation-style system for trustee income

82. There are other options that would integrate the taxation of trustee income with the personal income tax system. However, they would involve fundamental changes to how trustee income is taxed. One approach would be to introduce an imputation-style system for the taxation of trustee income, similar to what is already in place for companies and Māori authorities.

83. Trustee tax would still be paid in the year that trustee income is derived, either at the current 33% rate or at the 39% rate (to align with the top personal tax rate). Trusts would receive imputation credits for tax paid on trustee income, and those credits would be distributed to the beneficiaries who later receive that income. Distributions of trustee income to beneficiaries would be taxed at the beneficiaries' personal tax rates, but beneficiaries would be able to offset their tax liability with any imputation credits from tax paid by the trust. Any surplus imputation credits could be refundable to the beneficiary, carried forward, or used to offset their tax liability for other income (such as employment income).

Example 4: An imputation-style system for trustee income

Thiago is the trustee of a discretionary trust with two beneficiaries, Indah and Matteo.

In the 2024–25 income year, the trust derives $200,000 trustee income – this is taxed at 39%, resulting in $78,000 tax paid, leaving $122,000 after tax. This gives the trust $78,000 of imputation credits for the amount of tax paid.

In the same year, Indah earns $200,000 personal income (with a marginal tax rate of 39%) and Matteo earns $30,000 personal income (with a marginal tax rate of 17.5%).

Deferral disadvantage to lower-rate beneficiaries

Two years later, in the 2026–27 income year, Thiago decides to distribute $30,500 trustee income, with $19,500 imputation credits attached (for a total of $50,000 tax-paid trustee income) to Matteo.

Matteo still earns $30,000 personal income. This distribution brings Matteo's taxable income to $80,000. Under the personal tax scale, $80,000 personal income results in a tax liability of $17,320. The imputation credits could satisfy the tax liability on the distribution of trustee income, and if Matteo can offset the imputation credits against his other personal income, then he would have no income tax to pay for that year. If the imputation credits are refundable, Matteo would receive a $2,180 refund at the end of the year.

Although Matteo would be able to use the imputation credits to reduce his tax liability and receive a refund, he would be disadvantaged by having to wait for the income to be distributed from the trust.

Deferral advantage to higher-rate beneficiaries

In the 2029–30 income year, five years after the income was derived, Thiago distributes the remaining $150,000 trustee income to Indah (comprised of $91,500 after-tax trustee income and $58,500 imputation credits). Indah is in semi-retirement and only works part-time – her personal income is now only $30,000. The $150,000 distribution brings Indah's taxable income to $180,000, with a tax liability of $50,320. Due to the amount of imputation credits, Indah could reduce her tax liability to nil and receive a refund of $8,180.

Although the trustee income was taxed at 39% in the year it was derived when Indah was on a marginal tax rate of 39%, Indah would be able to benefit from the distribution being deferred until she was on a lower marginal tax rate.

Under-taxation and over-taxation

84. This approach would help ensure that the ultimate recipients pay tax on distributions of trustee income at their personal tax rates in the year a distribution is received. Recipients on higher personal tax rates than the trustee rate (if the trustee rate remains at 33%) would pay additional tax. Depending on the specific design, surplus credits for recipients on lower personal tax rates could be credited against other tax liabilities, refunded, and/or carried forward for use in later years.

85. This option would likely improve the long-term robustness, sustainability, and flexibility of the tax system. It would be robust to different designs of the personal tax system. The ability to shelter income permanently in a trust would be greatly limited, regardless of the specific trustee or top personal tax rates, and concerns regarding over-taxation would be mitigated.

86. However, if the trustee tax rate remains at 33%, there would be a delay between the year in which tax is paid on trustee income by the trustees and the year in which additional tax is paid by beneficiaries. Similarly, regardless of what trustee tax rate applies, there would be a delay between the year in which tax on trustee income is paid and the year in which lower-rate beneficiaries get the benefit of surplus imputation credits. This is similar to the existing situation for natural person shareholders of a company, although a larger deferral benefit currently applies to income earned in companies.

- *Deferral benefit for high-rate beneficiaries*: There would be a deferral benefit for higher-rate beneficiaries if the trustee tax rate that applied in the year income is derived by a trust remained lower than the top personal tax rate. The Government would not receive the additional income tax payable on trustee income until that income is later distributed to the higher-rate beneficiary. If the income is not distributed until the beneficiary is on a lower rate (e.g., once the beneficiary is only working part-time or has retired), no additional tax would be paid, even if the beneficiary was on the 39% top personal tax rate when the income was originally derived by the trust. This issue could be resolved by also increasing the trustee tax rate to 39%.
- *Deferral disadvantage for beneficiaries on lower rates*: There would be a deferral disadvantage for beneficiaries on a personal tax rate lower than the trustee tax rate. The Government would receive the benefit of income retained as trustee income being taxed at the higher trustee tax rate in the year the income was derived, and lower-rate beneficiaries would not receive the benefit of surplus credits until trustee income is later distributed. This disadvantage would be exacerbated if the trustee tax rate was increased to 39%.

Complexity

87. This option would be significantly more complex to design than Options 1 or 2, given it would involve a significant departure from the current trust taxation regime. Further consideration would need to be given to:

- **Continuity and commonality requirements** for imputation credits – should a beneficiary be allowed to receive imputation credits for tax that was paid before they became a beneficiary of the trust? Or should it be a requirement that to receive imputation credits from a trust, a person must have been a beneficiary of the trust in the income year to which the credits relate?

- The **treatment of surplus credits** – should beneficiaries be allowed to offset these against other income (e.g., employee income)? Should surplus credits be refundable? Or should beneficiaries just be able to carry surplus credits forward to offset against any future tax liability arising from trustee income that is distributed to them in the future?
- **Anti-streaming rules** – these would be required to prevent trustees from streaming tax-exempt distributions (such as capital gains or corpus) to higher-rate beneficiaries and streaming tax-paid trustee income to lower-rate beneficiaries (who would have surplus credits, which could be refundable depending on how this option is designed).
- **Distributions to minors** – the minor beneficiary rule is currently the only defence in the law against income-splitting (apart from anti-avoidance rules, such as in the case of personal services income derived through trust structures). Would a special rule have to apply to trustee income that is distributed to a minor beneficiary to ensure allocations of trustee income are not used to split income with minors?

88. If the trustee tax rate remains at 33%, this option would allow tax planning opportunities. For example, 39% rate settlors could defer distributions of trustee income until later in life, when they have less income and lower personal tax rates. This is currently possible with closely-held companies but not with trusts.

Coherence and sustainability

89. This option would improve the coherence of the tax system by implementing similar rules to the imputation system for companies and the Māori authority tax regime. Parallels could be drawn from these existing systems in terms of both policy design, implementation, compliance, and education – however the unique features of discretionary trusts would mean this would not be seamless.

90. This option would also improve the sustainability of the tax system by integrating the taxation of trusts with the personal tax system. The ultimate recipients of income derived by trusts would pay tax at their personal rates – although there would be deferral issues, as noted above. An imputation system could also improve social policy targeting. Distributions of trustee income would form part of a beneficiary's personal income and therefore would count towards the abatement of social policy measures, such as Working for Families.

Administrative and delivery implications

91. This option would require large-scale initial system development for Inland Revenue, and the detailed design of the rules may need to take into account the requirements and limitations of software providers. Although Inland Revenue currently administers an imputation credit system for companies and Māori authority credits, it is expected that significant development would be required to achieve the policy outcomes as described. Inland Revenue would need time to engage with its ecosystem partners, such as software providers, and this would be aligned to Inland Revenue's regular annual change engagement process. However, additional time would be required to develop a solution for all parties. The earliest implementation date would be 1 April 2025.

92. There would likely be a medium to large initial administrative impact for Inland Revenue in the first year to support trustees with understanding the new rules and to help individuals understand the impact on their tax assessments. Ongoing administration costs for Inland Revenue are expected to be medium.

Compliance costs

93. Despite the existing imputation systems for companies and Māori authorities, experience suggests that both taxpayers and their agents find imputation one of the most challenging aspects of the tax system, so extending it to trusts could require a significant educational effort and ongoing support for taxpayers and their agents.

94. Additional compliance costs would arise from trustees needing to maintain memorandum accounts for imputation credits and understanding and complying with complex anti-streaming and integrity rules.

Well-being and economic considerations

95. All three options considered above would have similar well-being and economic impacts.

96. The options would all raise additional revenue in ways that support the Government's distributional objectives, as they would prevent taxpayers from circumventing the top personal tax rate on their individual income. Therefore, all options would likely strengthen the sense of fairness in the tax system (social cohesion) through improving horizontal and vertical equity. The counter to this is that Option 1 could result in some individuals being over-taxed if income is retained in a trust as trustee income and later distributed to lower-rate beneficiaries, which could result in a perception of unfairness.

97. All options would likely have less benefit by themselves than they would as a package of three measures addressing misalignment across the tax system, including changes to the tax treatment of PIEs (or at least PIEs that are not KiwiSaver or other retirement savings schemes) and changes to the tax treatment of companies/shareholders. This is because increased taxes on trusts would inevitably result in some leakage of revenue to entities such as PIEs and companies, which would reduce the effectiveness and economic efficiency of the trust tax changes. There would also be some compliance costs incurred if assets or business activities were to be shifted from a trust to another entity. However, as discussed above, PIEs and companies are not fully substitutable for trusts.

98. Even by themselves, the changes would likely support fairness, economic efficiency, and well-being. While an increase in the absolute amount of tax raised would inevitably give rise to some economic costs, the options discussed above would broaden an existing tax base and make it harder for people to circumvent the personal tax scale. The additional economic costs per dollar of revenue raised would likely be lower than many alternatives because broader tax bases are generally more efficient than narrower tax bases.

Māori perspectives

99. The tax system provides specific tax rules for Māori organisations who manage and own communal assets for the benefit of whānau Māori, hapū, and iwi. Māori organisations that are eligible to apply these rules are called Māori authorities and are taxed at 17.5%. These rules were purpose-built to meet the unique characteristics and circumstances of how Māori own and manage communal assets and pursue their specific development outcomes. Changes to the Māori authority tax rules are outside the scope of this RIS.

100. We would expect that most trusts used by Māori for communal ownership purposes would, in principle, be eligible to be taxed as Māori authorities. Therefore, our initial view is that the objectives and options of the proposals in this RIS are unlikely to impact Māori

development outcomes or present a barrier to sustainable prosperity and resilience for whānau Māori and future generations.

101. Due to Budget sensitivity constraints, we have been unable to publicly consult on the impact of these proposals. In the absence of full public consultation, the impact of the proposals on broader considerations of well-being beyond the use of trust structures by Māori, including any boundary matters relating to the interpretation of the Māori authority rules, is not fully understood. However, during policy development officials did undertake limited engagement with Te Tumu Paeroa – the Office of the Māori Trustee. This engagement focused on the reasons why a trust might choose not to elect to be a Māori authority. Very few trusts handled by Te Tumu Paeroa are not Māori authorities for income tax purposes, and as mentioned above, Māori authorities are not expected to be affected by these proposals.

Distributional impacts

102. We consider that all three options would increase the progressivity of the tax system. However, the available data is limited. As noted in Table 5, 2020–21 tax returns indicate that a relatively small number of trusts (5%) earn most trustee income (78%). In addition, data from the Household Economic Survey 2018 (HES 2018) suggests that net-worth decile 10 households[23] hold 40 percent of their wealth in non-financial (generally property) and financial assets in family trusts. Some of the non-financial assets, such as principal residences, would not generate any taxable income, so would not be impacted by any tax change. However, other assets may generate taxable income streams.

Impact on investment, savings, economic efficiency, and broader well-being

103. All three options increase the tax paid by trusts so that the top personal tax rate would apply to individuals with incomes over $180,000 more so than at present. This would mean a higher level of tax on income earned in trusts, including income from business investments undertaken by trusts.

104. While there may be impacts on specific investments (for example, in business or rental properties) and savings, these are unlikely to have a large effect on aggregate capital stock, productivity or wages. It would not give rise to the same level of concern about increases in the costs of capital (or hurdle rates of return) that an increase in the company tax rate might do. This is because non-residents are unlikely to be significant participants in New Zealand-based trusts; they mainly invest in New Zealand through companies. While New Zealanders on the top personal tax rate would obtain lower after-tax returns from investing through trusts, these would be the same as the after-tax returns they receive from investing directly.

105. Some specific impacts of increasing the trustee tax rate to 39% (Option 1) are set out here. The magnitude of all these impacts is uncertain but is unlikely to be large. There are many factors that influence decisions to invest other than the trustee tax rate. These impacts are an inevitable consequence of reducing opportunities for individuals to side-step the top personal tax rate and seeking to have a fairer tax system:

- Under-taxed assets: A higher trustee tax rate would increase the incentive to invest in lightly-taxed assets, such as owner-occupied housing.

[23] Note that some individuals in net worth decile 10 would be in lower income deciles.

- Rental housing: Current Inland Revenue data suggests about 16% of rental properties are held in a trust.[24] A higher trustee tax rate would have a mixed impact on investments in rental housing. To the extent rental income is subject to a higher tax rate, this could reduce incentives to invest in rental property. It could therefore put downward pressure on house prices and/or increase rents. However, to the extent rental properties derive untaxed income, in the form of capital gains, any increased tax may encourage investment in rental properties over other forms of investment.

- Business investment: Increasing the trustee tax rate may impact incentives to invest in businesses through trusts, including farming and commercial property. To the extent that existing integrity issues remain with companies and shareholders, this may result in restructuring rather than a reduction in investments. Such restructuring would likely result in some one-off compliance costs.

- Labour income: Increasing the trustee tax rate would reduce the return on labour income earned through a trust. However, most labour income is not earned through trusts, so increasing the trustee tax rate would improve fairness by ensuring a broader set of individuals pay tax according to the personal scale.

- Savings: Increasing the trustee tax rate may reduce incentives for those on higher marginal tax rates to accumulate savings in trusts. Conversely, a higher tax on savings means individuals would need to save more to reach a savings goal. This makes the overall impact on savings hard to determine.

- Investment in different entities: Consistent taxation of income earned through different entities can also promote the efficient organisation of income-earning activities. If investors in less efficient business structures can pay less tax than those investing in more efficient business structures, investment may be distorted towards the less efficient business structures (which is not desirable). Removing distortions means businesses can be organised in the most efficient way.

[24] Inland Revenue's Residential Rental Property Data Model suggests that 43,080 2019–20 tax returns indicated that trusts were involved with residential rental income (out of a total of 269,346 residential rental property filers).

How do the options compare to the status quo?

Key for qualitative judgements:	
++	much better than doing nothing/the status quo
+	better than doing nothing/the status quo
0	about the same as doing nothing/the status quo
–	worse than doing nothing/the status quo
– –	much worse than doing nothing/the status quo
?	unknown impact

Table 9: Option analysis

	Option 1 – Increase trustee tax rate to 39%	**Option 2 – Mandatory settlor attribution for trustee income**	**Option 3 – Imputation-style regime for trustee income** (33% trustee tax rate / 39% trustee tax rate)
Under-taxation	++ Aligning the trustee tax rate and top personal tax rate would help ensure that the 39% rate applies to income attributable to individuals who earn over $180,000.	++ This option would ensure that the 39% rate applies to trustee income for trusts with higher-rate settlors, helping ensure that trusts cannot be used to circumvent the top personal tax rate.	+ / ++ Integration of the taxation of trusts with the personal income tax system would ensure that the ultimate recipients of income derived by trusts would pay tax at their personal tax rates. This option with a 39% trustee tax rate would better address under-taxation compared with the status quo because there would be no deferral benefit for beneficiaries on the 39% personal tax rate.
Over-taxation	– Some taxpayers may be over-taxed. However, this should be able to be mitigated under current law in most situations.	+ Lower rates would apply to trustee income for trusts with lower-rate settlors – this would help mitigate over-taxation. However, there would be no benefit for trusts without a living settlor.	++ / + Integration of the taxation of trusts with the personal income tax system would ensure that the ultimate recipients of income derived by trusts would pay tax at their personal tax rates.

	Option 1 – Increase trustee tax rate to 39%	Option 2 – Mandatory settlor attribution for trustee income	Option 3 – Imputation-style regime for trustee income (33% trustee tax rate / 39% trustee tax rate)
Revenue impact	+ + The impact is highly uncertain. A 2020 costing estimated this change, with no modifications, would raise approximately $350m per annum.	? / + We expect this option would raise revenue compared with the status quo. However, due to lack of detailed design, the revenue impact has not been estimated.	? / + We expect this option would raise revenue compared with the status quo. However, due to lack of detailed design, the revenue impact has not been estimated.
Complexity	0 / – This is the simplest option. Depending on whether modifications are introduced and how these are designed, there may be a small increase in complexity for taxpayers who choose to use any modifications.	– This option would be more complex than the status quo. Rules would be needed to address issues relating to trusts with multiple principal settlors, mid-year changes in principal settlor, and when a person is the principal settlor of multiple trusts.	– – This option involves fundamental reform of the taxation of trusts and would introduce significant complexity. Experience suggests that both taxpayers and agents find imputation one of the most challenging aspects of the tax system.
Coherence and sustainability	+ Improves the coherence and sustainability of the tax system, although the trustee tax rate would need to be reconsidered if any changes were made to the top personal tax rate.	+ This option reduces the coherence of the tax system by introducing different trust taxation regimes depending on whether the trust has a living principal settlor. However, to counter this, when there is a living settlor, this option improves the coherence of the tax system by helping to ensure income is taxed at an appropriate rate. This option improves sustainability by future-proofing against changes to the personal tax system.	+ + Similarities with existing imputation rules for companies and the Māori authority tax regime. This approach would future-proof the taxation of trusts from changes to the personal tax system.

	Option 1 – Increase trustee tax rate to 39%	Option 2 – Mandatory settlor attribution for trustee income	Option 3 – Imputation-style regime for trustee income (33% trustee tax rate / 39% trustee tax rate)
Administrative and delivery implications	– There is likely to be a small initial system development impact on Inland Revenue, although this depends on how any modifications are designed. There would be a medium-sized administrative cost in the first year, with minimal ongoing administration costs. Earliest implementation date of 1 April 2024.	– There is likely to be a small initial system development impact on Inland Revenue, depending on the detailed design of this option. There would be a medium-sized administrative cost in the first year, with small ongoing administration costs. Earliest implementation date of 1 April 2025.	– – This option would require large-scale initial system development, and a medium to large initial administrative impact in the first year. Ongoing administration costs are expected to be medium. Earliest implementation date of 1 April 2025.
Compliance costs	**0 / –** Depending on detailed design, this option is not expected to result in a significant increase in compliance costs. Trustees that restructure by shifting income-producing assets out of trusts will face low one-off compliance costs.	– Determining the appropriate rate of tax on trustee income based on the personal income of the principal settlor of the trust would result in increased compliance costs. No change for trusts without a living principal settlor.	– – This option would result in additional compliance costs for trustees, including needing to maintain memorandum accounts for imputation credits and complying with anti-streaming rules.
Overall assessment	+ + This option is the most effective approach to addressing misalignment within the existing trust tax regime. It is the simplest to design, implement and administer (subject to the detailed design of any modifications).	+ This option would improve the status quo in terms of addressing under- and over-taxation. However, it would be complex to design, administer and implement.	+ This option addresses under- and over-taxation of trusts but would introduce deferral issues. This approach would require fundamental reform of the taxation of trusts and have significant complexity in policy design, administration, and implementation.

What option is likely to best address the problem, meet the policy objectives, and deliver the highest net benefits?

106. Option 1 (increasing the trustee tax rate to 39% and introducing modifications to address over-taxation, if necessary) is the preferred option. It would be the simplest to design, administer and implement; however, the specific impact on Inland Revenue would depend on the detailed design of any modifications. This option would improve the robustness and sustainability of the tax system compared with the status quo by helping ensure the 39% rate applies to income attributable to individuals who earn over $180,000. Existing law should mitigate the risks of over-taxation in most situations (although public consultation would be necessary to confirm this). Provided that any modifications are relatively simple, this option could be implemented from 1 April 2024. This option is estimated to raise approximately $350m per annum, although this estimate is highly uncertain.

107. Option 2 (taxing trustee income at the principal settlor's personal tax rate) would be more complex than Option 1 in terms of policy design, implementation, and administration. Option 2 would likely improve the robustness and sustainability of the tax system by ensuring that, generally, the 39% rate would apply to trustee income for trusts with higher-rate settlors, and lower rates would apply to all or some of the trustee income for trusts with lower-rate settlors. Given that trusts can already allocate income to lower-rate settlors as beneficiary income (where the settlors are also beneficiaries), it is not clear whether the benefits of this option, as compared to Option 1, warrant the additional complexity it would introduce. This option could be implemented from 1 April 2025.

108. Option 3 (imputation-style system) would involve fundamental reform. It would be the most complex option to design and implement and would involve significant compliance costs, especially when it is first implemented. However, this option would improve the robustness and sustainability of the tax system by integrating the taxation of trusts with the personal income tax system. The ultimate recipients of income derived by trusts would pay tax at their personal rates. This option could be implemented from 1 April 2025.

What are the marginal costs and benefits of the preferred option?

Table 10: Cost benefit analysis of Option 1

Affected groups	**Comment** *Nature of cost or benefit, evidence and assumption, and risks*	**Impact** *$m present value, where appropriate, for monetised impacts; high, medium or low for non-monetised impacts.*	**Evidence Certainty** *High, medium, or low*
Additional costs of the preferred option compared to taking no action			
Trustees	• Trustees will likely face ongoing additional compliance costs in determining whether to allocate income to beneficiaries as beneficiary income to mitigate over-taxation. • Some trustees will need to trade-off retaining income for non-tax reasons or allocating income to mitigate over-taxation. They may also need to consider the potential social policy impacts of allocating beneficiary income.	Unknown	Low – trustees already need to make these decisions under law. The extent to which the proposed changes would increase costs above current obligations is unclear.

	• Trusts that restructure in response to the proposal (e.g., by moving income-earning assets out of trusts into companies) will likely face low one-off compliance costs.		
Settlors and beneficiaries	Existing rules should be sufficient to mitigate over-taxation in most situations (by trustees allocating income as beneficiary income).	Unknown	Low – it is unclear how much over-taxation might arise without undertaking public consultation.
Inland Revenue	Option 1 will have both one-off and ongoing implementation costs, as well as ongoing administrative costs, for Inland Revenue. This relates to implementing the new rules, responding to queries from taxpayers and tax intermediaries, and compliance activity for return filing.	Implementation and ongoing administrative costs are expected to be between $5 million and $11 million. At the upper end of the cost range, over the forecast period (2022–23 to 2026–27): • the estimated one-off capital build costs are $2.9 million, • the one-off operating build costs are $0.7 million, and • the ongoing administrative costs are $7.4 million.	Medium – the level of certainty depends on final policy decisions of all Budget 23 initiatives that impact on other projects on Inland Revenue's work programme progress.
Total monetised costs		One-off costs: $3.6 million Total ongoing costs (over 2022–23 to 2026–27): $7.4 million	Medium
Non-monetised costs		Unknown	Low
Additional benefits of the preferred option compared to taking no action			
Taxpayers	Addressing misalignment of the trustee and top personal tax rates will ensure that trusts cannot be used to circumvent the 39% personal tax rate. This would likely strengthen the sense of fairness in the tax system (social cohesion) through improving horizontal and vertical equity.	Unknown	Medium
Government	Increasing the trustee tax rate will generate increased tax revenue in a relatively low-cost way. Ensuring that the top personal tax rate cannot be circumvented through the use of trusts supports the Government's distributional objectives.	Increasing the trustee tax rate to 39% is estimated to raise $350 million per annum.	Low – the impact on tax revenue is highly dependent on the behavioural response by trusts.
Total monetised benefits		$350 million per annum	Low
Non-monetised benefits		Unknown	Medium

109. Due to the inability to conduct public consultation during the Budget preparation period, there is significant uncertainty regarding the exact impact of increasing the trustee tax rate to 39%.

110. The amount of revenue raised is highly uncertain and heavily dependent on the behavioural response by trusts. The more income that trusts divert to other entities or allocate as beneficiary income instead of paying tax at the trustee tax rate, the less revenue that will be raised.

Section 3: Detailed design

111. This section covers detailed design of Option 1 (Increasing the trustee tax rate to 39% with modifications, if necessary), specifically focusing on issues relating to mitigating any risks of over-taxation and whether additional rules are necessary to buttress the proposed 39% trustee tax rate. Other consequential matters are covered in the appendix.

Rule needed to buttress proposed 39% rate

112. To buttress the 39% trustee tax rate, we recommend a rule to prevent income allocations to corporate beneficiaries being used to circumvent the rate. A company can be a beneficiary of a trust. Under current law, income allocated to a corporate beneficiary is taxed at 28%. In the context of a family trust, this is generally not appropriate for a number of reasons.

113. The real beneficiary of such an allocation is the ultimate natural person shareholder in the company. The allocation should be taxed at the marginal tax rates of that person or persons. There is no reason for taxing the income earned by a trust and allocated to a company in the same way as income earned directly by the company.

114. If the shareholder of the corporate beneficiary is the trust that is making the allocation, the allocation achieves nothing. The income effectively remains within the trust. The principal, or in many cases only, effect of the allocation is to ensure that the income is taxed at 28% rather than the trustee tax rate. While a subsequent distribution of the income by the company to the trust will be taxable as a dividend (with imputation credits attached), such a distribution may never be made.

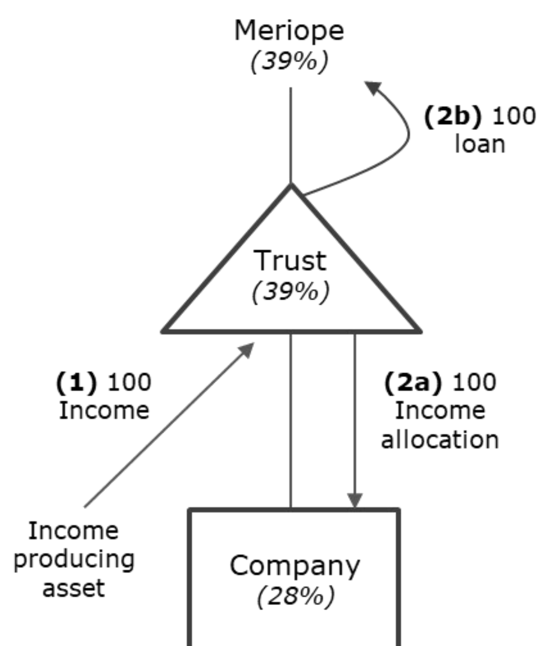
115. Currently, allocations of income to corporate beneficiaries are not common in New Zealand, outside certain specialised contexts. However, the proposed increase in the trustee tax rate to 39% would significantly increase the attractiveness of making such allocations. These allocations are a major issue in Australia, where the trustee tax rate is 47% and the corporate tax rate is often 25%. Australian officials have told us that it is common, for instance, for income to be allocated by a trust to a corporate beneficiary owned by the allocating trust (referred to as a "bucket company") but for the cash to be retained in the trust or lent to a high-rate individual beneficiary, with the loan outstanding indefinitely. They have told us that these kinds of transactions give rise to significant compliance problems.

116. The difference between the 28% corporate tax rate and the current 33% trustee tax rate does not seem to motivate this behaviour in New Zealand. However, we think it is likely that the proposed increase in the trustee tax rate, and the greater differential between the corporate and trustee tax rates, would lead to similar practices and problems in New Zealand to those already experienced in Australia. To give just one instance of a problem, the tax law might need to be amended to ensure that an allocation to a company that is not paid in cash gives rise to a loan by the company to the trust, which in turn gives rise to a deemed dividend if the loan is not subject to interest. Such rules would inevitably involve a high level of complexity.

117. Accordingly, to ensure that trusts cannot allocate beneficiary income to companies to circumvent a 39% trustee tax rate, a rule should be introduced so that income allocated to corporate beneficiaries is taxed as trustee income for the purposes of determining the rate of tax (39%), who pays the tax (the trustees) and who provides the return of income (the trustees). This rule should be limited to corporate beneficiaries that are "close

companies"[25] and where a settlor of the trust has "natural love and affection"[26] for a (direct or indirect) shareholder of the company. This ensures that the rule is targeted towards family trusts and would not affect the commercial use of trusts in large corporate groups. This is very similar to the treatment of income allocated to minor beneficiaries under the minor beneficiary rule.

Example 5: Income allocated to corporate beneficiary



Meriope is a beneficiary of a trust. She has a personal tax rate of 39%. The trust has derived $100 of income (this is **(1)** in the diagram).

To avoid the $100 being taxed at the 39% trustee tax rate, the trust allocates the income to a corporate beneficiary as beneficiary income (this is **(2a)**). The income is taxed at the 28% rate in the hands of the company.

The trust then loans $100 to Meriope (this is **(2b)**). The $100 is not taxable income in the hands of Meriope.

Overall, only $28 of tax has been paid on the income. However, $39 of tax should have been paid on the income, since the $100 has actually gone to Meriope (via the loan from the trust).

Under the proposal, the $100 allocated to the company would be taxed at the 39% trustee tax rate. $39 of tax would be paid on the income.

118. Treating beneficiary income allocations to these corporate beneficiaries as trustee income will avoid the under-taxation that would otherwise arise if the income were taxed at the corporate rate. It should not give rise to over-taxation. A family trust will not make an allocation to a corporate beneficiary unless the company is owned by one or more of the other beneficiaries or the trust itself. If one or more of those shareholder beneficiaries is on a lower rate, the trust can allocate the income directly to that person to prevent over-taxation. If the corporate beneficiary has a real need for funds, either the shareholder beneficiary or the trust on their behalf can invest the money in the company by way of either debt or some form of capital contribution.

119. We note that this rule would not prevent trusts from restructuring in response to an increased trustee tax rate, for example, by transferring the ownership of income-producing assets to companies owned by trusts or investing in PIEs. However, as discussed above, companies and PIEs are not completely substitutable for trusts. This reduced substitutability would limit the degree to which trusts are able to shift assets to circumvent the 39% rate.

[25] A "close company" is a company where five or fewer natural persons or trustees hold more than 50% of the voting interests in the company (treating associated persons as one person).

[26] "Natural love and affection" is an existing concept in tax law. It is used to describe an action by a person where the motive is induced not by a promise of something in return, but by the natural love and affection the person has for another. Natural love and affection is generally considered to subsist between relatives, whether by blood, marriage, a non-spousal domestic relationship, or adoption. It can be present between close friends as well, although not ordinary acquaintances or colleagues.

Financial implications

120. This rule would help ensure the estimated revenue raised by increasing the trustee tax rate to 39% is not negatively impacted by the use of corporate beneficiaries by trusts to avoid the 39% rate. The rule is not expected to result in any additional revenue over the forecast period.

Administrative and compliance implications

121. Although this rule is broadly similar to the current minor beneficiary rule, we expect that taxing beneficiary income allocations to certain corporate beneficiaries as trustee income would have a small administrative impact on Inland Revenue. This would include helping trustees understand the new rules and amending forms and guidance. This rule may result in some trusts changing their behaviour or restructuring to ensure they are not affected by the proposed 39% trustee tax rate.

Further analysis of the risk of over-taxation

122. Beneficiary income is the primary method that trustees can use to mitigate risks of over-taxation under current law. As discussed above in the "Current tax law" section in Section 1, beneficiary income is trust income that is paid or allocated to the trust's beneficiaries before the trust's tax return is filed. There are three main types of beneficiary income:

- Income distributed or paid to a beneficiary.
- Income allocated to a beneficiary that is credited to the beneficiary's current account.
- Income that is allocated to a beneficiary for them to possess at a future date or event (e.g., when they reach a certain age).

123. If trust income is retained and taxed as trustee income, a 39% trustee tax rate may result in over-taxation, particularly for trusts with only lower-rate settlors and beneficiaries. However, in most circumstances where a trust only has lower-rate settlors and beneficiaries, trustees should be able to mitigate over-taxation by allocating income to beneficiaries (including a living settlor in their capacity as a beneficiary of the trust) as beneficiary income, so that the income is taxed at the beneficiaries' personal tax rates. This is the method that comparable jurisdictions mostly rely on to mitigate over-taxation.

124. The following sections outline the risks of over-taxation that we are aware of for various types of trusts. Due to the inability to undertake public consultation during the Budget preparation period, there may be some situations where trusts could be over-taxed at a 39% trustee tax rate that we have not been able to identify.

Trusts for which modifications are required

Estates

125. Estates are taxed as trusts, with the executor or administrator of an estate considered a trustee for tax purposes. If an amount of income would have been included in a deceased person's income had they still been alive when it was received, the income is considered income of the trustee. Generally, estates are subject to the same tax rules as trusts. Therefore, estates can allocate income as beneficiary income to mitigate over-taxation.

126. Some estates have no choice but to retain income as trustee income if the affairs of the deceased person are still being worked through and the beneficiaries (and their interests)

are not yet known. Examples include where the deceased had overseas shares (because going through probate in other countries can take time) or where there are succession issues regarding Māori land. Also, unlike trusts that have a living settlor, income cannot be allocated to the settlor of the estate to access the settlor's marginal tax rates because the settlor is the deceased person. Applying a 39% trustee tax rate to estates could therefore result in over-taxation where the deceased and/or the beneficiaries of the estate are lower-rate individuals.

127. In the 2020-21 income year, estates[27] reported $300m of trustee income. Roughly 90% of estates report total income of $20,000 or less. Only 1% of estates report trustee income over $180,000, but they account for 63% of trustee income derived by estates. While over-taxing the trustee income of estates is an issue that already exists with the current 33% trustee tax rate, this over-taxation would be exacerbated with a 39% rate.

Table 11: Trusts and estates with assessable income for the 2020–21 income year

	Trusts (excluding estates)		**Estates**	
Trustee income per trust	*Number of trusts*	*Aggregate amount of trustee income*	*Number of estates*	*Aggregate amount of trustee income*
Nil	40,700 (26%)	Nil (0%)	2,300 (13%)	Nil (0%)
Up to $180,000	105,300 (66%)	$2,190m (14%)	14,700 (85%)	$110m (37%)
Over $180,000	13,800 (**8%**)	$14,410m (**86%**)	200 (**1%**)	$190m (**63%**)
Total	159,800	$16,800m	17,200	$300m

128. A modification should be introduced that would allow all income derived by an estate within 12 months of a person's date of death to be taxed at the deceased's marginal tax rates. The modification would provide trustees of estates with an option for mitigating over-taxation for estate income received during this period. Where the 12-month period spans multiple income years, the deceased's marginal tax rates would apply in the income year in which the person died, and the personal tax scale would apply to trustee income received in the income year after the person's death. This is illustrated in the following example.

[27] Note that these figures may also include testamentary trusts, which are trusts established expressly or implicitly by a statement in a will (e.g., when property is left for a minor beneficiary to receive when they reach a particular age).

> ***Example 6: Modification for estates***
>
> Ortus dies on 20 February 2025. He had received $50,000 of personal income in the income year of his death. His estate derives $10,000 of income before 31 March 2025, and another $10,000 after 31 March 2025 but before 20 February 2026 (i.e., within 12-months of Ortus's date of death).
>
> The affairs of Ortus's estate are still being worked through, so the income received by the estate is considered trustee income for tax purposes. The estate chooses to apply the modification to the income it derives.
>
> Instead of the $20,000 of trustee income being taxed at 39%:
>
> - the $10,000 of trustee income in the 2024–25 income year is taxed at Ortus's marginal tax rates. The combination of Ortus's $50,000 of personal income and the $10,000 trustee income falls within the 30% personal income tax bracket ($48,001 to $70,000); and
> - the $10,000 derived by the estate in the 2025–26 income year is taxed at 10.5% because it falls within the $0 to $14,000 personal income tax bracket).

129. We understand that many estates are wound up within 12 months of a person's date of death, so allowing the modification to apply for this length of time may be sufficient for many estates. However, without public consultation, it is difficult to determine the appropriate length of time for this modification. If the period is too long, this modification would create incentives to delay the distribution of assets to the beneficiaries. Engagement with stakeholders once these proposals are made public would help refine how long this modification should apply.

Financial implications

130. Introducing a modification for estates would have an estimated fiscal cost of $5 million per annum for the 2025–26 and later fiscal years.

Administrative and compliance implications

131. A modification for estates is not expected to result in a significant increase in compliance costs for estates. It will likely require amending the tax return for estates, communicating the new rules to taxpayers, and assisting estates with queries regarding their tax treatment.

Trusts for which modifications should not be required

132. This section of the report sets out trusts for which we explicitly considered the risk of over-taxation but concluded that modifications should not be required based on the information we currently have. Without undertaking public consultation, there is a risk that there are barriers we have not identified that would prevent existing rules being fully effective at mitigating over-taxation for these trusts. We expect our decisions on the necessary modifications to be challenged and tested once the proposals become public and that consultation with stakeholders could bring unexpected concerns to light.

Fixed trusts

133. A fixed trust is a trust when the trust deed specifies how the assets of the trust are to be distributed exactly.

Existing rules should mitigate over-taxation for fixed trusts…

134. We understand that almost all trust deeds of fixed trusts provide trustees with a power of advancement, so trustees have the discretion to bring forward allocations of beneficiary income in advance of the future event (e.g., the beneficiary attaining a particular age) specified in the deed. However, without undertaking public consultation, we have no data on how prevalent the power of advancement is in fixed trusts.

135. To prevent over-taxation for fixed trusts with lower-rate beneficiaries, the trustees of these trusts could exercise a power of advancement to allocate income as beneficiary income, so that the income is taxed at the beneficiary's marginal tax rates. If the trustees do not want the beneficiary to have access to that income until the future date or event specified in the trust deed, they could allocate the income to the beneficiary as future possession beneficiary income. Future possession beneficiary income is still taxed at the beneficiary's rate in the year the income is derived, even though the income does not become available to the beneficiary for their possession until sometime in the future. However, allocating income as future possession beneficiary income may result in additional compliance costs when compared with distributing or allocating the income for immediate access.

…so a modification should not be required

136. Since existing rules should be able to mitigate over-taxation for fixed trusts where the trustees have a power of advancement, we do not consider it necessary to introduce a modification for these trusts.

Trusts for disabled people

137. The Law Commission's 2012 review of trust law noted that some trusts are established to provide for family members with special needs ("disability trusts").[28] However, the Law Commission's papers do not provide data on the number of disability trusts or how they are used. Without public consultation, it is unclear how many disability trusts there are in New Zealand or how they are used. We consulted the Ministry of Justice – Te Tāhū o te Ture, the Public Trust and Whaikaha – Ministry of Disabled People during the development of these proposals, but they were unable to provide data on how many trusts are used to support disabled people in New Zealand.

Existing rules should be sufficient to mitigate over-taxation for disability trusts…

138. The needs of a disabled beneficiary can likely be met by trustees paying or allocating income to the disabled person as beneficiary income. Beneficiary income is taxed at the beneficiary's marginal tax rates rather than the trustee tax rate, so a modification for these trusts should not be necessary. However, it is possible these trusts may face barriers to using existing rules to mitigate over-taxation that we are not aware of because we have not been able to publicly consult on the potential impacts of the proposed 39% trustee tax rate.

139. For disability trusts, paying or allocating beneficiary income to an intellectually disabled beneficiary may be undesirable if it means the beneficiary has immediate access to the income. However, this is not solely a tax issue. As a general matter, we expect that beneficiaries with impaired decision-making capacity will have an agent acting on their

[28] Law Commission (November 2012) Review of the Law of Trusts: Preferred Approach (lawcom.govt.nz) from [1.21].

behalf. In these situations, allocating income as beneficiary income would likely be sufficient to mitigate over-taxation.

140. Similar to other trusts, if trustees know they will allocate income to a particular beneficiary but do not want the beneficiary to have access to the funds until sometime in the future, they could either allocate to the settlor (as a beneficiary) to access the settlor's tax rate or allocate income to the disabled beneficiary as future possession beneficiary income. Refer to the "Current tax law" section in Section 1.

…overseas regimes have low uptake and seem to have non-tax objectives…

141. Australia has a special regime for disability trusts. The regime was mainly put in place for social policy reasons, although it does provide a special tax treatment for disabled beneficiaries of these trusts. Uptake of the Australian regime has been very low – there are only approximately 1,000 special disability trusts in Australia. Given the population of Australia is significantly larger than the population of New Zealand, if a modification for disability trusts were to be introduced in New Zealand and uptake were similar to that of Australia's regime, it is likely that any modification introduced in New Zealand would only be used by a very small number of trusts.

142. Although Canada, the UK, and the US have special regimes for these trusts, like Australia these regimes seem to be predominantly focused on providing social assistance rather than tax relief for disabled people. By contrast, the objective of any modification put in place in New Zealand would be to ensure disability trusts are not over-taxed if the trustee tax rate is increased to 39%.

…and a modification would be difficult to design

143. Based on the limited information available to us at present, we do not think a modification for disability trusts is required to mitigate over-taxation. However, public consultation would help us confirm whether this is correct.

144. If a modification is necessary to mitigate over-taxation for disability trusts, we recommend consulting the disabled community on its design. Our research on similar regimes overseas shows that a modification for disability trusts would likely be complex and would require drawing boundaries that may be difficult to target correctly without input from the disabled community. Designing a modification for disability trusts would involve considering various issues, including:

- What rate should apply instead of the trustee tax rate? To prevent both under- and over-taxation, ideally the beneficiary's marginal tax rates would apply to any trustee income of a disability trust. This would be relatively straightforward for trusts with only one beneficiary. If a disability trust was allowed to have multiple disabled beneficiaries, or a mix of disabled and non-disabled beneficiaries, it would be challenging to determine how trustee income should be apportioned or taxed. A simplification could be to either (i) tax trustee income at a lower flat rate for disability trusts, or (ii) tax trustee income at the highest personal tax rate of the disabled beneficiaries. If Ministers decide to introduce special rules, we do not recommend either of these approaches without first consulting the disabled community to further understand how these trusts are used.
- Should disability trusts be allowed to have more than one beneficiary? The modification would be simpler to administer and comply with if disability trusts were only allowed to have one beneficiary. This is the approach taken in

Australia. One disadvantage of this approach is that any existing trusts with multiple disabled beneficiaries would need to restructure or set up new trusts to access the modification. Multiple disabled beneficiaries could be allowed, however, as noted above, this would require arbitrary or complex rules on how trustee income should be taxed.

- <u>How should "disability" be defined?</u> There are risks with defining who the modification should apply to without consulting the disabled community. A simple way to define "disability" would be to link the definition to the receipt of Government support payments (such as the Supported Living Payment on the ground of restricted work capacity, or the Child Disability Allowance). A key risk of defining "disability" in this way is that disabled people who do not receive those support payments would not be able to access the modification. There are risks with creating a bespoke definition, especially without public consultation, as Inland Revenue lacks the expertise to both design and apply such a definition.

- <u>Should specific rules apply if a trust ceases to be eligible for the modification?</u> After tax on trustee income is paid at the disabled beneficiary's marginal tax rates or a lower flat rate, the trustees may decide to add further non-disabled beneficiaries (or disabled beneficiaries with higher marginal tax rates) to the trust. The trust would no longer qualify for the modification, but trustee income that has previously been taxed at a lower rate because of the modification might still be retained in the trust. If that retained income is then distributed to those new beneficiaries, they would be able to benefit from the modification. There is a risk that this could allow higher rate individuals to benefit from income being taxed on another person's lower marginal tax rates. We have identified three possible responses:

    i. *Clawback mechanism:* If trustee income is taxed at a lower (<39%) rate under the modification, the distribution of that income to a person other than the disabled beneficiary could be subject to a clawback mechanism. This would ensure that disability trusts do not provide tax planning opportunities and would minimise any under-taxation of trustee income. However, such a mechanism would likely be punitive.

    ii. *Specific anti-avoidance rule:* Instead of a clawback mechanism, a specific anti-avoidance provision could be introduced to target the use of disability trusts to obtain a tax benefit for non-disabled beneficiaries.

    iii. *No specific rules:* No specific rules would be introduced to prevent the use of disability trusts in tax planning, although if restrictive eligibility criteria are put in place (such as requiring these trusts to have only one disabled beneficiary) this should be sufficient to minimise tax planning opportunities. The existing general anti-avoidance rule should be sufficient if the modification is used to avoid tax.

145. Given Ministers' concerns regarding disability trusts (refer to "2020 decision to introduce a new top personal tax rate" subsection in Section 1), we have considered how such a modification should be designed.

Table 12: Potential design of a modification for disability trusts

Design feature	Recommended design	Alternative design options
Trustee tax rate	The disabled beneficiary's marginal tax rates.	• Flat rate – e.g., 10.5%, 17.5%, or 33%. • If multiple beneficiaries are allowed, the highest personal tax rate of the beneficiaries.
Number of beneficiaries	Only allow one – the disabled beneficiary.	Allow multiple beneficiaries (but must all be disabled).
Definition of "disability"	Link to receipt of Government support – the Child Disability Allowance, or the Supported Living Payment on the ground of restricted work capacity.	n/a
Rules if trust ceases to qualify for modification	No specific rules.	Either: • a specific anti-avoidance rule to target the use of disability trusts to gain a tax benefit; or • a clawback mechanism to tax distributions of tax-paid trustee income at the recipient's marginal tax rates (where distributions are made to people other than the disabled beneficiary).
Other features	No restrictions on: • the number of disability trusts that can be settled for the care of a disabled person; • who can settle property on a disability trust; • what property can be settled on a disability trust; or • whether the trust is an *inter vivos* trust or a testamentary trust.	n/a

Trusts for orphans

146. We do not recommend a modification for trusts settled for the care of orphans, as we have no data that suggests trusts are widely used for this purpose in New Zealand or that such trusts would have specific barriers to mitigating over-taxation. Similar to disability trusts, existing rules should be sufficient in mitigating risks of over-taxation. We recommend monitoring this situation to establish whether a problem exists and, if so, undertaking consultation to determine how best to address it.

"Widely-held" trusts

147. Although "widely-held" is a misnomer when describing a trust (because apart from a unit trust, a trust is not owned or held), it is a useful term to informally describe trusts that have a large number of beneficiaries (e.g., trusts with more than 100 beneficiaries, with beneficiaries that are associated persons treated as 1 beneficiary). Inland Revenue data shows a large variety in these types of trusts,[29] and that this group includes trusts in large corporate groups, estates and family trusts.

148. As outlined above, the main defence against over-taxation is for trustees to allocate or pay income as beneficiary income to ensure that the income is taxed at a beneficiary's lower marginal tax rates.

Widely-held trusts may face an increased risk of over-taxation…

149. Widely-held trusts may have an increased risk of over-taxation because they may face practical limitations (such as difficulties collecting beneficiaries' IRD numbers), and they have different behaviours and motivations when compared with family trusts with fewer beneficiaries. As a result, widely-held trusts may also choose to treat all their income as trustee income for simplicity, regardless of the specific circumstances of the individual beneficiaries.

150. Some Māori land trusts will have large numbers of beneficiaries. However, we expect these trusts will be eligible to be Māori authorities. Trusts that are Māori authorities are subject to a bespoke tax regime and are taxed at 17.5%. However, as noted in the "Well-being and economic considerations" subsection of Section 2, the inability to undertake public consultation during the Budget preparation period with relevant Māori groups limits our understanding of the potential impacts of a 39% trustee tax rate.

…but existing mechanisms should be sufficient to address risks of over-taxation for these trusts

151. While there is a risk of over-taxation for widely-held trusts, we do not consider it appropriate to provide special rules for trusts simply because they have a large number of beneficiaries. Trustees of a discretionary trust would be able to easily add beneficiaries to the trust simply to satisfy a "widely-held" definition. Generally, we expect that existing mechanisms would be sufficient to address risks of over-taxation for widely-held trusts.

152. Without undertaking public consultation, it is difficult to determine whether there are legitimate risks of over-taxation in this group. We expect affected taxpayers will want to provide feedback on this issue once the proposals are made public.

Energy consumer trusts

153. Most electricity distribution companies in New Zealand are owned by trusts or local councils. The electricity industry was reformed in the 1990s, resulting in the ownership structures of most energy companies being standardised through trusts settled in accordance with the Energy Companies Act 1992.[30]

[29] There are significant limitations in this analysis. Trustees are not required to disclose details of beneficiaries that do not receive a distribution to Inland Revenue. Therefore, this analysis is based on trusts that are making distributions to beneficiaries and may be less likely to be at risk of over-taxation.

[30] Some energy companies are not owned by trusts, but by local councils or have foreign ownership.

154. There are 20 energy consumer trusts ("ECTs"), or lines trusts, that are subject to tax,[31] and their objective is to hold the shares of their respective energy companies on behalf of electricity consumers. Generally, the beneficiaries of an ECT are the persons whose premises are connected to (and who are liable for payment of use of, or connection to) the energy company's distribution network.

A small amount of income derived by ECTs is currently taxed as trustee income…

155. Twelve of the ECTs generally retain all income as trustee income. There is a risk that increasing the trustee tax rate to 39% would result in many beneficiaries of these trusts being over-taxed if some ECTs continue to retain all their income as trustee income. However, it is possible that ECTs that retain income as trustee income could use existing rules to allocate that income to beneficiaries as beneficiary income so that the income is taxed at beneficiaries' marginal tax rates (although this may result in increased compliance costs). Most income derived by ECTs is beneficiary income and is therefore already taxed at the personal tax rates of the beneficiaries, rather than at the trustee tax rate.

…but we expect they can use existing rules to mitigate over-taxation

156. Without public consultation, it is difficult to determine whether there are specific barriers to these ECTs allocating income as beneficiary income. Given we expect that ECTs should be able to use existing rules to mitigate over-taxation, we think the 39% trustee tax rate should continue to apply to ECTs until we can engage with the sector to determine whether a modification is required.

Table 13: Energy consumer trusts that are subject to tax – 2020–21 income year

	Number of ECTs	Beneficiary income	Trustee income
ECTs that allocated some income as beneficiary income	6	$167m (87%)	$25m (13%)
ECTs that allocated all income as trustee income	12	Nil (0%)	$7m (100%)
ECTs that reported a loss	2	Nil	Nil
Total	**20**	**$167m (84%)**	**$32m (16%)**

Superannuation funds that are taxed as trusts

157. A "superannuation fund" is defined in the Income Tax Act 2007 as a "retirement scheme" within the meaning of the Financial Markets Conduct Act 2013. This includes:

- A registered scheme that is a KiwiSaver scheme or a superannuation scheme.
- A workplace savings scheme.
- A "Schedule 3" scheme (a single person self-managed superannuation scheme).

158. Superannuation funds that are not "widely-held" are taxed at the trustee tax rate and widely-held superannuation funds are taxed at 28%. Generally, a widely-held superannuation fund is a superannuation fund that has 100 or more investors

[31] ECTs that are registered charities are outside the scope of this RIS.

(beneficiaries), treating all associated persons as one investor.[32] Unregistered superannuation schemes (i.e., retirement schemes that do not fall within the meaning of the Financial Markets Conduct Act) are generally taxed as unit trusts[33] at 28%.

A small number of superannuation schemes are taxed at the trustee tax rate…

159. The schemes that will be affected by a change in the trustee tax rate are superannuation funds with fewer than 100 investors (when aggregating associated persons as one person). Based on the New Zealand Companies Office's Disclose Register for superannuation schemes, there are 275 of these funds. Of these, 239 are "Schedule 3" single-person schemes, and 211 of those were set up by judges, coroners and Members of Parliament.

Table 14: Number of superannuation funds by type as at 31 March 2022

Type of superannuation fund	Number of funds
Market retail superannuation schemes with <100 members	2
Restricted workplace savings schemes with <100 members	34
Schedule 3 (single person) schemes	239

…and cannot use existing rules to prevent the 39% rate applying…

160. Superannuation funds that have fewer than 100 investors (when treating associated persons as one person) are taxed as trusts and would be subject to a 39% trustee tax rate. All income derived by these superannuation funds is taxed as trustee income. By law, these trusts cannot allocate income as beneficiary income, which is the main method of mitigating over-taxation for other trusts.[34]

…but we expect most beneficiaries of these funds to be on the 39% top personal tax rate

161. Although these trusts cannot access the main method of mitigating over-taxation, we consider it appropriate to continue taxing them at the trustee tax rate for two key reasons:

- At least 211 (out of 275) of these funds are likely to have 39% rate beneficiaries as they were set up by judges, coroners and Members of Parliament. Introducing a modification for these trusts would risk providing a tax advantage to a small group of taxpayers and could be considered particularly unfair to other taxpayers.
- A modification would reduce the overall coherence of the trust tax regime.

162. How these superannuation funds are taxed could be reconsidered when the PIE rates are reviewed, given the similarities between PIEs and the use of these trusts as retirement savings vehicles.

[32] Technically, a superannuation fund is a widely-held superannuation fund if it meets 1 or more of paragraphs (a) and (c) to (e) of the definition of "public unit trust" in section YA 1 of the Income Tax Act 2007.

[33] Registered superannuation schemes are specifically excluded from the definition of a "unit trust" (paragraph (b)(vii), definition of a "unit trust", section YA 1 of the Income Tax Act 2007), whereas unregistered superannuation schemes with contributing beneficiaries fall within paragraph (a) of the "unit trust" definition.

[34] Income derived by a trust that is a superannuation fund is excluded from the definition of "beneficiary income" under section HC 6(2)(a) of the Income Tax Act 2007.

Section 4: Delivering an option

How will the new arrangements be implemented?

163. Amendments to the Income Tax Act 2007 would be required to implement the proposals. These changes are proposed to be included in an omnibus taxation Bill, scheduled to be introduced on Budget night, 18 May 2023. The Bill is expected to progress through the full select committee process and be enacted after the 2023 General Election and before the end of March 2024. The proposals are recommended to apply for the 2024–25 and later income years (beginning 1 April 2024 for most trusts), with a commencement date of 1 April 2024.

164. Inland Revenue currently has a significant Tax and Social Policy Work Programme utilising the majority of the department's specialist design and delivery capacity. The Budget 23 work programme is proposed to be implemented primarily between September 2023 and April 2025 with significant implementations required for 1 April 2024 and 1 April 2025. The accumulative delivery effort during a compressed period presents potential risks to successful delivery due to the volume of design and development work, limited specialist capability and extensive testing. This will impact Inland Revenue's ability to deliver other initiatives and services to support customers.

165. Inland Revenue provides services within a wider ecosystem which includes 3rd Party Software Developers, Payroll Providers, and Intermediaries. The Budget 2023 initiatives will also require these partners to make significant system changes with short lead in times and compressed timeframes which may result in delivery risk and impacts on partnership relationships.

166. Inland Revenue will work with stakeholders and tax intermediaries on communicating the proposals to affected taxpayers. The specifics of any education campaigns and communications strategies will be considered once policy proposals are further developed. The usual guidance will be published on the proposed changes on Inland Revenue's website and in a *Tax Information Bulletin* shortly after the proposals are enacted.

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

167. The inability to undertake public consultation during the Budget preparation period is a risk. However, stakeholders and affected parties will have the opportunity to provide input on the proposals through the select committee process, refining the quality of the legislation. There will likely be issues and barriers that have not been identified due to the lack of consultation.

168. We do not expect to need to collect any further data – the recently introduced trust disclosure rules will help monitor the effectiveness of the proposals. Inland Revenue is scheduled to undertake a post-implementation review of those rules in 2023.

169. Inland Revenue will continue to monitor the outcomes through the Generic Tax Policy Process (GTPP), including a focus on the risks of over-taxation and other structures that could be used to undermine a 39% trustee tax rate. An advantage of consultation through the select committee process is that it may bring to light such issues.

170. Inland Revenue regularly reviews tax settings on an ongoing basis and provides advice and updates to the Government accordingly. Policy officials also maintain strong communication channels with stakeholders in the tax advisory community, and these stakeholders will be able to correspond with officials about the operation of the proposals

at any time. If problems emerge, they will be dealt with either operationally or by way of legislative amendment, if agreed by Parliament.

Appendix: Consequential issues

171. This section covers a range of issues that arise as a consequence of increasing the trustee tax rate to 39%. We have considered whether changes are needed in response to these issues but do not consider any necessary at this stage.

Minor beneficiary rule

172. Beneficiary income derived by a minor (under 16 years old) from property settled on a trust by a relative or legal guardian, or an associated person of the relative or legal guardian, is subject to tax at the trustee tax rate. This is an integrity measure to prevent parents, other relatives, or guardians from splitting their income with children. A 39% trustee tax rate would increase the incentive for trustees to allocate amounts to beneficiaries on lower incomes, particularly children 16 years or older.

173. Due to the limited time for policy design, we have not considered potential changes to the minor beneficiary rule in detail. Consideration of whether the minor beneficiary rule is fit-for-purpose would benefit from public consultation and further policy consideration.

Resident withholding tax

174. Resident withholding tax (RWT) is deducted at 33% from dividends by the payer before the recipient receives the dividend. RWT is intended to help taxpayers that receive investment income to pay their tax throughout the year. We do not think it is necessary to increase the RWT rate on dividends. Although a significant proportion of income derived by trusts is dividend income, such a change would affect many recipients of dividends that are not subject to a 39% rate.

Provisional tax

175. Provisional tax for a year is generally paid in three instalments. Under the standard option, provisional tax is calculated based on the taxpayer's prior year's residual income tax plus 5% or 10% when the taxpayer has an extension of time to file their prior year's tax return (and has not yet filed it).

176. The use of money interest regime incentivises taxpayers to pay their entire residual income tax for the year by the final provisional tax instalment, as after that date interest will accrue on any difference between the amount paid and the taxpayer's residual income tax liability. Therefore, practically, taxpayers will pay the total tax owing on the final instalment date.

177. For the first two years of the proposed 39% trustee tax rate, the standard option would be based on the tax liability under a 33% trustee tax rate and could thus underestimate the amount of tax that trusts need to pay. This could result in trusts underpaying tax in their first two instalments and having a higher catch-up third instalment.

178. We do not think it is necessary to make any changes to the provisional tax rules. Providing special rules to address this transitional issue would be complex and extremely difficult to implement. The provisional tax rules were not amended when the top personal tax rate of 39% was introduced. Given that taxpayers are already incentivised to pay their liability at the final instalment, this issue is a small timing difference overall.

Taxable distributions from non-complying trusts

179. **Complying trusts** are trusts that have always paid New Zealand tax on the worldwide trustee income of the trust settled by a New Zealand resident. **Foreign trusts** are trusts that have not had a New Zealand resident settlor at any time since 17 December 1987.

180. **Non-complying trusts** are trusts that are neither complying nor foreign trusts. Typically, this class covers trusts with New Zealand resident settlors and non-resident trustees that have not paid New Zealand tax on all worldwide income of the trust. New Zealand resident settlors are liable to pay this tax as agents of the trustees.

Table 15: Taxation of different types of trusts

Type of Trust	*Tax rate for trustee income*	*Tax rate for beneficiary income*	*Other distributions taxable to beneficiaries*
Complying trust	33%	Beneficiary's marginal tax rates	Not applicable
Foreign trust	33%	Beneficiary's marginal tax rates	Accumulated trustee income taxed at beneficiary's marginal tax rates – corpus and capital profits excluded
Non-complying trust	33%	Beneficiary's marginal tax rates	Accumulated trustee income and capital profits taxed to beneficiary at 45% rate – corpus excluded

181. A distribution from a non-complying trust is a **taxable distribution** to the extent to which it is not a distribution of:

- an amount that is beneficiary income;
- a part of the corpus of the trust; or
- a payment or transaction that represents a distribution of the corpus of the trust.

182. A taxable distribution will generally be made up of accumulated income or capital gain amounts. A taxable distribution is excluded income of the recipient.[35] All taxable distributions from non-complying trusts to New Zealand resident beneficiaries are taxed at 45%. However, only New Zealand-sourced distributions from non-complying trusts are taxed at 45% to non-resident beneficiaries.

183. The higher 45% rate, and the inclusion of distributions of capital profits or gains within the taxable distribution definition, is because New Zealand income has been avoided or deferred by using trusts, which are now classified as non-complying trusts. This policy setting is also intended to encourage non-complying trusts to be converted to complying trusts by an election procedure.

The current 45% rate was calculated based on the 33% trustee tax rate…

184. The 45% tax rate on taxable distributions from non-complying trusts is based on the 33% trustee tax rate with a time value of money calculation factored in to recognise the deferral of New Zealand tax between when the income was originally derived and when it is subsequently distributed.

[35] Sections CX 59 and HC 19 of the Income Tax Act 2007.

185. Increasing the trustee tax rate from 33% to 39%, without changing the tax rate on taxable distributions from non-complying trusts, would erode the time value of money calculation. Therefore, increasing the trustee tax rate from 33% to 39% would increase the benefit from deferring or avoiding New Zealand tax on trustee income for non-complying trusts.

…but no change is required at this stage

186. Although increasing the trustee tax rate to 39% would erode the time value of money factor of the 45% rate, we do not consider it necessary to increase the tax rate on taxable distributions from non-complying trusts. The rate is already relatively high, and other 45% tax rates were not increased when the 39% top personal tax rate was introduced.

Regulatory Impact Statement: OECD's Pillar Two GloBE Tax Rules

Coversheet

Purpose of Document	
Decision sought:	*Agreement to introduce the OECD's Pillar Two GloBE tax rules into New Zealand, if a critical mass of other countries do*
Advising agencies:	*Inland Revenue*
Proposing Ministers:	*Minister of Finance* *Minister of Revenue*
Date finalised:	*2 March 2023*

Problem Definition

Under the current international tax system, a large multinational enterprise (MNE) can significantly reduce its tax liabilities through relocating mobile assets (e.g. debt in other group companies, intellectual property and financial assets) to countries where that income is subject to no or a low tax burden. This makes it difficult to tax the income of such groups, and gives them a competitive advantage over purely domestic businesses.

The Organisation for Economic Co-Operation and Development's (OECD's) Pillar Two initiative targets this problem with the global anti base-erosion (GloBE) rules, which apply a minimum 15% tax rate on a large MNEs (MNEs with revenue over EUR 750 million) mobile profits in every country it operates in. The GloBE rules will reduce pressure on high tax countries to lower their corporate tax rates.

The GloBE rules will apply to New Zealand resident in-scope MNEs whether New Zealand introduces the rules or not, provided a critical mass of countries introduces the GloBE rules. The policy decision is therefore, if a critical mass of countries adopts the GloBE rules, should New Zealand?

Executive Summary

The G20 mandated the OECD to look into the perceived under-taxation of MNEs which has resulted from globalisation and digitalisation. In 2021, over 130 countries (including New Zealand) endorsed a 2-pillar multilateral solution to address structural changes needed to bring the global tax system into the 21st century (this endorsement was not binding).

This Regulatory Impact Statement considers the introduction of the GloBE rules into New Zealand, if a critical mass of other countries adopt the rules:

- The GloBE rules are designed to ensure that in-scope MNEs, i.e. those with consolidated revenues above EUR 750 million, pay at least a 15% effective tax rate (ETR) on their mobile income in each country where that income is reported for financial reporting purposes.
- They do this by applying a top-up tax in respect of every country where the MNEs ETR on mobile profits, calculated under the GloBE rules, is below 15%.

The country where this top-up tax is payable is determined according to allocation rules:

- The Income Inclusion Rule (IIR): gives the ultimate parent entity (UPE), or an intermediate holding company, country the right to collect top-up tax for the MNE's group entities.
- The Under-Taxed Profits Rule (UTPR): applies as a back-up to the IIR. If no IIR applies to an MNE, the UTPR will allocate top-up tax in proportion to the group's payroll costs and tangible asset values in each participating country.
- The Domestic Minimum Tax (DMT): a participating country can opt to introduce a DMT. The DMT gives the country priority over the IIR and UTPR in the collection of the top-up tax for that country.

- In-scope MNEs will work out if they are subject to any GloBE top-up tax which they will need to disclose in an annual GloBE information return which is intended to be available to every country in which they operate.

Due to the operation of the UTPR, whether New Zealand introduces GloBE rules or not, in-scope New Zealand MNEs will need to comply with and pay GloBE tax if the rules are adopted by a critical mass of other countries. Through consultation undertaken by Inland Revenue officials' submitters generally agreed that New Zealand should introduce the GloBE rules to reduce the compliance obligations and associated costs they would incur from complying with multiple country UTPRs.

Inland Revenue estimates that if the rules are made effective in 2024, the government will collect approximately $25 million in GloBE tax and $16 million in taxes that would have otherwise been shifted to low tax countries from the 20-25 New Zealand resident MNEs in scope. Note the $16 million will be collected whether New Zealand implements GloBE or not. The costs to build the necessary systems and administer the tax are estimated to be $11.1 million upfront and $3.1 million ongoing.

The modest amount collected under the GloBE rules is a result of New Zealand's comparatively high corporate tax rate, robust international tax system and low number of taxpayers in scope. As a small country that relies on imported capital, New Zealand generally supports strong international rules-based frameworks, where the frameworks aim is to protect and enhance New Zealand interests and strengthen international cooperation. GloBE achieves this by reducing pressure on New Zealand's corporate tax rate with no impact on New Zealand's investment attractiveness.

Certain elements of the GloBE rules are still to be finalised, including safeharbours which could further reduce the compliance costs for New Zealand in-scope MNEs. Officials at Inland Revenue expect, due to the general positive reception to the GloBE rules amongst New Zealand's main investment partner countries, that a critical mass of countries will implement GloBE. It is likely that the GloBE rules will be effective in a critical mass of countries by 2024, but this timing is still subject to some uncertainty.

Limitations and Constraints on Analysis

1. Whether and when a critical mass of countries adopts the GloBE rules

Inland Revenue does not know for certain if a critical mass of countries will adopt the GloBE rules[1]. At this stage it seems likely this will be achieved as the general consensus amongst New Zealand's main investment partners is positive with regards to the design of the GloBE rules.

It is uncertain however, when countries' GloBE rules will become effective such that they would apply to tax New Zealand MNEs. Whilst the OECD's original intention was for the rules to be effective in 2023, given that the rules are still not finalised it seems that an effective date in 2024 or possibly 2025 is more likely.

This Regulatory Impact Statement is limited to the Pillar Two GloBE rules, it does not cover other international tax initiatives such as Pillar One s 9(2)(f)(iv)

- Pillar One – this aims to ensure a fairer distribution of profits and taxing rights among countries with respect to the largest and most profitable MNEs around the world. It is intended that Pillar One will replace unilateral digital services taxes (DSTs).

- Pillar Two – as set out in this paper, this seeks to put a floor on tax competition on corporate income tax through the introduction of a global minimum corporate tax (i.e. the GloBE rules) that countries can use to protect their tax bases.

2. Forecasting expected tax revenue

There are limitations on Inland Revenue's ability to forecast the potential revenue that will be raised by introducing the GloBE rules including:

- Elements of the design are yet to be finalised, including safe harbours (where the rules will not apply).
- GloBE will have a deterrent effect (i.e. MNEs will be less likely to engage in profit shifting, thus leaving their income in New Zealand) this behavioural change is difficult to quantify.
- GloBE tax raised will depend on the reaction by other governments (i.e. whether and how they introduce the GloBE rules) and by MNEs (i.e. whether they restructure to move assets out of low tax countries).

The OECD has provided models that aid participating countries in preparing estimates of the expected tax revenue based on a number of assumptions, which have been used to prepare forecasts.

3. Estimating the administrative cost

The administrative requirements of the GloBE rules are still being designed. Inland Revenue have prepared the estimated build cost on the basis of:

- similar regimes that have been implemented, and
- a conservative estimate of the additional requirements unique to the GloBE rules.

[1] For these purposes a "critical mass" means enough countries adopt the GloBE rules that it is not possible for New Zealand MNEs to escape the tax by earning income only in countries which do not adopt the rules.

Responsible Manager(s) (completed by relevant manager)	
Casey Plunket Special Policy Advisor Policy and Regulatory Stewardship Inland Revenue 2 March 2023	
Quality Assurance (completed by QA panel)	
Reviewing Agency:	Inland Revenue
Panel Assessment & Comment:	The Quality Assurance reviewer at Inland Revenue has reviewed the OECD's Pillar Two GloBE Tax Rules Impact Summary and considers that the information and analysis summarised in it meets the quality criteria of the Regulatory Impact Analysis framework. This issue has been subjected to wide consultation, including through a public issues paper. As identified in the Key Limitations or Constraints on Analysis section, a difficulty with assessing the revenue implications of the various options has been establishing the administrative costs of adopting the GloBE rules without knowing aspects of the detailed design, and the extent to which behavioural changes occur if a critical mass of other countries adopt the GloBE rules.

Section 1: Diagnosing the policy problem

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

Background

The GloBE rules are the main component of Pillar Two of the G20/OECD 2 Pillar solution to reforming the current international tax framework in response to challenges posed by the increasing globalisation and digitisation of the economy.

The current rules allow large MNEs to earn significant profits in a jurisdiction without paying corporate income tax on that income. New business models that rely heavily on intellectual property and vertically integrated cross-border supply chains have made it easier for MNEs to shift profits to places where it bears no tax, or a low effective tax rate.

The OECD has estimated that Pillars One and Two will have a positive impact on the global economy over the long term. This is largely based on the assumption that implementation of

the pillars will avoid negative economic implications of a protracted tax and trade related conflict, estimated to reduce global GDP from between 0.1 percent to 1.2 percent.[2]

Indeed, countries which introduce unilateral measures can face tax and trade tension, consequently, the OECD[3] have been mandated by the G20 to facilitate the design and delivery of multilateral solutions with the OECD-sponsored Inclusive Framework (IF).[4]

In October 2021, the G20/OECD two Pillar solution was endorsed by over 130 countries in the IF, including New Zealand:

- Pillar One aims to ensure a fairer distribution of profits and taxing rights among countries with respect to the largest and most profitable MNEs around the world. It is expected that USD 100 billion of profits will be reallocated to market jurisdictions each year. It is intended that Pillar One will replace unilateral digital services taxes (DSTs)

- Pillar Two seeks to put a floor on tax competition on corporate income tax through the introduction of a global minimum corporate tax that countries can use to protect their tax bases. It is estimated that Pillar Two will generate around USD 150 billion in additional global tax revenues per year.[5]

This endorsement did not bind any country to adopt either Pillar, rather it gave the OECD a mandate to continue to develop the rules and instruments with the contribution of the IF ready for implementation and ratification in participating states.

This Regulatory Impact Statement considers the Pillar Two measures only.

New Zealand has a comparatively high corporate tax rate, consequently, it benefits from multilateral measures aimed at reducing pressure to lower corporate tax rates. In the absence of this proposal, there is an incentive for foreign owned intellectual property to be moved out of New Zealand and for New Zealand MNEs to develop their intellectual property outside New Zealand. To that end, New Zealand has been actively participating in the IF to ensure the GloBE rules result in an outcome as advantageous to New Zealand as possible.

GloBE tax rules

The GloBE rules are designed to ensure that in-scope MNEs pay at least a 15% effective tax rate (ETR) on their income in each country where that income is reported for financial reporting purposes.

An important aspect of the rules is that they only apply to income in a country in excess of a substance-based income exclusion. The exclusion is calculated under a formula which gives

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[2] OECD (2020), Tax Challenges Arising from Digitalisation – Economic Impact Assessment, retrieved from www.oecd.org

[3] The OECD bring together a very high level of tax technical expertise and are very influential in international tax policy matters.

4 The IF brings together over 140 countries to collaborate on the implementation of the OECDs work, including the Base Erosion Profit Shifting (BEPS) project, which was delivered in 2015 and addressed gaps and mismatches in tax rules that were being exploited.

5 (OECD) 2021, OECD releases Pillar Two model rules for domestic implementation of 15% global minimum tax, retrieved from www.oecd.org

a percentage return on the value of tangible assets and payroll expense in the country. The exclusion is intended to focus the rules on the taxation of mobile forms of income.

An in-scope MNE will follow three steps to work out if they are subject to any GloBE top-up tax which they will need to disclose in an annual GloBE information return which will be provided to every country in which they operate:

1. The MNE calculates its ETR by comparing the accounting tax expense in a country with its accounting profit (with some GloBE specific adjustments).
2. If the MNE's ETR in a country is less than 15%, it calculates GloBE top-up tax, which is the tax required to bring the ETR on its mobile income in the country up to 15%.
3. The GloBE top-up tax is then allocated under the following rules:

    - *The Income Inclusion Rule (IIR)* which applies on a top-down basis, gives the ultimate parent entity (UPE), or in some cases an intermediate holding company, country the right to collect GloBE top-up tax for the MNE's group entities.

    - *The Under-Taxed Profits Rule (UTPR)* applies as a back-up to the IIR. If no IIR applies to an MNE, the UTPR will allocate the GloBE top-up tax in proportion to the group's payroll costs and tangible asset values in each participating country. The UTPR also allocates top-up tax for the UPE country. The UTPR protects the integrity of the IIR by discouraging MNEs from relocating to countries that do not implement the GloBE rules.

The GloBE rules also allow a country to introduce a Domestic Minimum Tax (DMT) to apply the rules to income earned in that country. A DMT is optional. It gives a country priority over the Income Inclusion Rule and the Under-Taxed Profits Rule in the collection of the GloBE top-up tax for that country.

In-scope MNEs will incur upfront and ongoing costs associated with building the systems or processes required to complete the GloBE information return. Given the complexity of the GloBE rules these compliance costs are expected to be significant in nominal terms, though given the size of the organisations to which they apply, they may be relatively insignificant. Compliance costs may also be reduced through the availability of safe harbours. The details and conditions of such safe harbours are still being developed and agreed by the IF.

Implementation of the GloBE rules

If a country adopts the GloBE rules, it must adopt the OECD's Model Rules released in December 2021, its Commentary released in March 2022 and the Agreed Administrative Guidance released in February 2023. This is critical to ensuring that the rules operate in a co-ordinated way to achieve the desired tax outcomes. There would be a high risk of double taxation or double non-taxation if implementing countries adopted different rules to measure the level of taxation and top-ups required in each country. Similarly, there could be significant double taxation and disputes between countries and taxpayers if some countries do not respect the agreed ordering rules.

What is the policy problem or opportunity?

As a comparatively high tax rate country, the GloBE rules are inherently beneficial to New Zealand. The GloBE rules reduce the pressure on New Zealand's corporate tax rate through setting a floor on the tax rates other countries can use to entice New Zealand MNEs to shift their mobile income to said countries (i.e. the lowest tax rate they can offer is a 15% effective tax rate). The GloBE rules also remove the need for New Zealand to develop unilateral rules which would risk making New Zealand a relatively less attractive place for an MNE to be based.

By adopting the GloBE rules New Zealand would support the initiative by contributing to the critical mass required to make the rules effective. New Zealand would also collect any GloBE tax on New Zealand MNEs that have mobile income in other countries taxed at less than 15%.

If New Zealand decides not to introduce the GloBE tax rules but a critical mass of other countries do

- There will be tax leakage to other jurisdictions as New Zealand will not collect the GloBE tax in relation to New Zealand MNEs
- New Zealand will still benefit by the disincentive to profit shift, given the applicability of foreign GloBE rules, in which case more income should be left in New Zealand to be taxed.
- Inland Revenue will not incur the IT system build or ongoing administrative costs of implementing the tax
- New Zealand MNEs in scope of Pillar Two (NZMNEs)[6] will need to comply with the GloBE rules and pay any GloBE taxes under the UTPR to every foreign jurisdiction they're operating in which has introduced the GloBE rules (some of our larger NZMNE's are operating in more than 30 countries). This will require more resource and will result in higher compliance costs on affected NZ MNEs than if New Zealand introduced the GloBE rules where the NZMNEs could comply with and pay any taxes to Inland Revenue.
- New Zealand's ability to influence the outcomes of the Pillar Two initiative at international fora, as they relate to New Zealand specific issues (e.g. capital gains or industry specific issues) would be more limited as well as any ongoing support a NZMNE may request.

What objectives are sought in relation to the policy problem?

- Provide support for the multilateral initiative, which New Zealand have contributed to designing, to target the mischief that puts pressure on New Zealand's corporate income tax rate.

- Where a critical mass of countries implements the GloBE rules:

    - Ensure New Zealand collects the tax on NZMNEs GloBE tax liabilities.
    - Assist NZMNEs in complying with the GloBE rules by introducing the IIR in New Zealand which removes their need to comply with multiple UTPRs and therefore reduces their compliance costs.

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

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

The criteria that have been used to assess the options are:

Compliance costs: Does the preferred option meaningfully lower the compliance obligations and associated costs for NZMNEs?

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[6] It is expected there will be around 20-25 NZMNE's in-scope of the GloBE rules

Administration: Is the preferred option possible for Inland Revenue to implement and administer without substantial upfront and ongoing administration costs?

Revenue raised: Does the preferred option raise tax revenue net of its cost to administer?

Coherence: Does the option align with and support international norms around tax policy.

What scope will options be considered within?

The scope of options are, if a critical mass of other countries adopts GloBE, should New Zealand adopt GloBE or not?

The option of New Zealand adopting the GloBE rules if a critical mass of countries does not adopt the rules has not been considered, as it is unrealistic.

What options are being considered?

Option One – New Zealand does not implement the GloBE rules (status quo)

Where a critical mass of countries introduces the GloBE rules, NZMNEs will need to comply with multiple country under taxed profit rules (UTPR), the criteria noted above are assessed as follows:

- This will result in a higher compliance obligation and associated costs through NZMNE's needing to comply with multiple UTPR's.

- Inland Revenue will not be required to administer the rules nor respond to taxpayer queries on them. To the extent NZMNE's face issues from the GloBE rules New Zealand would not be well placed to influence the outcome of these issues.

- In terms of revenue raised, no tax revenue will be raised in New Zealand under Option One other than through any behavioural changes by NZMNE's to retain in, or relocate mobile income to, New Zealand. To the extent New Zealand MNE's are required to pay tax under the GloBE rules this will be to foreign jurisdictions (i.e. tax leakage).

- On the impact of not introducing GloBE rules on the coherence of New Zealand's tax system:

    - There may be a minor impact on New Zealand's international tax reputation by not joining the critical mass.
    - Due to the mechanics of the GloBE rules, and that they would be applied by other countries in any event, there would be no practical effect of New Zealand not adopting the rules – the attractiveness of New Zealand as a destination for foreign investment, and as a place to headquarter an MNE group, would be unaffected.

Option Two – New Zealand adopts the GloBE rules, if a critical mass of other countries do

Where a critical mass of countries introduces the GloBE rules, NZMNE's will need to comply with New Zealand's income inclusion rules (IIR):

- This will result in a lower compliance obligation and associated costs against the status quo, through complying with only one tax through Inland Revenue.

- This option will have a higher administrative cost for Inland Revenue which will incur the upfront build costs as well as ongoing administrative costs.

- Option Two raises tax revenue, where NZMNE's have a GloBE tax liability it will be payable to New Zealand under the IIR (and possibly the DMT). The revenue generated should be above the costs of administration.

- With regards to coherence, adopting GloBE rules would be consistent with New Zealand's general approach to corporate income taxation, including cross-border, by supporting OECD initiatives.

- As a small country that relies on imported capital, New Zealand generally supports strong international rules-based frameworks, where the frameworks aim is to protect and enhance New Zealand interests and strengthen international cooperation. GloBE achieves this by reducing pressure on New Zealand's corporate tax rate with no impact on New Zealand's investment attractiveness.

There are still some outstanding design issues with how the GloBE rules would interface with the New Zealand tax system such as the interaction with the New Zealand imputation regime and the mode of implementation of the GloBE rules[7].

Stakeholder views

Whether New Zealand does or does not adopt GloBE if a critical mass of other countries does was the subject of an officials' issues paper *"OECD Pillar Two: GloBE rules for New Zealand"* released on 5 May 2022. The officials' issues paper canvassed the relevant options and went into further detail about incorporation into New Zealand's tax framework and laws.

Eleven submissions were received from a mix of representative bodies, advisors, non-government organisations and individuals. Officials met individually with submitters to discuss the content of their submissions and discussed the officials' preferred options.

Submitters generally supported New Zealand adopting the GloBE rules if a critical mass of other countries does. Submitters noted that:

- It is in New Zealand's interests to adopt GloBE rules as the goal of the rules, to disincentivise profit shifting by MNEs, aligns with the Government's priorities.
- The operation of the rules means that were New Zealand not to adopt GloBE rules, but a critical mass of countries does adopt, taxpayers would have the compliance costs regardless and there would be tax leakage to other jurisdictions.
- Adopting GloBE rules in New Zealand would streamline and simplify compliance for NZMNEs making it easier for them to pay top up tax in New Zealand as opposed to paying tax under the UTPR to multiple jurisdictions. There was a general preference for NZMNEs to deal with Inland Revenue rather than other tax authorities.

[7] The mode of implementation will be whether New Zealand tax legislation should directly incorporate the GloBE rules or simple reference these rules.

How do the options compare to the status quo/counterfactual?

	Option One – New Zealand does not implement the GloBE rules (if a critical mass of other countries do)	Option Two – New Zealand does implement the GloBE rules (if a critical mass of other countries do)
Compliance costs	- -	++
Administration costs	0	- -
Revenue raised	+	+
Coherence	-	+
Overall assessment	-	++

Key:

++	much better than doing nothing/the status quo/counterfactual
+	better than doing nothing/the status quo/counterfactual
0	about the same as doing nothing/the status quo/counterfactual
-	worse than doing nothing/the status quo/counterfactual
- -	much worse than doing nothing/the status quo/counterfactual

What option is likely to best address the problem, meet the policy objectives, and deliver the highest net benefits?

The option that is likely to best address the problem, meet the policy objectives, and deliver the highest net benefits is Option Two: implementing the GloBE rules into New Zealand if a critical mass of other countries do.

The option has clear benefits over Option One (not implementing the GloBE rules if a critical mass of other countries do): it reduces compliance costs, ensures New Zealand is well placed to influence the outcomes of the global regime, is revenue positive and ensures New Zealand's international tax system remains dynamic to future responses proposed by the OECD.

What are the marginal costs and benefits of the option?

Affected groups *(identify)*	**Comment** *nature of cost or benefit (eg, ongoing, one-off), evidence and assumption (eg, compliance rates), risks.*	**Impact** *$m present value where appropriate, for monetised impacts; high, medium or low for non-monetised impacts.*	**Evidence Certainty** *High, medium, or low, and explain reasoning in comment column.*
Additional costs of the preferred option compared to taking no action			
Regulated groups: MNE's with revenues over EUR 750m	There are no additional costs for NZMNE's as they will need to comply with GloBE rules whether NZ introduces them or not.	Inland Revenue expects NZMNE's compliance costs to be reduced.	Medium, the administrative design of the GloBE rules are still being worked through.
Regulators: Inland Revenue	Inland Revenue will be required to build and maintain a system to send and receive GloBE tax information and accept payments.	Preliminary estimates are $11.1m upfront build cost and ongoing costs of $3.1m p.a.	Low, the administrative design of the GloBE rules are still being worked through.
Government	N/A	N/A	N/A
Total monetised costs		$11.1m upfront $3.1m p.a.	Low
Non-monetised costs		*Low*	*Low*
Additional benefits of the preferred option compared to taking no action			
Regulated groups: New Zealand MNE's with revenues over EUR 750m	New Zealand MNE's compliance costs will be reduced through having only one tax authority interface for GloBE tax.	It is not possible to estimate the compliance cost savings for New Zealand MNE's but Inland Revenue expect the saving to be significant.	High
Regulators: Inland Revenue	By joining the critical mass of countries Inland Revenue will have a seat at the table where they can attempt to influence the outcomes of the GloBE rules to support advantageous outcomes for the New Zealand government.	It is not possible to estimate the expected benefits as the GloBE rules are not yet finalised.	Medium
Government	New Zealand will collect the GloBE tax payable by New Zealand MNE's.	Total GloBE tax estimated to be $20-25m p.a.	Low, based on modelling, though behavioural

			reaction can materially impact this number.
Total monetised benefits		$20-25m	Low
Non-monetised benefits		*Low*	*Low*

Our initial modelling, aided by the OECD's global economic impact assessments indicate that the GloBE rules proposals will raise a modest amount of revenue. It is noted that there are a high number of assumptions in this model, as it is dependent on the final rules (in particular safe harbours), how and which countries implement the GloBE rules and the behavioural response of MNEs.

Our forecast estimate of GloBE top-up tax revenue from New Zealand adoption is approximately **$25 million** per annum made up of:

- $25 million per annum from GloBE top-up tax from applying the IIR to NZMNEs. This amount makes allowance for the possibility of other countries increasing their tax rates in response to Pillar Two to reduce the amount of top-up tax collected by us. We expect this revenue to increase over time as transitional concessions are unwound.
- A further positive amount from the UTPR and the DMT, however it is not possible to estimate how much this will be because it is dependent on the behavioural reaction to the GloBE rule from governments and MNEs so has conservatively been forecast at zero.

Inland Revenue have also estimated that the adoption of GloBE rules by other countries is likely to lead to increased income tax revenue of approximately **$16 million** per annum due to reduced profit shifting (i.e. this will occur irrespective of what option is chosen).

From a cost perspective, the administration costs for Inland Revenue are dependent on the final design aspects, but have been provisionally estimated at $11.1m for the upfront build cost and $3.1m per annum in ongoing costs.

Section 3: Delivering an option

How will the new arrangements be implemented?

The proposal to introduce the GloBE rules into New Zealand is to be legislated via a taxation bill that is likely to be introduced in March 2023. The rules would apply by way of an Order in Council once a critical mass of countries have adopted the rules.

Inland Revenue will be responsible for the implementation and ongoing administration of the new rules. No concerns have been identified with its ability to implement the proposal. Information will be provided to increase awareness regarding the new rules. This will include producing a relevant Tax Information Bulletin item and updating guidance on Inland Revenue's website along with any relevant press releases which might be issued advising taxpayers of the changes.

Adopting these rules into domestic law would require legislative change. If the OECD Model Rules are incorporated by reference in domestic legislation, then legislative change would be simpler (i.e. a legislative change could be made to state that the OECD model rules have force in New Zealand's domestic legislation). Greater legislative change would be required for replicating the rules into New Zealand legislation.

From an administration perspective, the preferred option would involve an upfront cost (preliminary estimates suggest circa $11.1m) to build functionality within START (Inland Revenue's computer system). to enable for the sharing and receiving of GloBE information with other jurisdictions.

Inland Revenue would need to exchange information with other countries, to the extent that NZ MNEs file returns that Inland Revenue must share with other countries which have implemented GloBE rules and where that MNE operates.

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

If the GloBE rules are implemented, the OECD will make any future changes to the model rules where necessary. Any changes to the OECD rules and or reporting will be reflected into domestic legislation in New Zealand[8].

Inland Revenue would also allocate resource to compliance initiatives to ensure that the information received is utilised and the correct amount of tax is paid.

Inland Revenue regularly reviews tax settings on an ongoing basis and provides advice and updates to the Government accordingly. Policy officials maintain strong communication channels with stakeholders in the tax advisory community and these stakeholders will be able to correspond with Inland Revenue about the operation of the new rules at any time. If problems emerge, they will be addressed either operationally, through discussions with the OECD, or by way of legislative amendment if agreed by Parliament.

[8] Either by way of amending legislation or automatically if the OECD Model Rules are referenced in the domestic legislation.

Regulatory Impact Statement: Taxation of backdated lump sum payments

Coversheet

Purpose of Document	
Decision sought:	*Analysis produced for the purpose of informing final Cabinet decisions*
Advising agencies:	*Inland Revenue*
Proposing Ministers:	*Minister of Revenue*
Date finalised:	*9 November 2022*

Problem Definition
The project seeks to address the tax disparity that arises where the timing of a backdated lump sum payment (BLSP) paid by the Crown results in a higher tax liability than if the amount paid had been spread over the years to which it relates (i.e., an amount that should have been paid over multiple years but is paid as a lump sum in a single year). The project focuses on two types of BLSPs – backdated Accident Compensation Corporation (ACC) payments and backdated Ministry of Social Development (MSD) entitlements.

Executive Summary
Generally, payments of employment income are taxed on a cash basis (when they are received). This principle allows tax to be deducted by the payer when paid in the current tax year. This reduces compliance costs and is simple and easy to understand. While taxing payments on a cash basis tends to be the best option for employment-related payments, this can lead to fairness issues when payments are paid in a later tax year but relate to two or more previous tax years. This tax treatment can result in a large tax liability, aggravating the unfairness of the delayed payment. The taxation of BLSPs, especially ACC BLSPs, has been a longstanding issue that has been raised repeatedly over several years. The objective of this project is that any tax effects from receiving a BLSP in one year are mitigated using alternative tax treatment to approximate the lower amount that would have been paid, had the payment been paid over multiple years. We considered three options (in addition to the status quo) to address this issue for backdated ACC payments and one alternative option for backdated MSD entitlements. *Preferred option for ACC payments:* apply the recipients' average tax rate for the 4 years prior to the year of receipt of the BLSP. *Preferred option for MSD payments:* assume the tax deducted by MSD is correct and ignore the payments for the purpose of calculating the recipients tax liability but not their social policy entitlements.

The preferred options are both likely to address the equity issues through achieving a lower tax liability than the status quo. Both options involve one-off administrative costs because they involve changes to the employment information return, however, once the changes are implemented the compliance costs for BLSP recipients and payers of BLSP should be minimal. The preferred options were supported by stakeholders during targeted consultation.

The fiscal cost (as lost tax revenue/Crown revenue) of the option for ACC payments is estimated to be $27.4million over the first four financial years from 1 April 2024, while the fiscal cost for MSD payments is unlikely to be a material fiscal cost due to the majority of these tax liabilities currently being written off.

The alternative tax treatment for both types of payments would apply from 1 April 2024 due to the system changes involved. The changes would not be retrospective, which will not address any past inequity for recipients who have been disadvantaged by the status quo. Officials recommend against applying this retrospectively because it does not meet the criteria for applying such a policy retrospectively and it would likely raise further inequity concerns (for example, how far back you apply the treatment). The fiscal cost would also be prohibitive.

Limitations and Constraints on Analysis

The options were limited by the problem definition, which in itself, was limited by initial consultation. Through initial consultation it was clear that although there are many lump sums that are paid which are employment related, the main payments of concern were ACC and MSD BLSPs. Other payments which were mentioned, such as holiday pay remediation or redundancy, were considered out of scope of the problem definition. If there are further payments that warrant similar treatment, this could be addressed through the legislative process in the future.

The ability to implement a workable solution was limited by what is possible within the existing tax and MSD/ACC systems. This limitation was considered when developing suitable options. The impact of system considerations was mitigated to some extent by a later implementation date of 1 April 2024.

Officials engaged in targeted consultation both during initial consultation and when consulting on the options. Targeted consultation was thought appropriate given the subject matter and the impact on payers.

Responsible Manager(s) (completed by relevant manager)

s 9(2)(a)

Carolyn Elliott

Policy Lead, Tax Administration

Inland Revenue

9/11/2022

Quality Assurance (completed by QA panel)

Reviewing Agency:	Inland Revenue

Panel Assessment & Comment:	The Quality Assurance panel at Inland Revenue has reviewed the *Taxation of backdated lump sum payments* Regulatory Impact Statement prepared by Inland Revenue and considers that the information and analysis summarised in the Regulatory Impact Statement **meets** the quality assurance criteria.

Section 1: Diagnosing the policy problem

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

1. Generally, payments of employment income are taxed on a cash basis (when they are received).[1] This principle allows tax to be deducted by the payer when paid in the current tax year. This reduces compliance costs and is simple and easy to understand.
2. While taxing payments on a cash basis tends to be the best option for employment-related payments, this can lead to fairness issues when payments are paid in a later tax year but relate to two or more previous tax years.
3. The taxation of ACC BLSPs is a longstanding issue that has been raised repeatedly over several years in complaints to the Commissioner, Ministerial correspondence, media articles, select committee submissions and letters from the Royal Commission of Inquiry on Abuse in State Care and the Ombudsman.
4. We carried out initial engagement in 2019 with key stakeholders to gauge perception of the problem definition, understand the types of BLSPs currently being made and identify compliance costs associated with payer involvement in implementing a solution. Overall, consultation supported the intent to improve the tax outcome for BLSPs. Within this consultation, a spectrum of BLSPs were identified from ACC payments to lump sum payments made under employment contracts. Throughout consultation it was clear that ACC BLSPs were considered a significant and continuing source of inequity.
5. In June 2022, we engaged in targeted consultation on options for the alternative tax treatment of ACC and MSD BLSPs where we refined the final proposal. The consulted groups supported the proposal and gave valuable feedback when refining the options.

What is the policy problem or opportunity?

6. The project seeks to address the tax disparity that arises where the timing of a BLSP results in a higher tax liability than if the amount paid had been spread over periods to which it relates (i.e., an amount that should have been paid over multiple years but is paid as a lump sum in a single year).
7. The problem arises where:
    a. between the period the person should have received their payments and the year they receive the payment the recipients tax rate has increased over time; and/or
    b. due to the size of the payment the BLSP pushes the recipient into a higher tax bracket.

[1] This is due to the main charging provision BD 3 for income tax in the Income Tax Act 2007 and case law.

Problem definition

8. We consider that a fairness issue arises when all the following occur:
    a. A backdated (or remedial) payment relating to two or more tax years is made in a lump sum,
    b. The amount is significant enough to move the taxpayer into a higher tax bracket,
    c. If spread over the relevant tax years, the taxpayer would have had a lower tax liability in relation to that amount, and
    d. The delay or error has been caused by an action or inaction by the Crown.
9. Example one demonstrates how this can occur in practice:

Example one

Montgomery Scott (Scotty) was a forklift operator for one of the major ports in New Zealand. In 2018, he was involved in a workplace accident that saw him suffer long-term damage to his leg.

For a time, Scotty received weekly compensation under the Accident Compensation Act 2001 for loss of earnings. However, ACC stopped paying him weekly compensation in 2018 when it considered he was able to return to paid employment. Scotty disputed this decision, but it took some years to resolve as there were several investigations that needed to be completed before final eligibility was established. In 2022, Scotty was awarded a payment of $50,000 per year. This was paid in a lump sum of $200,000 in March 2022.

If Scotty had received this amount in the relevant years, his tax liability for the payments would have been as follows:

	2019	2020	2021	2022	**Total**
Income	$50,000	$50,000	$50,000	$50,000	$200,000
Tax liability	$8,020	$8,020	$8,020	$8,020	**$32,080**

However, for tax purposes the payment is only taxed on receipt of the full amount in 2022. This will result in income in the 2022 year of $200,000, and a tax liability for Scotty of **$58,120**.

The difference between the two treatments is an additional tax liability for Scotty of **$26,040**.

10. Receipt of a BLSP can 'artificially' push a recipient into a higher tax bracket for a single year. This compounds the disadvantage suffered by the affected person, who in addition to the delay in receiving their entitlement, also receives a smaller net amount than if the amount was paid over multiple years.
11. A contributing issue is that over time the recipient could move tax brackets as their income increases. This will also mean that the BLSP is taxed at a higher rate that it would have if it was paid over the period that it should have been.

Payments within the problem definition

12. During the initial scoping of the project, we drew a distinction between lump sum payments in general, and BLSPs which relate to prior years. A lump sum payment of income may lead to a higher tax bill in one tax year than if it were spread over multiple

years. However, this does not create a policy issue unless the entitlement to the payment arose, and should have been paid, in earlier years.

13. After initial consultation, we considered that there were two types of payments that fell within the problem definition and were of most concern, ACC lump sum payments and backdated MSD entitlements. Around 1,200 backdated lump sum payments are made annually by ACC with an average payment of around $48,000. MSD make more payments annually, but the amounts are much smaller, with many being under $1,000. In the majority of MSD cases, any resulting tax payable is written off, so the issue for MSD payments is much smaller.

ACC lump sum payments

14. ACC makes different types of compensation or reimbursement payments depending on the situation. In some cases, whether a person is entitled to ACC compensation may be the subject of dispute or delay in awarding compensation and making payment to the person. These payments can relate to several years, meaning these payments can be large, running into tens or hundreds of thousands of dollars.
15. Payments of weekly compensation are akin to employment income and PAYE must be withheld when such payments are made. If these payments are made belatedly in a lump sum in one tax year, the individual may be overtaxed when compared with the tax that would have applied if the payments were made over multiple years.

Backdated MSD entitlements

16. Backdated payments of MSD entitlements may also give rise to an increased tax liability if they are paid in a subsequent tax year, although these payments tend to be smaller amounts than ACC payments. This may occur for multiple reasons, including a system error, or incorrect or incomplete information being provided at the time of an assessment.
17. There are some existing legislative provisions that can help mitigate these issues:
    a. **Withholding**: the Income Tax Act 2007 and the Social Security Act 2018 provides that the Commissioner of Inland Revenue can agree a withholding rate and tax payable with the Chief Executive for the Ministry of Social Development. However, this is not particularly useful for BLSP, as each individual BLSP may require a different rate of withholding and it does not alter the tax liability assessed on the payment, just any shortfall in withholding.
    b. **Write off**: the *Tax Administration Act 1994* allows the Commissioner to write off tax for an individual when their income is solely comprised of income-tested benefits, education grants, New Zealand superannuation or a veteran's pension. However, this write-off is not available if the recipient is receiving Working for Families or where an individual moved to employment for all or part of a year and is awarded a backdated amount of an income-tested benefit by MSD, they will not qualify for this write-off.
18. While these existing mechanisms may mitigate consequences for some BLSP recipients, a tailored solution will ensure all BLSP recipients are treated the same.

Payments that were out of scope

19. As mentioned, we have drawn a distinction between lump sum payments in general and BLSPs which relate to prior years.
20. Further distinctions may be drawn when a lump sum payment arises from an employment agreement, in other words, when it is contemplated the payment will be paid out in a lump sum as opposed to spread over multiple tax years.

21. Where a provision in an employment agreement triggers an entitlement and this entitlement is paid out pursuant to the provisions in the employment agreement (e.g., bonuses), we consider no alternative tax treatment is required.
22. This was affirmed through consultation that although arguments can be made for other types of payments to be included, [2] other lump sum payments are generally either:
    a. calculated with reference to prior years but incurred because of an action during the current year (e.g., redundancy and pay equity payments); or
    b. are not material enough to shift a person into a higher tax bracket (e.g., holiday pay reparation).

What objectives are sought in relation to the policy problem?

23. The main objective is that any tax effects from receiving a multi-year payment in one year are mitigated using an alternative tax treatment to approximate the lower amount that would have been paid had the payment been made over multiple years.
24. We note that implementing an alternative tax treatment would not compensate customers for delayed payments. This project seeks to address the tax impacts only. We acknowledge that the delayed nature of these payments adds to the perception of a lack of fairness. However, to the extent that further compensation for delayed payment is desirable,[3] this is outside the scope of this project and should ultimately be dealt with in the specific Act that authorises the payments.

[2] Feedback from initial consultation was that the most common lump sums paid were holiday pay remediation payments, redundancy payments and payments ordered by the Employment Court/Employment Relations Authority.

[3] ACC BLSPs generally include a portion intended to compensate for the time value of money.

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

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

The criteria that have been used to assess the options are:

- **Equity**: do the options address the fairness issue?
- **Compliance costs**: do the options impose disproportionate compliance costs on payers or BLSP recipients?
- **Fiscal cost**: the fiscal costs to the government should be minimised.
- **Administrative cost**: are the options possible for Inland Revenue, ACC, and MSD to implement and administer without substantial administration costs?
- **Stakeholder support:** are the options supported by interested parties?

What scope will options be considered within?

26. Several employment-related payments relate to prior year entitlements (e.g., holiday pay recalculations). One of the complexities in considering the BLSP issue is fairness and where to draw the line as to which payments should be eligible for an alternative tax treatment.
27. The scope of the project was refined through initial targeted consultation and agreement by the Minister of Revenue.[4] The payments that warranted alternative tax treatment were:
    a. backdated payments of ACC weekly compensation, and
    b. backdated MSD entitlements.
28. The scope was further refined by the problem definition because we are most concerned with payments which artificially push a recipient into a higher tax bracket for a single year.
29. Both of the identified payments are paid by the Crown and involve people who have often suffered a disadvantage. The disadvantage suffered by the affected person is compounded as, in addition to the delay in receiving their entitlement, they also receive a smaller net amount than if the amount was paid over multiple years.
30. These payments also result due to some failure of the Crown whether this be an action or inaction by the Crown that prevented the person being paid at the time they should have been paid.

[4] IR2022/310 refers.

What options are being considered?

The options that have been considered are

- **Option one**: status quo;
- **Option two**: apply an average tax rate from the previous four income years to the BLSP;
- **Option three**: apply the average marginal tax rate from the current year, ignoring the BLSP;
- **Option four**: allow reassessment of earlier tax years when the payment should have been received; and
- **Option five** (for MSD payments only): ignore the BLSP and assume the tax deducted is correct.

Background

31. The options for dealing with payments made by ACC and MSD differ due to the way in which tax is calculated by each of the payers.
32. For BLSPs made by ACC, tax is deducted from the payment at the extra pay rate (or potentially the modified withholding tax rate as advised by Inland Revenue). In this case, depending on whether they use the correct rate of withholding, a tax debt may still arise.
33. MSD BLSPs are paid “net of tax” (with tax already deducted). MSD determine how much the recipient is entitled to in their hand and then gross up that amount for the tax payable. MSD calculate the tax to withhold as if the payments had been made on time (by reference to previous years). Since Inland Revenue tax the BLSP in the year of receipt, this may result in a higher amount of tax payable for the recipient.
34. Whilst we could use the same options for both types of payments, using the ACC solution for MSD payments could still result in tax debts unless MSD changed the way they withhold tax from the payments. We considered that the way MSD calculates the tax should result in a more accurate calculation for MSD BLSPs, than under the approximated ACC model.
35. Options 2 and 3 below would only apply to ACC payments and option 5 would apply to MSD payments. Option 4 would apply to both.

Option One – *Status Quo*

36. Option one is the status quo. Maintaining the status quo would continue to tax BLSPs on a cash basis. While taxing these payments on a cash basis is often the best option for employment-related payments, applying this to BLSPs can give rise to fairness issues if they are paid in a later tax year but relate to two or more previous tax years.
37. Maintaining the status quo would continue to lead to unfair outcomes for recipients of BLSPs.

Option Two – Apply an average tax rate from the previous four income years

38. Inland Revenue would calculate an average tax rate[5] of the person based on the previous 4 years’ income information Inland Revenue holds. This rate would then be applied to the BLSP separately from the person’s annual income tax calculation. This

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[5] Average tax rate refers to the total amount of tax paid divided by total income.

option is based on the way a person who invests in a portfolio investment entity is squared up for the year.

39. Under this option, the payer could request the person's average tax rate before the BLSP is made and then apply that as the withholding rate. This would mean no additional amount of tax should be payable for the BLSP (assuming the recipient's circumstances do not change).
40. Initially, consultation posed the option of either 2 or 4 years. Overwhelmingly submitters preferred the four-year option as averaging the tax rate over more time should smooth the rate for any changes within that time.
41. This option would apply to payments made on or after 1 April 2024 due to the lead in time required to make system changes both at Inland Revenue and the paying agencies.
42. A retrospective application date was considered as an option during consultation and in reporting to Ministers. However, officials considered there was no clear basis to make such a change retrospective. It did not meet any of the usual requirements to make a change retrospective such as confirming a long-standing policy intent or correcting a clear error in the legislation. This would also have increased the fiscal cost significantly.

Equity

43. This option would address the issue of the BLSP pushing the person into a higher tax bracket by removing the BLSP from the person's tax calculation. This would mean their overall tax liability should be lower than the status quo.
44. Using the average tax rate rather than an average marginal tax rate should also result in a more accurate taxation of the payment as it represents a true average tax rate for the recipient.
45. It would also partially smooth any changes in a person's tax rate between the time they should have received the income and the time they receive the BLSP. The "lower of" test[6] would allow the status quo to be applied if that resulted in a lower tax impost. This should address any issues of fairness if the option would disadvantage the recipient.
46. It would also enable ACC to request the withholding rate before making the payment, to enable the correct amount of tax to be deducted (provided their income situation did not change for the current year) which would avoid the recipient having additional tax to pay.

Compliance costs

47. This option would require ACC to contact Inland Revenue to obtain their average tax rate before making the payment. ACC would then have to apply that withholding rate and indicate that they are paying a lump sum on the employment information supplied to Inland Revenue.
48. This option will have minimal compliance costs for recipients. For ACC payments, ACC will be able to request a withholding rate from Inland Revenue and apply this without requiring further information from the recipient. Provided the recipients position does not change in the current year, they will not be required to pay any additional tax.

Fiscal cost

49. The fiscal cost of this option applying to payments made on or after 1 April 2024 is outlined below:

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[6] See paras 60-62

Table 1: Four-year average tax rate

	$m – increase/(decrease)			
Vote Revenue **Minister of Revenue**	**2023/24**	**2024/25**	**2025/26**	**2026/27 & outyears**
Crown Revenue and Receipts: Tax Revenue	(1.900)	(8.100)	(8.500)	(8.900)

Administrative cost

50. Implementing this option will require moderate systems changes from ACC. This is because it will require an update to the employer information return to identify the BLSPs. This will impact ACC because they will be required to identify when the payment is a BLSP, which will flow through to Inland Revenue where the alternative tax treatment needs to be applied. There will also be costs involved in requesting the new proposed tax rate from Inland Revenue to enable them to withhold correctly from the BLSPs.
51. ACC has indicated the changes required are possible within the timeframe, and system changes may cost between $200,000 - $400,000 to implement.
52. This option will also involve complex system changes by Inland Revenue to alter the annual tax calculation to account for the differing treatment of those payments. The differing treatments may also be more difficult for recipients to understand over the status quo (notwithstanding that the status quo results in higher taxation). Inland Revenue has indicated that the changes required are possible within the timeframe, and while they will be included within wider changes, Inland Revenue estimates the cost will be in the range of $200,000 - $400,000.

Stakeholder support

53. This option was the preferred option during targeted consultation given its simplicity and ability to address the current inequities.

Option Three – Apply the average marginal tax rate from the current year, ignoring the BLSP

54. This option is similar to option two, but instead of using the recipient's average tax rate over the previous four years, it would use their average marginal tax rate[7] for the year the BLSP is received (excluding the BLSP). Like option two, this rate would then be applied to the BLSP in a separate calculation.

Equity

55. This option would address the issue of the BLSP pushing the person into a higher tax bracket by ignoring the BLSP for the person's tax calculation. However, it would not

[7] Average marginal tax rate refers to the incremental tax paid on incremental income. For example, the current marginal tax rate for each dollar of income up to $14,000 has a tax rate of 10.5%.

address the issue of any changes in a person's tax rate between the time they should have received the income and the time they receive the BLSP.

56. Using the average marginal tax rate would effectively be a snapshot of the person's current tax position, rather than achieving a more even average tax rate (using multiple years) as in option two.

Compliance costs

57. These would be the same as option two.

Fiscal cost

58. The fiscal cost for this option is as follows:

Table 2: Current year marginal tax rate

	$m – increase/(decrease)			
Vote Revenue **Minister of Revenue**	**2023/24**	**2024/25**	**2025/26**	**2026/27 & outyears**
Crown Revenue and Receipts: Tax Revenue	(1.600)	(6.600)	(6.900)	(7.200)

Administrative cost

59. This option would require similar system changes for Inland Revenue and ACC as option two.

Stakeholder support

This option was not preferred during targeted consultation. Stakeholders thought this may lead to unfair outcomes where their current tax rate does not reflect their previous position when they should have received the payments.

Additional rules for options two and three

60. In addition to each of option two and three, the lowest tax rate to be applied would be 10.5%,[8] and there would be a "lower of" test.

61. Changing the status quo could result in some recipients being worse off than under the current treatment. This could occur where a person has had a higher tax rate in the four years prior to the lump sum payment but has a lower tax rate in the year the lump sum is paid. In this case, the recipient may end up with a higher tax bill than under the status quo. To counter this, a "lower of" test would ensure recipients are not worse off under this proposal compared to the status quo.

62. If there was no "lower of" test, from the information we have obtained from ACC, we estimate that the number of people worse off than under the current treatment, would be between 39-84 per year. Due to the small number of affected taxpayers, this may be

[8] For example, a person with an average tax rate of less than 10.5% would be capped at 10.5% to account for the payment itself. However, the cases where a person would have an average tax rate at less than 10.5% would be rare, given the lowest rate applied to any income over $0 is 10.5%.

delivered in a slightly different way than the main proposal (i.e., it may require some manual intervention by the recipient). These issues will be worked through in the ultimate design of any proposed solution.

Option Four – Allow reassessment of earlier tax years when the payment should have been received

63. This option would essentially remove the cash receipt "basis" for these BLSPs by allowing the taxpayer to re-open assessments for earlier tax years and spread the income back over the periods to which it relates. After the income is spread, the lump sum would be taxed as if it was received in those years.
64. For some claimants, their BLSP could relate to over 10+ years which would result in multiple reassessments over a large number of years.
65. Re-opening assessments would also trigger the reassessment of related obligations and entitlements, for example Working for Families tax credits and student loan obligations.
66. Essentially this is the treatment that MSD follow in calculating the withholding tax from the BLSPs that it pays.

Equity

67. This option would produce the fairest, and most accurate result in terms of tax liability. This would tax the BLSP as if it was received in those years. However, because this would re-open earlier years' assessments it would also trigger the re-assessment of related obligations and entitlements, for example Working for Families tax credits and student loan obligations. This could claw back previous years entitlements and lead to other inequitable outcomes.

Compliance costs

68. This would place a high compliance burden on Inland Revenue to identify every past income return and verify the tax code. For some, this would require 10 or more years of returns and may include a mix of paper and electronic records. This would come with a significant manual intervention.
69. As this would reopen previous assessments, it would reassess all social policy entitlements which could lead to the creation of debt and owing entitlements. The multiple reassessments could be complex to understand and may require recipients to dispute or apply for reassessment again. This would be administratively burdensome and have significant compliance costs for the recipient.

Fiscal cost

70. Due to the workability and complexity of this option, particularly in relation to the need to reassess social policy entitlements, it was not formally costed. Inland Revenue considers it would likely have at least as large of a fiscal cost as option two (see table 1 above). This would be due to the amount of manual intervention required, in addition to the effect of reassessing many years of entitlements.

Administrative cost

71. This option would require significant system changes for Inland Revenue and ACC.

72. As mentioned above, this would result in a large administrative cost, given the large amount of work involved in reopening and reassessing previous tax assessments, especially where there may be limited information (for example, in the transition from

paper to electronic returns). It would also require a significant manual effort by Inland Revenue to ensure the reassessment can be processed.

Stakeholder support

73. This option was not preferred during targeted consultation. While Stakeholders acknowledged this would be the most accurate option, we received some feedback that the prospect of the reassessment of all social policy entitlements outweighed the benefits of spreading the income.

Option Five – Ignore the BLSP and assume the tax deducted is correct

74. This option would apply only to MSD BLSPs. This option would assume the tax deducted by MSD is correct and ignore the BLSP for the purpose of the recipient's income tax liability (but not social policy entitlements).
75. We would accept the tax withheld as correct because of the way MSD calculates the tax on the BLSPs.
76. MSD calculates entitlements from the ground up. They first decide how much a person is entitled to in their hand and then grosses that amount up for the tax payable. This also occurs for BLSPs, MSD calculates the net amount of the underpayment and calculates the tax to withhold with reference to the period the client was underpaid. In essence, MSD calculates the correct tax liability as if the payments had been correctly made on time. This is similar to option four, however, this would not trigger a reassessment of social policy obligations for previous years because the reassessment is being calculated by MSD.

Equity

77. This option would produce a fairest, and accurate result in terms of tax liability for most BLSP recipients. This is because the result would tax the BLSP as if it was received in the years it related to. It would also remove the additional tax liability that occurs because of Inland Revenue's application of tax in the current year, which can result in additional tax being payable.
78. This would also resolve the inconsistency of the current tax write-off that is available for some MSD BLSP recipients where there is additional tax payable.
79. This write off is available for auto-calculation customers who do not receive Working for Families and for whom their only income is from MSD (with a de minimis that allows a small amount of other income).[9] However, for those who receive Working for Families or those who are no longer on a benefit, the differences in tax are payable.
80. As MSD would calculate the reassessment, this removes the additional square-ups than would occur in option four.

Compliance costs

81. This option will have minimal compliance costs for MSD recipients, and they will be unlikely to have any additional income tax owing.

Fiscal cost

82. We have not accounted for any fiscal cost for the change to the treatment for MSD BLSPs. This is on the basis that because in the majority of cases, any tax liabilities arising from those payments is subject to a write off. It will only be where a recipient

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[9] Section 22J of the Tax Administration Act 1994.

has ceased to receive a benefit or where they have WFF debt that the amount will be payable.

83. The fiscal cost is likely to be immaterial. Given this, we consider the fiscal cost of these BLSPs to be within the margin of error of the fiscal cost of the ACC BLSPs, and therefore no additional amount needs to be accounted for.

Administrative cost

84. Implementing this option would require moderate systems changes from MSD. This is because it will require an update to the employer information return to identify the BLSPs. This will impact MSD because they will be required to identify when the payment is a BLSP, which will flow through to Inland Revenue where the alternative tax treatment needs to be applied.
85. The proposals will also involve complex system changes by Inland Revenue to alter the annual tax calculation to account for the differing treatment of the BLSP payments.
86. MSD has indicated this work is doable in the timeframe, and they estimate the cost of the changes to be $525,000.

Stakeholder support

87. This option was supported during external (stakeholders and MSD) and internal consultation. MSD agreed that this option is likely solve the current equity issues for their customers.

How do the options compare to the status quo/counterfactual?

	Option One – *Status Quo*	Option Two – *Applying an average tax rate from the previous four income years*	Option Three – *Applying the average marginal tax rate from the current year, ignoring the BLSP*	Option Four – *Allow reassessment of earlier tax years when the BLSP should have been received*	Option Five – Ignore BLSP and assume tax deducted is correct (MSD BLSP only)
Equity	0	++ *This option would address the fairness issue, resulting in a lower tax liability than the status quo*	+ *This option would address the fairness issue to some extent but would not address the issue of changes in the recipient's tax rate*	- *This option would produce the most accurate result in terms of tax liability, but as it could trigger the reassessment of social policy entitlements and obligations, this could lead to other inequitable outcomes*	++ *This option would address the fairness issue, resulting in a lower tax liability than the status quo*
Compliance costs	0	0 *This option would have minimal compliance costs for recipients and for payers*	0 *This option would have minimal compliance costs for recipients and for payers*	- - *This option would have significant compliance costs for recipients and for payers*	0 *This option would have minimal compliance costs for recipients and for payers*
Fiscal cost	0	- *This would have a fiscal cost of $27.4m (2023/24 – 2026-27 & outyears)*	- *This would have a fiscal cost of $22.3m (2023/24 – 2026-27 & outyears)*	- This option was not formally costed but would likely have at least as large of a fiscal cost as option two	- *This option would have a small fiscal cost*

Administrative cost	0	- *This option would involve system change from IR and ACC*	- *This option would involve system change from IR and ACC*	- - *This option would involve significant system change and manual intervention*	- *This option would involve system change from IR and MSD*
Stakeholder support	0	++ *Stakeholders favoured this option*	0 *Stakeholders did not prefer this option to the status quo*	- *Stakeholders considered this was not desirable as it would increase the complexity for recipients given the reassessments and claw-back of social policy entitlements that would flow from it*	++ *Stakeholders agreed that this was the best way to solve the fairness issue for MSD BLSP recipients*
Overall assessment	0	++	-	- -	++

Example key for qualitative judgements:

++	much better than doing nothing/the status quo/counterfactual
+	better than doing nothing/the status quo/counterfactual
0	about the same as doing nothing/the status quo/counterfactual
-	worse than doing nothing/the status quo/counterfactual
- -	much worse than doing nothing/the status quo/counterfactual

What option is likely to best address the problem, meet the policy objectives, and deliver the highest net benefits?

88. For ACC BLSPs, option two is likely to best address the problem and deliver benefits to BLSP recipients, compared to the status quo. The option is likely to achieve the objective, by mitigating the tax disparities that currently arise for BLSP recipients.

89. For MSD BLSPs, option five is likely to best address the problem and deliver benefits to BLSP recipients, compared to the status quo. This option is the best way to address the tax disparity that arises with the current treatment and would impose almost no compliance costs on recipients. This option essentially calculates the correct amount of tax that would have been payable if the BLSP was paid in the years it should have been received, without the additional reassessments, that would be generated in the tax system, that would occur under option four.

90. Option two and option five are the preferred options which best meet the policy objectives and are able to be implemented within the existing ACC, MSD, and Inland Revenue systems. Both options involve one-off moderate systems changes for ACC, MSD, and complex changes for Inland Revenue. However, once the treatment is implemented, the compliance costs for BLSP recipients and payers of BLSPs should be minimal. As the changes involve modifying the employment information tax return, the policy would apply to payments made from 1 April 2024 to allow sufficient time to implement the changes required.

What are the marginal costs and benefits of the option?

Affected groups *(identify)*	**Comment** *nature of cost or benefit (eg, ongoing, one-off), evidence and assumption (eg, compliance rates), risks.*	**Impact** *$m present value where appropriate, for monetised impacts; high, medium or low for non-monetised impacts.*	**Evidence Certainty** *High, medium, or low, and explain reasoning in comment column.*
Additional costs of the preferred option compared to taking no action			
Regulated groups (taxpayers who receive BLSPs)	Taxpayer friendly	No cost	Medium
Regulators (Inland Revenue)	One-off. System changes are required to implement the proposal.	Medium	Medium
Payers (ACC/MSD)	One-off. System changes are required to implement the proposal	Medium ACC: $200-000 – 400,000 MSD: $525,000 IR: $200,000 - $400,000	Medium
Others (Government)	Ongoing. Fiscal cost	Fiscal cost of $27.4m (2023/24 – 26/27 & outyears)	Medium
Total monetised costs	Fiscal and administrative cost	Fiscal cost: $27.4m (2023/24 – 26/27 & outyears) Administrative cost: $925,000-$1,125,000	Medium
Non-monetised costs	One-off	Medium	Medium
Additional benefits of the preferred option compared to taking no action			
Regulated groups	Ongoing. This will likely lower the BLSP recipients' tax liability to a fairer rate.	Reduced tax liabilities totalling $27.4m (2023/24 – 26/27 & outyears)	Medium
Regulators	Ongoing. Fairer tax system and less customer contacts	Medium	Medium
Payers	Ongoing. Fairer treatment of BLSP and less customer contacts	Medium	Medium
Total monetised benefits	Fiscal cost	$27.4m (2023/24 – 26/27 & outyears)	Medium
Non-monetised benefits	Ongoing	Medium	Medium

Section 3: Delivering an option

How will the new arrangements be implemented?

91. To implement the proposal, it will require legislative, and system change from ACC, MSD, and Inland Revenue.
92. The proposals, if agreed, would be included in the 2023 omnibus taxation bill. The alternative tax treatment for ACC and MSD BLSPs will apply to payments made on or after 1 April 2024. The purpose of a later application date is to allow ACC, MSD, and Inland Revenue time to implement the required system changes.
93. Under the new proposals for ACC payments, ACC BLSP recipients will still be provided the option to choose their desired withholding rate for their BLSP, with this new rate (provided by Inland Revenue to ACC) as an option. Appropriate guidance will be issued to those involved.

Application date

94. Due to the prospective application date of 1 April 2024, this would not address any past inequity for recipients who have been disadvantaged by the status quo. While applying the proposed solution retrospectively may be seen to be "undoing a wrong", we do not consider this change would meet the usual criteria for a retrospective change.
95. Changes are normally made retrospective where a change fills in a gap in existing legislation - in particular, a relatively newly enacted regime. Usually, retrospective application either "fills gaps" in such a regime, fixes an obvious error or confirms well-documented policy intent. The tax treatment of BLSPs would fill no such gap and it is a well-established policy decision that employment "type" payments are taxed on receipt.
96. A second reason legislative changes may be applied retrospectively is where the change is taxpayer friendly, and the fiscal cost is acceptable. On a prospective basis, this change is taxpayer friendly because it reduces the tax impact on BLSPs. However, extending the change retrospectively will favour some taxpayers in this situation but not all, unless the change was made back to when these types of payments were first made (which could in theory go back to 1974 when ACC was created). To extend the benefit for some taxpayers for a shorter period will continue to result in some taxpayers not getting the benefit of the change. Additionally, determining where that line should be set would be arbitrary. The fiscal cost of such a change would also be prohibitive.

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

97. Inland Revenue will monitor the effectiveness of the proposed reforms on an ongoing basis, through the normal use of data analytics. The data obtained will assist with analysing whether the new rules are effective and whether they have lessened the tax BLSP recipients have to pay.
98. Once the rules are implemented, Inland Revenue will monitor any feedback from external stakeholders on how the rules are functioning.

Regulatory Impact Statement: Government payment of an employer contribution to qualifying paid parental leave recipients

Coversheet

Purpose of Document	
Decision sought:	Analysis produced for the purpose of informing final Cabinet decisions on the government payment of a three percent employer contribution to paid parental leave recipients who contribute at least three percent to their KiwiSaver accounts
Advising agencies:	Inland Revenue (IR) with input and review from the Ministry of Business, Innovation and Employment
Proposing Ministers:	Minister of Revenue, Minister of Commerce and Consumer Affairs
Date finalised:	26 April 2023

Problem Definition

Concerns about how well KiwiSaver is working for women have been raised by Te Ara Ahunga Ora Retirement Commission and the New Zealand Institute of Economic Research (NZIER), as well as by KiwiSaver providers.

Executive Summary

The government is concerned about retirement outcomes for women. The position of women at retirement is typically less secure than that of men, who have savings which are on average 20 percent higher than women. Lower average balances, coupled with a higher average life expectancy can result in less financial security for women at the point of retirement and beyond.

The reasons for differences in retirement savings are varied but include overrepresentation in lower paid roles, time spent out of paid employment and lower rates of labour force participation – often as a result of caring and child-rearing duties.

Possible options

The government is interested in reducing the gender retirement savings gap for women in paid work, with a particular focus on KiwiSaver enhancements relating to government Paid Parental Leave (PPL) arrangements. Two options have been identified in addition to the status quo (Option 1):

- Option 2: the government pays a three percent employer KiwiSaver contribution into the KiwiSaver accounts of PPL recipients who similarly contributed at least three percent of their PPL payments to their KiwiSaver accounts.
- Option 3: the government pays a three percent employer KiwiSaver contribution into the KiwiSaver accounts of PPL recipients, irrespective of how much they are contributing to their KiwiSaver from their PPL payments.

While women are expected to disproportionately benefit from the proposal owing to the greater representation of women among PPL recipients, the proposal would benefit all PPL recipients regardless of gender.

Inland Revenue's preferred option

On balance, IR supports the overall proposal of a government payment of a three percent employer contribution. While the solutions to issues such as overrepresentation in lower paid roles and lower rates of labour force participation among women lie outside KiwiSaver, developing comprehensive solutions to these issues represents a long-term project which would require resourcing as part of the government's work programme.

Although the overall impact of the proposal is likely to be small, and disproportionately benefit wealthier households who are able to contribute to their KiwiSaver accounts while a member of the household is on PPL, the proposal would nonetheless go some way toward mitigating the effect of time spent out of work for PPL recipients. Additionally, although the amount paid to a PPL recipient over the course of parental leave would be small, the effect of compound interest over the remainder of a caregiver's career would increase the absolute value of the contribution and promote an improvement in financial security for caregivers in retirement.

While this is a finely balanced assessment, IR supports option 2 over option 3, as this is consistent with current KiwiSaver settings where employers must pay a contribution only if the employee contributes three percent or more from their pay. This alignment with existing KiwiSaver settings means it is likely to be lower in cost and simpler to administer. Additionally, the selection of option 2 would not preclude the subsequent selection and implementation of option 3 at a later date, if a future government decided the proposal had merit and should be adopted as part of a future budget initiative.

Views from consultation

Due to the time constraints imposed by the budget process and time constraints in preparing advice, consultation with the public or with iwi and hapū has not been undertaken on the options.

However, in 2022 a joint agency working group[1] undertook some initial engagement on a range of issues and options for KiwiSaver Enhancement. While the working group engaged on broad issues and enhancement options, it did not get feedback on the PPL options specifically from iwi or hapū, business or small business representatives KiwiSaver providers or the general public.

However, feedback from these meetings on the enhancement approach generally indicate it is likely that:

- either option would be supported by KiwiSaver providers
- iwi and hapū might support option 3 over option 2.

[1] This included officials from the Ministry of Business, Innovation and Employment (MBIE), Ministry of Social Development (MSD), IR and the Public Service Commission (PSC).

The Treasury

In general the Treasury does not support the government payment of an employer KiwiSaver contribution to eligible PPL recipients. Although the proposed KiwiSaver enhancements are a positive first small step, they are unlikely to address wider gender disparity issues.

Manatū Wahine Ministry for Women and Ministry for Social Development

In previous advice, Manatū Wahine Ministry for Women and the Ministry of Social Development supported the government payment of an employer KiwiSaver contribution to eligible PPL recipients.

Ministry of Business, Innovation and Employment

MBIE supports option 2 over option 3 for the same reasons as IR above. Option 3 has the significant benefit of better addressing income inequality between PPL However, in MBIE's view, distributional inequity is better addressed via interventions which, unlike PPL, are not tied to participation in paid work.

MBIE notes that neither option addresses the more fundamental issues identified with current KiwiSaver contributions settings, regarding the adequacy of default contribution rates, affordability of contributions, and support for the self-employed to save for the future beyond investing in their home and business.

Further, because the gender retirement savings gap is driven by differences in participation in paid work, changes to reduce this gap will be more effective if they are not tied to participation in paid work. However, providing additional government contributions for recipients of PPL would improve retirement savings outcomes for women who also contribute from their PPL.

Limitations and constraints

This analysis has been prepared at pace under time constraints. Officials were instructed to prepare a Budget bid for this proposal late in the Budget process and before detailed policy design had been completed. Due to the timing and proposed inclusion as a Budget item, there was no opportunity for external consultation on the proposal beyond the limited discussions that were carried out in 2022 as part of broader early-stage KiwiSaver enhancement policy work.

Responsible Manager

Carolyn Elliott

Policy Lead

Policy and Regulatory Stewardship

Inland Revenue

s 9(2)(a)

26 April 2022

Quality Assurance (completed by QA panel)	
Reviewing Agency:	Inland Revenue and the Ministry of Business, innovation and Employment
Panel Assessment & Comment:	The Quality Assurance Panel with representatives from Inland Revenue and the Ministry of Business, Innovation and Employment has reviewed the Regulatory Impact Statement (RIS) *Government payment of an employer contribution to qualifying paid parental leave recipients* prepared by Inland Revenue and considers the information and analysis partially meets the quality assurance criteria. This is because the time constraints imposed on the policy development of the proposal have not enabled consultation on the various options and refinement of the preferred option.

Section 1: Diagnosing the policy problem

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

1. The position of women at retirement is typically less secure than men. The reasons for differences in retirement savings are varied but include the overrepresentation of women in lower paid roles, time spent out of paid employment and lower rates of labour force participation. This also includes more women than men exiting the paid workforce or taking leave from paid work to raise children and/ or care for family members.

2. Women are also more likely than men to experience financial hardship and to be sole parents which may lower retirement funds over time.[2] Access to affordable, quality childcare is a significant barrier to women's paid employment. Māori and Pacific women are overrepresented among those who are not in the paid workforce due to caring responsibilities.[3]

What is the policy problem or opportunity?

3. Although women live longer on average than men, their KiwiSaver balances are on average 20% less than those of men.[4] As noted above, the reasons for this are varied but include such factors as the gender pay gap, the overrepresentation of women in lower paid roles, time spent out of paid employment and lower rates of labour force participation.

[2] Stats NZ NZ General Social Survey (2014) The hardship rate for children in sole-parent households is typically three to four times higher than for two-parent households. A major factor in the difference is the more limited potential for paid employment hours in a one-adult household, with or without children. Bryan Perry, Child Poverty in New Zealand (2022).

[3] Dale, M.C and St John, S. (2020). Women and Retirement in a post COVID-19 world

[4] Review of Retirement Income Policies 2019 and Te Ara Ahunga Ora Policy Brief 01 (2022)

4. These issues affect women's ability to contribute to their KiwiSaver accounts and otherwise save for their retirement, including their eligibility for the member tax credit (MTC), a government incentive designed to encourage New Zealanders to save for their retirement.

5. The primary solutions to address these inequalities lie outside of KiwiSaver settings. These solutions include labour market interventions as well as education policy relating to childcare. However, providing additional government contributions for recipients of PPL would enable better outcomes for women who are currently in the workforce and others who contribute to KiwiSaver from their PPL. While PPL is available to all parents regardless of gender, we estimate that for the 2020 – 21 financial year, approximately 95 percent of PPL recipients identified themselves as women.[5]

What objectives are sought in relation to the policy problem?

6. The objective is to improve retirement outcomes for women. Although the primary avenues for addressing the identified inequities lie outside KiwiSaver, the interventions identified could go some way towards mitigating the effect of labour market and social differences on women.

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

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

7. The options identified will be compared using the effectiveness and efficiency criteria in the table below. In evaluating the effectiveness of the proposal, the "EAST" behavioural insights framework has also been considered. This identifies the successful features of behavioural change interventions as Easy, Attractive, Social and Timely.

[5] Gender is taken from individuals preferred titles (i.e., Mr, Mrs or Miss), as disclosing gender is optional upon a Paid Parental Leave application. In a small percentage of cases gender cannot be determined form title (gender neutral or no title provided)

Effectiveness		Cost/efficiency		Wider considerations
Extent to which the proposal addresses the objective	**Alignment with EAST**	**Implementation (Govt)**	**Employer (incl Govt) Employees Providers**	
Size of the potential impact	"Easy" includes simplicity as an original design feature of KiwiSaver "Attractive" includes trust and confidence in KiwiSaver. Social and Timely	Likely size of implementation cost to Inland Revenue, FMA etc	Includes consideration of cost to government as an employer and contract of services	Treaty/Te Tiriti Equity Macro Economic Considerations

What scope will options be considered within?

8. This project is being considered in the context of joint agency work focused on identifying opportunities to enhance KiwiSaver, its settings and design. KiwiSaver was first introduced in 2007 as a private retirement savings scheme intended to supplement the basic retirement income provided by New Zealand Superannuation. However, new and emerging challenges such as financial instability, high inflation and declining rates of home ownership are likely to place pressure on many retirees.

9. With almost 15 years having passed since the KiwiSaver scheme's commencement, a joint agency group has sought to consider enhancement options to help New Zealanders financially prepare for retirement and become more resilient to short-term financial shocks.

10. This work identified issues relating to the affordability of KiwiSaver contributions and the adequacy of KiwiSaver savings for retirement, as well as the impact of gender on women's KiwiSaver balances. The government is particularly interested in options that would improve the gender gap in retirement savings.

What options are being considered?

Option 1 – Retain the status quo

11. The government could choose to retain the status quo and take no active steps toward addressing the existing retirement gender equity issues. Wider government work on options to address these issues (e.g. pay equity, access to affordable childcare) would continue as resources allow.

Option 2 – The government would pay a matched three percent "employer" KiwiSaver contribution to contributing PPL recipients

12. The government could subsidise the payment of a three percent KiwiSaver "employer" contribution to PPL recipients provided the recipient also pays at least a three percent KiwiSaver employee contribution into their KiwiSaver retirement savings accounts.

Option 2 – The government would pay a three percent "employer" KiwiSaver contribution to eligible PPL recipients, irrespective of how much they contribute to their KiwiSaver account from their PPL payments

13. The government could subsidise the payment of a three percent KiwiSaver "employer" contribution to all PPL recipients, regardless of whether or not they were making an employee contribution into their KiwiSaver retirement savings account.

Comparison of options against the status quo

14. The following table uses assessment criteria to assess Options 2 and 3 against the status quo (Option 1). Each option is scored on how it contributes to each criterion in comparison to the status quo and the high-level reasons for the score are recorded directly below each criteria score. The final assessment is provided in the final row of the table.

Key:

++ 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

How do the options compare to the status quo/counterfactual?

		Option 1	Option 2	Option 3
Effectiveness	**Extent to which the proposal addresses the objective**	0 No change in savings for eligible PPL recipients.	+ Small increase in savings for eligible PPL recipients (those that also contribute)	+ Small increase in savings for all PPL recipients
	Alignment with EAST	0 No change to EAST alignment.	++ Maintains consistency with existing settings (individual must contribute to receive employer contributions)	- Inconsistent with existing settings – decouples employee-employer contribution requirement
Cost/efficiency	**Implementation (Govt)**	0 No impacts to employer. Employee or providers.	- Increased cost to the government both fiscal and implementation cost (IR), with an estimated fiscal cost of $19.219m over the 2022/23-2026/27 forecast period, and an administrative cost of $0.510m.	- - A significantly (5x) larger increase in cost to government (with an upper estimate of $101.8m over the forecast period). We do not expect the administrative costs to be materially different from those associated with Option 2.
	Employer (incl Govt), Employees and Providers	0 0 Continued poor alignment with Article 3 of Te Tiriti 0 No impact on trust and confidence 0 No impact on inflation	0 Minimal impacts. However, the government payment of a contribution could "crowd out" contributions from the private sector. For example, some employers may already be contributing and could chose to either reduce their contributions or cease contributing to their employee's KiwiSaver altogether.	0 Minimal impacts. Some employers could already be contributing and could chose not to continue.

Wider considerations	**Treaty/Te Tiriti** **Impact on inflation** **Trust and confidence in KiwiSaver**	0	- Poor alignment with Article 3 of Te Tiriti + Minor positive impact overall on trust and confidence 0 No material impact on inflation	+ Some alignment with Article 3 of Te Tiriti + Minor positive impact overall on trust and confidence 0 No material impact on inflation
Overall assessment		**0**	**++**	**0**

What option is likely to best address the problem, meet the policy objectives, and deliver the highest net benefits?

15. Each of the options considered above has specific costs and benefits. For example:

    - *Option 1 – Status quo:*

        - Taking no additional action would maintain the status quo, with resource continuing to be applied as it is currently and the KiwiSaver gender inequality issues outlined in the problem definition would remain. This assumes that no other KiwiSaver policy enhancements are currently being considered. However, work focused on developing wider solutions to gender pay and participation in paid work could continue as resources allow.

        - Both options 2 and 3 apply to PPL recipients. Although IR does not have comprehensive data on the gender of PPL recipients it is estimated that 95 percent of those receiving PPL in the 2020-21 financial year were women, with men comprising two percent of PPL recipients. The gender of the remaining three percent of PPL recipients was unknown on his methodology.[6]

    - *Option 2 - government would pay a three percent KiwiSaver employer contribution to PPL recipients provided the PPL recipients contributed at least three percent of their PPL to their KiwiSaver accounts:*

        - Currently, approximately 15% of PPL recipients contribute to their KiwiSaver accounts while receiving PPL. As the proposal would incentivise PPL recipients to contribute to their KiwiSaver accounts, it is possible that the proportion of PPL recipients contributing to their KiwiSaver would increase, along with the KiwiSaver balances of PPL recipients.

        - At the current maximum government PPL contribution of $661.12 (gross) per week, a three percent government contribution would represent $19.83 per week, for a maximum of $516 over 26 weeks of PPL. As PPL recipients would have to contribute the same amount to qualify for the government contribution, this would represent up to $1,032 in annual KiwiSaver contributions which might otherwise not be made.

        - Additionally, the proposal's incentivisation of KiwiSaver employee contributions could also result in KiwiSaver members receiving some portion of the Member Tax Credit (MTC). The MTC matches KiwiSaver employee contributions at 50 percent up to a maximum of $1,042.86, meaning the government contributes up to $521.43 to a KiwiSaver member's account each year. A KiwiSaver member who contributes $516 over 26 weeks of PPL would receive an MTC of $258 from the government.

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[6] Gender is taken from individuals preferred titles (i.e., Mr, Mrs or Miss), as disclosing gender is optional upon a Paid Parental Leave application. In a small percentage of cases gender cannot be determined from title (gender neutral or no title provided).

- Although the proposal would result in a small contribution in absolute terms, it would account for approximately 20 percent of the shortfall of contributions for a woman on the median wage taking a full year off full-time paid work. Additionally, the impact of compound interest over the remaining course of a retiree's working life would increase the value of this contribution considerably.

- However, as the receipt of the government subsidy is conditional on the PPL recipient also contributing, there is a risk that the benefit of this proposal could disproportionately accrue to higher income households who are able to afford KiwiSaver contributions while on PPL.

o *Option 3 - government would pay a three percent KiwiSaver employer contribution to PPL recipients regardless of whether they were making employee contributions:*

- Requiring the member to have contributions deducted from PPL is likely to result in a large proportion of the new benefit being captured by those who are more financially comfortable and so can afford to have deductions made from their PPL. However, it maintains the core KiwiSaver principle of "matched employee contributions".

- Making government contributions while on PPL unconditional would reach a greater number of those unable to afford to make their own KiwiSaver PPL deductions. However, it would not encourage 'employee' contributions.

- Option 3 would also cost significantly more in fiscal terms. Although the administrative costs of Options 2 and 3 are not expected to be substantially different, the cost of Option 3 is expected to have an upper estimate of $101.8m over the 2022/23 – 2026/27 forecast period. This is more than five times the expected cost of Option 2 (of $19.219m).

Trust and confidence criterion – same for options 1 and 2

16. KiwiSaver providers have previously indicated that frequent 'tweaks' to KiwiSaver have the potential to reduce trust and confidence in KiwiSaver as a stable long-term government intervention. While these are minor changes, we consider that they are more likely to increase trust and confidence in KiwiSaver than to reduce it, because they are increasing government incentives for participation.

17. By acknowledging structural inequities, these options for providing targeted support have potential to strengthen the 'social licence' of the scheme and increase public confidence and engagement in KiwiSaver.

18. The risk that people "over save" in KiwiSaver and would have better financial wellbeing if they used the funds in the present is mitigated by the opt-in nature of those options which would otherwise affect present spending.

Inflation – same for all three

19. Finally, the interventions will not have a material inflationary effect, given the increased government spending would be invested directly into KiwiSaver accounts and not be expended in the economy until a person reaches 65 or is eligible for early withdrawal (e.g. a first home withdrawal or serious illness). The proposed payments would not be

considered income and would therefore not affect entitlement to benefits or Working For Families payments

Views from initial engagement

20. Due to the time constraints imposed on officials in preparing advice and the budget process it has not been possible to undertake consultation with the public or with iwi and hapū on the options.

21. However, in 2022 a joint agency working group undertook some initial engagement on issues and options for KiwiSaver Enhancement.[7]

22. Officials engaged with KiwiSaver and funds management providers, the KiwiSaver lead for the Prime Minister's Business Advisory Council, representatives from capital markets and academic sectors, the Council of Trade Unions, Business New Zealand, the Small Business Advisory Council and staff at a number of iwi savings schemes. Officials also met with representatives of two iwi without savings schemes and two social services providers who work primarily with Pacific Peoples and whānau Māori.

Impacts for iwi and hapū and whānau Māori

23. Engagement with iwi/Māori was limited, but the feedback received indicated that:

    - there is a strong and widely held interest in saving for the future among Māori, focussed on being able to pass on savings to support tamariki and mokopuna.
    - KiwiSaver is valued for its support of home ownership, and its rewards and incentives. However engagement with KiwiSaver could be increased among whānau Māori.

24. Survey data indicates KiwiSaver works similarly for Māori as for non-Māori in terms of participation, when controlling for income level, employment status and other factors.[8] Māori who contribute to KiwiSaver are more likely than non-Māori to be contributing at 4 and 6 percent. This is consistent with engagement feedback about the high value placed on saving and on KiwiSaver's role in saving towards home ownership.

25. KiwiSaver settings do not vary by ethnicity; however, they currently compound the impact of colonisation for Māori.[9] Since Māori are over-represented in low paid work, underemployment and unemployment, incomes are significantly lower than for non-Māori. For this reason iwi, hapū and whānau Māori may potentially

    - prefer option 3 over option 2, as it better addresses distributional impacts; and

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[7] These included work to consider KiwiSaver recommendations of the 2019 RRIP, Capital Markets 2029 report and Prime Minister's Business Advisory Council.

[8] Māori have lower rates of membership and of contribution than non-Māori, due to being overrepresented in unemployment, underemployment and low paid work.

[9] Māori have lower rates of home ownership, higher rates of unaffordable housing, and are over-represented among the unemployed, as well as in jobs that involve lower pay, fewer skills, and fewer advancement opportunities. Māori have significantly lower net worth and life expectancy than non-Māori.

- prefer any option which is not tied to participation in paid work, over PPL based options.

Impacts for KiwiSaver providers

26. A range of individual KiwiSaver providers have publicly noted the gender retirement savings gap[10] and need to close it.[11]

27. Both options 2 and 3 may have some small implementation costs and impacts on the KiwiSaver industry, such as updating existing information and guidance on government contribution entitlements. Despite these costs, we expect the options would be supported by industry on the basis that they seek to acknowledge and partially address the gender gap in retirement savings and/or drive KiwiSaver membership and contributions. Each option would also increase KiwiSaver funds under management and industry revenue from management fees.

Overall assessment

28. Although neither option will directly address the wider issues associated with gender and retirement savings, the assessment model (above) indicates Option 2 is preferable to Option 3. Two key factors in reaching this assessment are the misalignment with the existing matched employee/employer contribution settings which would occur if Option 3 were to be implemented, as well as the significantly lower fiscal cost associated with Option 2.

29. While, as noted above, the overall impact of Option 2 is likely to be small, the proposal would nonetheless go some way toward mitigating the effect of time spent out of work for PPL recipients.

[10] ASB Media Release in 2022 (https://www.asb.co.nz/documents/media-centre/media-releases/women-better-off-day-to-day-but-miss-out-on-750-million-at-retirement.html).

[11] ANZ Dollars and Sense: A Decade of KiwiSaver (2017); ANZ, KiwiSaver Equity for Women NZIER for KiwiWealth (2022).

Discussion

Affected groups *(identify)*	**Comment** *nature of cost or benefit (eg, ongoing, one-off), evidence and assumption (eg, compliance rates), risks.*	**Impact** *$m present value where appropriate, for monetised impacts; high, medium or low for non-monetised impacts.*	**Evidence Certainty** *High, medium, or low, and explain reasoning in comment column.*
Additional costs of the preferred option compared to taking no action			
Regulated groups (PPL recipients)	None	No cost	High
Regulators (Inland Revenue)	This change will bring a small administrative cost to Inland Revenue	$0.510 million (for the forecast period 2022/23 to 2026/27).	High
Wider government	Fiscal cost to the Crown	$19.219 million (for the forecast period 2022/23 to 2026/27).	Medium – some uncertainty around behavioural change impact
KiwiSaver fund providers	May be some guidance updates required	Low	High – change will be administered using existing systems
Total monetised costs		$19.729 million (for the forecast period 2022/23 to 2026/27).	Medium
Non-monetised costs		*Low*	*High*
Additional benefits of the preferred option compared to taking no action			
Regulated groups (PPL recipients)	Small increase in savings for eligible recipients. May result in increased number of PPL recipients choosing to contribute to KiwiSaver during PPL.	$19.219 million in additional "employer" contributions (for the forecast period 2022/23 to 2026/27).	Medium – some uncertainty around behavioural change impact
Regulators (Inland Revenue)	None	No change	High
Others (KiwiSaver fund providers.)	Small increase in funds under management	Low	High
Total monetised benefits		$19.219 million (for the forecast period 2022/23 to 2026/27).	Medium
Non-monetised benefits		*Low*	*High*

Section 3: Implementation

30. Provided Cabinet agrees to progress the policy, the proposal would be introduced in the 2023-24 Annual Rates' Bill and would take effect from the 2024-25 Financial Year (i.e. from 1 July 2024). This would mean that existing PPL recipients who contribute to their KiwiSaver accounts would be eligible for a three percent government contribution on any remaining PPL payments beginning from 1 July 2024 (but not on any PPL payments received prior to 1 July 2024). By contrast, PPL recipients who begin receiving PPL after 1 July 2024 would be eligible for a three percent government contribution for the full duration of their PPL.

Section 4: Delivering an option

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

31. KiwiSaver is jointly administered by the Treasury, MBIE, and IR, and is monitored on a ongoing basis as part of the agencies' ongoing stewardship obligations, including through regulatory reviews.

32. The operation and progress of the proposal will be observed by the responsible agencies and reported on as required. Additionally, KiwiSaver settings may be considered by the Retirement Commissioner as part of a statutory review of retirement savings settings every three years, (the focus is set in the Terms of Reference issued by the Minister of Commerce and Consumer Affairs).

33. This provides an opportunity for an independent consideration of KiwiSaver's features and their success in achieving the Government's objectives.

34. The findings of external reporting frameworks which monitors the performance of pension systems around the world (such as the Mercer CFA Institute Global Pension Index) could also be considered as a method of evaluating the operation of the KiwiSaver scheme.

Coversheet: Extending tax exemption for non-resident oil rig and seismic vessel operators

This document is the 2018 RIS with updates to reflect changes since 2018. The Treasury's Regulatory Impact Analysis team has granted an exemption from producing a new RIS, conditional on a quality assurance check to ensure the updated 2018 RIS reflects any developments since it was originally produced. Inland Revenue's quality assurance panel has confirmed that the RIS is still fit for purpose. A copy of the 2018 RIS is available at: https://taxpolicy.ird.govt.nz/publications/2019/2019-ria-tax-exemption-oil-rig

Advising agencies	*Inland Revenue*
Decision sought	*Whether to extend the current income tax exemption for non-resident oil rigs and seismic vessels which is scheduled to expire on 31 December 2024*
Proposing Ministers	*Hon David Parker (Revenue)*

Summary: Problem and Proposed Approach

Problem Definition **What problem or opportunity does this proposal seek to address? Why is Government intervention required?**
There is currently an exemption from New Zealand income tax for non-resident-owned oil rigs and seismic vessel operators. The aim of this exemption is to remove a tax distortion that incentivises operators to churn[1] rigs and vessels, thereby slowing resource development, increasing operators' costs, and reducing tax and royalty revenue. This exemption was first introduced in 2004 for five years and was subsequently extended in 2009, 2014 and again in 2019. The most recent extension is due to expire on 31 December 2024. This RIA considers whether the exemption should be further extended.

Proposed Approach **How will Government intervention work to bring about the desired change? How is this the best option?**
This exemption was introduced to discourage oil rigs and seismic vessels from leaving New Zealand before 183 days to avoid being treated as a New Zealand tax resident under a double tax agreement. Extending this exemption would prevent this churning reoccurring.

[1] Having one rig leave the country and another enter to complete the work.

Section B: Summary Impacts: Benefits and costs

Who are the main expected beneficiaries and what is the nature of the expected benefit?
The main beneficiaries are petroleum prospectors, explorers and miners with New Zealand petroleum permits, and the Crown. These miners would incur lower costs and undertake greater exploration which would have flow on benefits to the New Zealand economy and tax and royalty revenue.

Where do the costs fall?
Although the exemption will theoretically make the non-resident rig and seismic vessel operators exempt from tax, in practice they were not paying New Zealand income tax anyway as they were leaving New Zealand before 183 days. If the exemption is extended, an increase in tax revenue forecasts would arise as a result of decreased tax deductions from churning. Forecast baselines include an assumption that the exemption would not be renewed. Absent that renewal, we anticipate a behavioural change toward churn of rigs and consequential reduction in tax revenue forecasts arising from the expense of that churn. Officials do not anticipate that the rigs would start paying tax if the exemption is not extended. There are also small one-off costs for regulators of extending the exemption.

What are the likely risks and unintended impacts, how significant are they and how will they be minimised or mitigated?
The proposal risks leading to increased domestic carbon emissions; however, the impact is expected to be minor, as carbon emissions from New Zealand's oil and gas production are very small. Given New Zealand's high environmental standards, the environmental footprint from developing oil, gas and mineral resources in New Zealand is likely to be less than many other countries we would otherwise source them from. As nearly all New Zealand oil is exported, increased New Zealand production will have no effect on the Government's international commitments. The proposal carries some other environmental risks, but these are low due to New Zealand's tight regulation and standards.

Identify any significant incompatibility with the Government's 'Expectations for the design of regulatory systems'.
The proposal is not incompatible with the Government's 'Expectations for the design of regulatory systems'.

Section C: Evidence certainty and quality assurance

Agency rating of evidence certainty?
There is a degree of uncertainty on the future level of petroleum exploration as this is determined by a number of factors, including the future oil price and other discoveries. However, historical comparison before and after the introduction of the exemption in 2004 provides a high degree of certainty that the policy achieves its desired goal of eliminating tax-driven rig and seismic vessel churning.

Quality Assurance Reviewing Agency:

This version of the RIS has been reviewed by Inland Revenue to ensure the analysis is still fit for purpose. The 2018 version was also reviewed by Inland Revenue.
Quality Assurance Assessment:
The Treasury's Regulatory Impact Analysis team has granted an exemption from producing a new RIS, conditional on a quality assurance check to ensure the updated 2022 RIS reflects any developments since it was originally produced. Inland Revenue's quality assurance panel has confirmed that the RIS is still fit for purpose.
Reviewer Comments and Recommendations:
This version of the RIS has been reviewed only to ensure that the analysis is still fit for purpose. The 2022 version has also been updated to respond to the updated comments from other Government agencies. The 2018 version was reviewed in 2018 and received a 'meets' rating from the Inland Revenue's QA panel.

Impact Statement: Extending tax exemption for non-resident offshore oil rig and seismic vessel operators

Section 1: General information

Purpose
Inland Revenue is solely responsible for the analysis and advice set out in this Regulatory Impact Assessment, except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing final decisions to proceed with a policy change to be taken by Cabinet.

Key Limitations or Constraints on Analysis
A constraint affecting the consideration of the options is that of time – the existing tax exemption expires at the end of 2024. Accordingly, any extension of the exemption should be enacted before the end of 2024. A limitation concerning the analysis is that there is some degree of uncertainty regarding the behaviour of rig operators if the exemption were to be removed. This affects our ability to reliably estimate the fiscal impacts of removing the exemption. However, MBIE's best judgement (based on the rig operators' behaviour before the introduction of the exemption) is that if the exemption was removed, rig operators are likely to modify their behaviour and begin churning again.
Responsible Manager (signature and date):
s 9(2)(a) Chris Gillion Policy Lead Policy and Strategy Inland Revenue 10 November 2022

Section 2: Problem definition and objectives

2.1 What is the context within which action is proposed?

Seismic vessels are used to gather data on potential oil and gas finds, and rigs are used to drill for oil and gas, in the exploration and development stages of petroleum mining. These are very specialist and expensive pieces of equipment that are owned by businesses that specialise in providing these services to petroleum miners who have permits for a specific area. These rigs and vessels do not generally work offshore in winter weather for health and safety reasons.

While there is a worldwide industry in rigs and seismic vessels, no New Zealand companies own these assets, so any company seeking to explore natural resources in New Zealand waters needs to use a rig or seismic vessel provided by a non-resident owner.

Offshore rigs and seismic vessels owned by non-residents are covered by an income tax exemption that is due to expire on 31 December 2024.

Wells generally take between 30 and 90 days to drill and there is significant cost in bringing a rig or vessel to and from New Zealand. Because of this, operators often align their plans in order to conduct their work using the same rig or vessel in the same summer period. There is usually a programme of work that forms the core activities of the rig or vessel, and then there may be opportunistic wells or surveys added because the rig or vessel is already coming. These opportunistic wells or surveys are at particular risk from the expiry of the existing exemption as completing these could result in the rig or vessel being in New Zealand long enough to become a New Zealand tax resident and therefore taxable on income derived from exploration and development activities in New Zealand waters, including from already completed contracts for core activities. In the absence of an exemption these operators leave New Zealand before this time to prevent a New Zealand income tax liability arising.

Since 2018, when the exemption was last extended, there have been a total of two offshore non-resident drilling rigs, spending 313 and 226 days in the country each and 14 wells have been drilled. By contrast, between 2000 and 2005 (before the exemption was introduced), no rigs stayed in New Zealand waters beyond six months.

Thirteen seismic vessels have operated in New Zealand since 2009, of which one stayed over 183 days. Before 2005, the average length of stay was around four months. Maintaining the exemption removes a barrier for lengthier stays (which have been fewer but are typically more lucrative).

There have been 80 offshore wells drilled since 1 January 2009. Twenty-three of these wells have been exploratory in nature, with some hosting sub-commercial discoveries. All of these efforts, successful or not, improve our knowledge of the Crown mineral estate, which is critical to making economic discoveries. A substantial discovery has the potential to significantly benefit the economy and the Government's fiscal position by way of direct economic benefits, royalties, increased tax revenue, and other indirect benefits (e.g. supporting goods and services and consumption).

It is likely that a number of wells would not have been drilled without the tax exemption, as the application of income tax would likely have created too large a barrier (due to the high

cost of mobilisation and demobilisation and the associated delays caused) for discretionary wells. Mobilisation and demobilisation costs can exceed $750,000 per day and, depending on where the rig comes from, the transition time and associated cost can be significant and in the order of $17-35 million[2].

Extending the exemption is likely to ensure oil and gas prospecting, exploration and production is not impeded compared with letting the exemption expire. This increases the chance of successful discoveries and consequentially oil and gas production, which increases economic development activity, and tax and royalty revenue. Increased oil and gas production could result in an increase in carbon emissions. However, given New Zealand's high environmental standards, the environmental footprint from developing oil, gas and mineral resources in New Zealand is likely to be less than many other countries we would otherwise source them from. Therefore, from a global emissions perspective, developing some of these resources in New Zealand could provide better environmental outcomes.

In the context of climate change, gas is internationally recognised as a transition fuel. In particular, natural gas emits 50 to 60 percent less carbon dioxide than coal when used to generate electricity. Thus, gas could play a role in New Zealand meeting its climate commitments in the short-term.

Furthermore, New Zealand's gas reserves are only sufficient to cover a decade of annual gas demand at current demand levels. To prevent the situation of gas reserve depletion interrupting our energy supply, new sources of gas would need to be found within the next few years. This could be by way of new gas finds, or extension of existing fields, but either of these would involve some lead-time to production.

2.2 What regulatory system, or systems, are already in place?

New Zealand generally taxes non-residents on income that has a source in New Zealand. However, our double tax agreements (DTAs) provide that non-residents are only taxable on their New Zealand-sourced business profits if they have a "permanent establishment" in New Zealand. Many of our DTAs (such as the New Zealand/United States DTA) have a specific rule providing that a non-resident enterprise involved in exploring for natural resources only has a permanent establishment in New Zealand if they are present for a particular period of time, often 183 days in a year. Once a non-resident has a permanent establishment in New Zealand, they are taxed on all their New Zealand business profits starting from their first day in New Zealand. While this 183 day rule does not apply outside of DTAs, in practice, no rigs or seismic vessels come from non-DTA countries.

Ordinarily, a broad-base, low-rate framework applies to the tax system. A consistent application of this framework will normally minimise any distortions caused by tax rules. However, with seismic vessels and rigs used for exploration and development work, the normal tax rules do not provide the right outcome.

The exemption was introduced to address an issue caused by this DTA provision – rigs and seismic vessels used in petroleum exploration and development were leaving New Zealand waters before the 183 day threshold was reached to avoid being subject to New Zealand tax.

[2] This increase since the previous RIS is a combination of increased costs and changes in the USD/NZD exchange rate.

This meant that rigs and vessels would leave before 183 days and a different rig or vessel was mobilised to complete the exploration programme, if it was completed. This increased the cost for companies engaged in exploration and delayed exploration drilling and any subsequent discovery of oil or gas. It also meant that there was no income tax collected from owners of rigs and seismic vessels. Because of the limited supply of offshore drilling rigs, it could also result in exploration activity not taking place when it otherwise would.

2.3 What is the policy problem or opportunity?

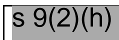
If the status quo is maintained (i.e. the temporary exemption is left to lapse at the end of 2024), it is likely that rigs and seismic vessels would resume leaving New Zealand waters before 183 days, so that the operators are not subject to tax. This would mean that the cost of offshore exploration and development activity would increase for New Zealand companies that engage offshore rig and seismic vessel services, as a new rig would have to be engaged to continue exploration and development work. Mobilising and demobilising such rigs has a cost of around $17-35 million per rig. This would have flow-on effects for tax revenue, as the cost would be deductible to the New Zealand company. The churn would also cause a delay in any potential revenue from successful exploration and development activity, which would have an impact on the present value of royalties received. However, this would be partially offset by the delay in the deductions associated with that additional exploration and development activity.

The underlying cause of the problem is that the normal tax rules increase costs for business by creating an incentive for seismic vessels and rigs to “churn”, that is, move in and out of New Zealand waters within a 183-day period where income is exempt under many of our DTAs.

2.4 Are there any constraints on the scope for decision making?

It is not possible to efficiently resolve this issue by renegotiating New Zealand’s DTAs. These DTAs are part of an international framework and it is not feasible to alter this particular article, particularly given this would require renegotiation of each of the DTAs which New Zealand is currently party to and would be dependent on our treaty partners being agreeable to such a change.

s 9(2)(h)



2.5 What do stakeholders think?

Targeted consultation has been undertaken with the oil and gas industry representative body, Energy Resources Aotearoa (ERA), which supports making the exemption permanent.

The Treasury, Ministry of Business, Innovation and Employment, Ministry of Foreign Affairs and Trade and the Ministry for the Environment support extending the exemption for a further five years to balance the need for business certainty while leaving scope for future changes at a time when tax and environmental policy is evolving.

The Treasury's view is that the exemption is not consistent with New Zealand's broad-based low-rate tax strategy, and that our tax system does not generally make accommodations for behavioural responses. Further, the environmental and energy policy context is changing. However, the Treasury concurs there are likely benefits from reduced churn, which is associated with wasteful consumption and unnecessary costs, and notes that no feasible alternatives have been identified that would address the issue in the near term. The Treasury considers the implications of permanently extending or not extending the exemption are difficult to assess while the policy landscape is changing and without a forward-looking view of exploration activity. In the Treasury's view, a five-year extension would address churn in the near term and enable the effectiveness and impacts of the exemption to be monitored as the environmental energy policy context evolves, including the development of the Energy Strategy and Gas Transition Plan. The Treasury suggests that, if an extension of the exemption is agreed, further analysis of the ongoing rationale, effectiveness and impacts of the exemption be undertaken to inform future decisions, including a forward-looking view of offshore exploration activity, alignment with environmental and energy strategy, international obligations, and alternative policy levers.

Section 3: Options identification

3.1 What options are available to address the problem?

Three options have been considered:

- **Option 1 – Status quo:** Do not extend the exemption. The current exemption will expire on 31 December 2024. After this date non-resident oil rig and seismic vessel operators will be subject to New Zealand income tax from the day they arrive if they are present in New Zealand for at least 183 days.
- **Option 2 – Temporary exemption:** Extend the current exemption for a further five years.
- **Option 3 – Permanent exemption:** Remove the expiry date from the current exemption so it applies permanently.

Both options 2 and 3 address the problem by effectively removing the 183 day test so that non-resident operators do not face an incentive to churn rigs and vessels by leaving New Zealand prior to 183 days.

These options are mutually exclusive and are the same options considered when the exemption has previously been due to expire in 2009, 2014 and 2019. No non-regulatory options are possible as the liability for income tax is determined through legislation.

Option 2 and option 3 are both unique to New Zealand. Officials are not aware of any other country having a similar exemption due to a combination of factors, such as: not having an offshore petroleum industry; having a sufficiently large market to have domestic owned rig and seismic vessel operators; being closer to other countries, so that mobilisation costs are much lower; and having different wording in their applicable DTAs, so that the 183 day threshold does not apply.

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 options have been assessed against the following criteria:

1. **Economic efficiency and neutrality** – The tax rules should generate funding for Government expenditure rather than influence whether a rig or seismic vessel remains in New Zealand. The use of tax instruments to implement non-tax outcomes should be approached with caution. The level of oil and gas exploration and development activity should be determined by what is economically efficient in conjunction with wider Government policies, and not by unintended consequences of tax rules.
2. **Certainty of tax treatment** – The tax rules should provide certainty of tax treatment.
3. **Administration costs** – Administration costs should be minimised as far as possible. In addition to costs arising to government agencies under the option, this includes policy and law-making costs.
4. **Compliance costs** – Compliance costs should be minimised as far as possible.

Criterion one is the most important as tax should not be influencing petroleum miners' decisions to act in ways that are economically inefficient, and care should be taken before using tax rules to implement non-tax policies, where other more direct, and transparent measures may be available.

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

Renegotiating New Zealand's DTAs to increase or reduce the number of days an operator can be in New Zealand without becoming a tax resident was not within scope. This would require individual renegotiation with each of New Zealand's treaty partners and would be inconsistent with international norms. This could not be achieved before expiry of the current exemption if it could be achieved at all, therefore this option is considered impractical.

Section 4: Impact Analysis

Marginal impact: How does each of the options identified at section 3.1 compare with the counterfactual, under each of the criteria set out in section 3.2?

	Status Quo – Letting exemption expire	Option 2 – Temporary exemption	Option 3 – Permanent exemption
Efficiency/neutrality	0	++ An exemption will prevent tax rules incentivising operators to leave New Zealand prior to 183 days. The level of exploration and development will be determined by the market and specific Government policies rather than an unintended consequence of tax rules. Petroleum miners able to coordinate rigs and seismic vessels and incur lower planning costs, thus improving efficiency.	++ As with the temporary exemption.
Certainty	0	+ Petroleum miners and operators will have certainty of tax treatment for a 5-year planning horizon.	++ As with the temporary exemption, with the benefit of additional certainty for petroleum miners and operators planning beyond the expiry of a temporary exemption.
Compliance costs	0	+ No impact on tax compliance costs (as no tax obligation on operators with or without exemption) but reduction in costs of complying with other Government regulation for operators and petroleum miners.	++ As with the temporary exemption, with the benefit of less compliance costs for exploration and development near to expiry of a temporary exemption.
Administration costs	0	+ Consistent with current (pre-December 2024) treatment, so less update needed to internal and external knowledge bases and other guides.	++ As with the temporary exemption, as well as removing need for further update when the temporary exemption expired, and only one-off policy and law-making costs.
Overall assessment	0	++ This option is significantly better than the status quo, as tax will not be an impediment to operators acting in an efficient manner. This option will not impose any additional costs on government or taxpayers. However, it is not the preferred option as it creates less certainty for taxpayers and imposes costs on officials, Parliament and stakeholders in reconsidering the exemption each time it expires.	++ This is the preferred option. It has all the benefits of option 2 with the additional benefits of providing greater certainty for stakeholders and fewer administration costs as a result of not needing to periodically renew the exemption.

Key:

++ 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

Section 5: Conclusions

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

Having an exemption beyond 31 December 2024 is significantly better than letting the exemption lapse and Inland Revenue recommend that this exemption is permanent rather than for a further five year period. As these rigs are planned well in advance, the additional certainty of a permanent exemption is supported by the petroleum industry.

An exemption removes a tax distortion that results in economically inefficient outcomes, and imposes no ongoing revenue cost to the Government, while negative environmental impacts are expected to be low. Removing the churn of oil rigs and seismic vessels has a number of benefits, including:

- opportunistic exploration not being hindered by the lack of availability of rigs and vessels;
- additional exploration increasing petroleum miners' and the Government's knowledge of the mineral estate;
- reduced costs of petroleum exploration and development resulting in higher revenue from taxes and royalties;
- increased domestic emissions from more production (but noting some reduction in carbon emissions as a result of fewer rigs and vessels travelling to and from New Zealand); and
- rigs and vessels may stay in New Zealand beyond 183 days for repairs and maintenance which would increase output of supporting industries.

There is a high degree of confidence in the assumptions and evidence used in this RIA as this exemption is already in place and data before and after its introduction can be compared.

Making the exemption permanent will significantly reduce the policy and parliamentary resources required to be dedicated to this issue.

Although the exemption has been in place since 2004, fiscal forecasts do not include the ongoing impact of this exemption beyond 2024. If the exemption is extended reduced churn costs would result in forecast tax revenue increasing by approximately $4.5m per year.

Inland Revenue notes the concerns other Government agencies have regarding making the exemption permanent given the evolving environmental policy and international law and the view that providing a further temporary exemption would provide greater flexibility. However, we consider that a permanent exemption is still preferable as:

- Churning rigs due to tax settings will always be inefficient and no suitable alternative has been identified since the exemption was first introduced. The only situation where Inland Revenue expects the exemption would not be the preferred tax response is if NZ's petroleum production industry becomes sufficiently small that all work for a season can be done within 183 days so there is no need to churn; however, in this circumstance the exemption would be ineffective rather than inappropriate.

- While New Zealand is attempting to transition from fossil fuels and will not issue new offshore petroleum exploration permits there continues to be an offshore petroleum industry and that industry, while it exists, will always be reliant on non-resident rigs and seismic vessels. New Zealand does not have a policy to actively disincentivise, or prevent, petroleum production and even if it was to do so in the future there would be more efficient measures to achieve this than a policy that inadvertently encourages churn.
- There is no expectation that tax legislation will remain constant. If a decision was made in the future to end this exemption the Government has regular tax omnibus bills and could repeal the provision in a shorter time than leaving the remaining time of a 5-year exemption to expire. While we have not attempted to quantify the cost, the administrative and parliamentary costs of a future repeal would be the same, or likely lower, than the cost of a single 5-year extension.

5.2 Summary table of costs and benefits of the preferred approach

Affected parties	Comment:	Impact	Evidence certainty
Additional costs of proposed approach, compared to taking no action			
Regulators	One-off cost of officials' and parliamentary resources required to extend the exemption	Low	High
Wider government	Assumed that operators would churn rigs and vessels to avoid a New Zealand tax liability, in the absence of an exemption, so no expected revenue cost	$0	High
Other parties	Environmental impacts of increased petroleum exploration and production	Low (refer to explanation in section 2.1)	Medium
Total Monetised Cost		$0	High
Non-monetised costs		Low	Medium
Expected benefits of proposed approach, compared to taking no action			
Regulated parties	Ongoing reduction in costs to petroleum miners of rigs and seismic vessels being churned Reduced health and safety risks from reduced churn	$17-35m per rig (assumed to be one per two years). Low	Medium Medium
Regulators	Reduced costs to update tax guidance	Low	High
Wider government	Increased tax revenue from petroleum miners due to reduced deductions for exploration costs	$4.5m per year	Medium
Other parties	Increased economic activity due to increased presence of rigs and seismic vessels	Medium	Medium
Total Monetised Benefit		$17-35m per two years	Medium
Non-monetised benefits		Medium	Medium

5.3 What other impacts is this approach likely to have?
The preferred approach is likely to increase oil and gas exploration and development (or not decrease it) compared with the status quo. This increases the chance of successful discoveries and consequentially increased oil and gas production, which increases economic development activity, tax revenue and royalties. Increased oil and gas production risks increasing carbon emissions. However, nearly all of New Zealand oil production is exported, so this increased production would have no effect on the Government's international commitments. Officials consider the impact of increased carbon emissions would be minor as the production in New Zealand of oil and gas has very little impact on consumption of oil and gas and, relative to international output, New Zealand production is so small that increases in production will not affect the world price. Other environmental risks are also low due to New Zealand's tight regulation and standards which have seen over 200 offshore wells drilled since the 1960s without a significant incident. As New Zealand is a net importer of oil, any increase in domestic production is likely to reduce the balance of payments deficit.

5.4 Is the preferred option compatible with the Government's 'Expectations for the design of regulatory systems'?
The preferred option is not incompatible with the Government's 'Expectations for the design of regulatory systems'.

Section 6: Implementation and operation

6.1 How will the new arrangements work in practice?
The preferred option would involve amendments to the Income Tax Act 2007 to remove the 31 December 2024 expiry date. This would continue the operation of the exemption, broadly as it has applied since 2004. As with other legislative changes this would be signalled in a *Tax Information Bulletin* shortly after the enactment of the bill containing the proposals as well as other documents published throughout the parliamentary process. Owing to the high mobilisation costs, the schedules for rigs and seismic vessels are frequently planned well in advance of the rig or vessel arriving in New Zealand. Thus, the industry would welcome timely advice of a Cabinet decision on the exemption. Cabinet approval of the preferred option would allow the necessary legislative changes to be included in the upcoming tax omnibus bill which is expected to be enacted in 2023. A press release is intended to be released after the Cabinet decision.

6.2 What are the implementation risks?
There are no risks with implementing a temporary or permanent exemption as this would be effectively continuing the law as it has applied since 2004. If there are delays in announcing an extension of the exemption and inclusion in a bill, or if the Government decides not to extend the exemption, this risks creating uncertainty in the market which could result in reduced operation of non-resident rigs and seismic vessels in New Zealand. If the preferred option is supported by Cabinet but not included in the upcoming bill there may not be a suitable tax bill enacted before the end of 2024 that could include this amendment.

Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?
MBIE monitors the number and duration of rigs and seismic vessels operating in New Zealand. Comparison of behaviour prior to and after the 2004 introduction of the exemption suggests that the exemption is successful in removing the incentive to leave New Zealand prior to 183 days. As the exemption is in place now, if extended we do not expect any change in behaviour.

7.2 When and how will the new arrangements be reviewed?
MBIE will continue to monitor the petroleum mining sector more generally. As the exemption has been working as intended since 2004, if the exemption is permanently extended it is not anticipated that further review will be necessary which will reduce administration costs compared with a temporary exemption, and reduce compliance costs compared with letting the exemption expire. Inland Revenue and MBIE have ongoing interaction with the petroleum mining sector which will provide that sector with the ability to raise concerns in the unlikely event they arise.