Inland Revenue
Te Tari Taake

POLICY ADVICE DIVISION

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: Cabinet Committee Paper – Temporary exemption from tax on foreign income for new migrants and certain returning New Zealanders

Date:	8 February 2005	**Priority:**	High
Security Level:	Budget Secret	**Report No:**	T2005/195 PAD2005/28

Action sought

	Action Sought	**Deadline**
Minister of Finance and Revenue	**Sign** and **refer** the attached paper to the Economic Development Committee	10am, Thursday 10 February 2005
Associate Minister of Finance (Hon Trevor Mallard)	None	None
Associate Minister of Finance and Revenue (Hon David Cunliffe)	None	None

Contact for telephone discussion (if required)

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8 February 2005

Minister of Finance and Revenue
cc: Associate Minister of Finance (Hon Trevor Mallard)
Associate Minister of Finance and Revenue (Hon David Cunliffe)

Cabinet Committee Paper – Temporary exemption from tax on foreign income for new migrants and certain returning New Zealanders

Attached for your consideration is a memorandum to the Economic Development Committee for consideration at its meeting on Wednesday 16 February 2005.

Following report PAD 2004/086, T2004/850 dated 20 May 2004 this paper seeks the committee's approval to include in the next tax bill scheduled for introduction in May 2005, amendments to the Income Tax Act 2004, resulting from the discussion document *Reducing tax barriers to international recruitment to New Zealand.* Namely a "two-tiered" exemption from tax on all foreign-sourced income (except dividends, interest, offshore employment income and business income relating to services performed offshore). The first tier would be a five-year exemption for employees who have not been resident in New Zealand for at least ten years. The second tier would be a three-year exemption for all new migrants and returning New Zealanders who have not been resident in New Zealand for at least ten years

Recommended action

It is recommended that you **sign** the attached paper and **refer** it to the Cabinet Economic Development Committee by 10am Thursday 10 February 2005.

Brock Jera
for Secretary to the Treasury

Carmel Peters
Manager, Business and International Tax
Policy Advice Division
Inland Revenue Department

Signed and Referred

Hon Dr Michael Cullen
Minister of Finance and Revenue

OFFICE OF THE MINISTER OF FINANCE
AND MINISTER OF REVENUE

The Chair
Cabinet Economic Development Committee

TEMPORARY EXEMPTION FROM TAX ON FOREIGN INCOME FOR NEW MIGRANTS AND CERTAIN RETURNING NEW ZEALANDERS

PROPOSAL

1. This paper seeks the Committee's approval to amend the income tax legislation to allow a temporary exemption from foreign income (except dividends, interest, employment income and business income relating to services performed offshore) for people who are new migrants, or have not been resident in New Zealand for at least ten years. (In this report references to "residence" or "residents" means residence for tax purposes.)

2. Following consultation, I am recommending the introduction of a two-tiered exemption. The first tier would be a five-year exemption for employees and the second tier would be a three-year exemption for all new migrants. In both cases the exemption would be from foreign income except dividends, interest and services income. To qualify the individual must not have been resident in New Zealand for at least ten years. I propose that these amendments be introduced in the next tax bill currently scheduled for May 2005.

EXECUTIVE SUMMARY

3. On 11 November 2003 the Government released the tax policy discussion document *Reducing tax barriers to international recruitment to New Zealand.* Generally, submissions welcomed the proposal of a temporary exemption from tax on foreign income for individuals coming to work in New Zealand. Submissions said that New Zealand's comprehensive international tax rules create a barrier to potential migrants and impose additional costs on New Zealand business.

4. Submissions were in favour of a proposal that was simple to comply with and would send a powerful signal internationally. Many submissions also stated that, to be effective, the exemption would need to apply for a minimum of five years.

5. After further consideration I have concluded that the best approach would be to provide a five-year exemption to employees from tax on all foreign income except dividends, interest, employment income and business income relating to services performed offshore. This would eliminate those taxes which are generally passed on to New Zealand employers and temporarily relieve migrants of the burden of the most compliance cost intensive aspects of returning foreign income in New Zealand. New migrants would continue to be taxed on New Zealand sourced income.

6. Submissions were also concerned that the proposal fell short of its objectives by not allowing the exemption to extend to independent contractors, and entrepreneurs. I am sympathetic to these concerns because many independent contractors perform services that are analogous to a contract of employment.

7. It is very difficult to target only those independent contractors that are analogous to employees, as opposed to entrepreneurs for example. Any form of legislative boundary can be structured around (even by persons who are essentially retirees) and difficult to enforce. Consequently, my preference is to provide a short period of exemption of three years for all new migrants who have not been resident in New Zealand for at least ten years. The cost of extending a short exemption to all new migrants should be outweighed by the benefits of extending the relief to independent contractors and by a reduction in compliance costs.

8. Most submissions commended the Government for including those returning New Zealanders who have been away from New Zealand for an extended period. Some thought the requirement of a ten year period of non-residency was too harsh while others strongly supported it. I disagree that the ten year period is too harsh. It is critical that the proposed relief is targeted at bringing successful New Zealanders living overseas back to New Zealand rather than encouraging them to move offshore to access the relief provided by the proposed reform. I believe that the proposed ten-year requirement meets that test.

9. Finally, I do not believe that an individual should be able to claim a tax exemption on the one hand, and at the same time be receiving financial help from the Government in the form of family assistance payments. I therefore recommend that if an individual has a certificate of exemption they should not be eligible to receive family assistance payments.

10. These proposals give rise to a fiscal cost. This cost arises because tax would no longer be imposed on those migrants who would have come to New Zealand in the absence of the exemption. The fiscal cost of package is estimated to be in the order of $10 - 13 million per annum. The inclusion of retirees is not expected to represent a significant portion of these costs. However, these costings do not take account of any gain to the economy, of the increase in productivity resulting from improved access to skilled migrants for New Zealand business and the potential increase in the free-flow of executives between Australia and New Zealand.

11. These proposals also give rise to administrative costs associated with administering, monitoring the exemption and informing new migrants of the application of the exemption. The one-off total administrative cost of this proposal is estimated at $1.1 million (GST inclusive), with ongoing operating costs estimated at $330,000 in 2006/2007 and out-years. Additional funding is required to fund this administrative cost.

BACKGROUND

12. In 2001 the Tax Review recommended in its *Final Report* that individuals with no previous connection to New Zealand who are resident for tax purposes should be taxed only on their New Zealand sourced income for the first seven years.

13. The Government discussion document *Reducing tax barriers to international recruitment to New Zealand* was released on 11 November 2003. It proposed that an exemption be provided for new migrants and expatriates who come to work in New Zealand. The central aim of the proposal is to reduce the costs to New Zealand businesses associated with recruiting highly skilled, mobile individuals

14. The discussion document advanced two potential options for an exemption for migrant employees:

- A seven-year exemption from the most comprehensive aspects of our international tax rules, including the controlled foreign company rules (CFC), the foreign investment fund rules (FIF), accrual rules, non-resident withholding tax and approved issuer levy, and possibly trust rules and share option rules (the narrow option);
- A three-year exemption from all foreign income of any description (the broad option).

15. Fifteen submissions were received on the proposals in the discussion document. The specific issues raised in submissions are detailed below.

COMMENT

Should the Government introduce an exemption?

16. General concerns were raised in submissions. One submission considered that the extent of the tax problem had not been satisfactorily identified and called for more compelling theoretical and empirical analysis. Another opposed the proposals on equity grounds stating that an exemption would be inconsistent with New Zealand's historically egalitarian tax system. A concern was also raised that the proposal would act as an incentive for New Zealand tax residents to move overseas to further their careers.

17. However, most submissions favoured an exemption because it would have the effect of removing barriers to international recruitment and reducing costs to local businesses. On this basis I conclude that an exemption from foreign income for new migrants who come to work in New Zealand is desirable.

The broad option versus the narrow option

18. Most submissions, favoured the broad option on the basis that it has the advantage of being extremely simple and eliminating all taxpayers' compliance costs. They also consider that the broad option would send a stronger signal internationally, is likely to be more marketable to those in the mobile workforce, and more successful in reducing the tax costs to New Zealand businesses. Furthermore, it should make New Zealand a comparatively more attractive destination for potential employees with specialised skills and experience.

19. Their concern with the narrow option is that affected individuals could restructure their affairs to avoid taxation. This need to restructure would in itself become a disincentive to coming to New Zealand. It was argued that the narrow option would provide an exemption from a complex set of international tax rules and, as such, the benefits of the exemption are unlikely to be understood or appreciated by potential foreign employees.

20. Submissions also noted that the broad exemption mirrors the exemption for non-domiciled persons in the United Kingdom. It is also in line with the proposal for a migrants' exemption, by the Australian Government, that may be reviewed following its re-election.

21. Many submissions stated that to be workable, however, the exemption would need to apply for a minimum of five years. This is because the majority of migrant employees take up employment contracts with a time span of three to five years. This view is supported by data collected by the Department of Labour (New Zealand Immigration Service) *Longitudinal Immigration Survey: New Zealand* (LisNZ) pilot survey.[1]

[1] LisNZ has collected data on the experiences of migrants in New Zealand. In terms of employment and income, the LisNZ pilot survey reveals that of Skilled/Business Stream principal applicants surveyed 18 months after taking up residence in New Zealand, 52 percent had only one job

22. A few submissions favoured the narrow option primarily because they prefer the longer seven year period of exemption. They believe that migrant employees frequently come on a three or four year contract and then seek to extend their stay, giving rise to unexpected tax consequences. Another said that the narrow option is more equitable that the broad option.

23. Submissions on both options have considerable merit. The rationale behind the narrow option, from a policy perspective, is to ensure that new migrants are not disadvantaged by coming to New Zealand relative to other jurisdictions. By contrast, the broad option would eliminate all foreign taxes and make New Zealand more attractive than other jurisdictions (except the United Kingdom and Hong Kong). In other words, it appears to be more of a tax incentive.

24. I recommend that the best approach would be to provide a five-year exemption to employees from tax on all foreign income except dividends, interest, employment income and business income relating to services performed offshore. This would eliminate those taxes which are generally passed on to New Zealand employers and temporarily relieve migrants of the burden of the most compliance cost intensive aspects of returning foreign income in New Zealand. New migrants would continue to be taxed on New Zealand sourced income.

25. The reason for continuing to tax dividends and interest is that these are items of income on which people in most countries expect to pay tax. The reason for continuing to tax income from services is to prevent New Zealand sourced income from being recharacterised as foreign sourced income.

26. I suggest that the time limit for the exemption be set at five years. This reflects the weight of submissions that suggested that three years was simply too short to achieve the desired aims of the proposal. Because the scope of the proposal is wider than the narrow option I do not think it necessary to provide the exemption for seven years. In fact, I have a general concern that any exemption on foreign sourced income will encourage taxpayers to disguise onshore income as offshore income. I am concerned to keep the period of exemption as short as practicable to minimise this risk.

Extension of the exemption to independent contractors and others

27. Submissions argued that independent contractors are widely used in New Zealand especially where specialist skills are not available locally. Consequently, drawing a line between employees and non-employees is arbitrary. Moreover, discouraging independent contractors from coming to New Zealand has the same negative economic and labour market consequences for New Zealand as in the employment context.

28. Conceptually I accept that there is a case for extending the exemption to independent contractors. That is, I expect that some independent contractors in contractual relationships that are broadly analogous to employment also explicitly, or implicitly, gross up their fee to compensate for New Zealand taxes on foreign-sourced income. This results in the New Zealand business having to pay more for the services provided by the

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in New Zealand. The Department of Labour advises that applicants for residence under the new Skilled Migrant Category, for example, are expected to hold a job offer for "ongoing employment". (This is defined as employment with a single employer for at least twelve months; or a contract basis where the applicant has one or more contracts totalling at least twelve months and has provided evidence of an employment history that includes at least two years of contract work.) For persons on a temporary permit, the maximum period of time for which they may be granted a temporary work visa or permit is three years. Renewals for a further period of time are possible, depending on the circumstances.

contractor. Furthermore some independent contractors will be deterred from working in New Zealand because of the tax impost and the associated compliance costs of New Zealand's comprehensive regime. In these cases, New Zealand business may end up with the second best candidate, which also represents a cost to those businesses.

29. On the other hand other independent contractors or entrepreneurs, particularly those in the business of providing services to multiple clients (such as consultants and professionals), may not gross up for these New Zealand taxes because they are exploiting a local opportunity, extracting economic rents, and are consequently less sensitive to New Zealand taxes on foreign income.

30. The problem is that it is very difficult to target only those independent contractors that are analogous to employees. Officials have considered whether it would be possible to devise legislative boundaries to limit the scope of the exemption. However, these types of boundaries can be structured around (even by persons who are essentially retirees) and are difficult to enforce. Moreover, they can produce arbitrary results for taxpayers.

31. I have concluded that in order to include independent contractors, it is desirable that this is achieved by extending the proposal to all new migrants. My preference is to provide a short period of exemption of three years for all new migrants who have not been resident in New Zealand for at least ten years (as long as they meet immigration criteria). This would provide genuine independent contractors with relief from our international tax rules for the period they are in the country. (A shorter period for independent contractors is justified because the term of their contracts will generally be shorter than that of an employment contract.) However, by extending the proposal in this manner, the exemption will potentially also be available to migrants and returning New Zealanders who are outside the target group of highly skilled migrants.

32. At first glance, it may seem excessive to extend the exemption to all new migrants merely to ensure relief is provided to those independent contractors in our preferred target group. The key issue at hand is whether the extension of the exemption to all new migrants (albeit for only three years), would mean that the exemption, as a whole, would be perceived as inequitable by providing special tax advantages to a favoured group of people (migrants). This is a matter of judgment. On balance, I believe that such a measure is sustainable because:

- Similar, or even more generous exemptions, have proven sustainable in other countries (for example, the United Kingdom).
- The express purpose of the reform is to eliminate a tax that is actually borne by New Zealanders.
- Unlike New Zealanders, new migrants have made their investment decisions without regard to New Zealand tax. In effect, the exemption is targeted at offshore income that New Zealanders normally would not have, for example, non-grey list investments and accrued gains on foreign debt (eg foreign mortgages).
- Offshore interest and dividends which New Zealanders are taxed on will also be taxed in the hands of new migrants.
- It would replace specific exemptions currently in the FIF rules and accrual rules which provide limited temporary relief for all new migrants from compliance with those rules. Consistent with those existing rules, this proposal would provide new migrants with sufficient time to organise their offshore investments in light of New Zealand's comprehensive international tax rules.

33. Extending the exemption to all new migrants also addresses some miscellaneous issues associated with the employee exemption that became apparent during consultation. The most important of these relates to the spouses of new migrants. The concern is that if they do not get some relief then the tax position of spouses will adversely affect the decisions prospective migrant employees would otherwise make. These issues are discussed in further detail below.

Including returning New Zealanders in the scope of the exemption

34. Most submissions commended the Government for including returning New Zealanders in the proposal. I believe that the exemptions should extend to returning New Zealanders who have been absent from New Zealand for a *significant* period of time. Anecdotal evidence suggests that these individuals are as sensitive to New Zealand taxes as new migrants in making their decision about where to seek future employment. Further, there may be some additional advantages in attracting mobile New Zealanders because of their familiarity with New Zealand culture and business practices.

35. Many submissions believed that the ten-year period of non-residency requirement is too harsh and should be reduced to say seven years, while others strongly supported it. They said that if the period was too short it could act as an inducement for New Zealanders to leave New Zealand and for those offshore contemplating a return to postpone their return for a little longer in order to qualify for the exemption. Conversely, one submission was concerned that imposing **any** qualifying period could entice talented New Zealanders to leave for the qualifying period and encourage those already overseas to stay away longer than they necessarily would.

36. I do not agree with those submissions that suggest that the period of non-residence should be reduced. It is critical to have robust rules restricting the extent to which prior New Zealand residents can access the relief provided by the exemption. The aim of the proposal is to target those New Zealanders who have emigrated from New Zealand on a permanent basis and have, therefore, become as sensitive as a new migrant to New Zealand's taxes on foreign-sourced income.

37. Moreover, it is a fundamental tenet of our tax system that New Zealand residents are taxable on their worldwide income. Rules relating to returning New Zealand residents that are too limited or too relaxed could undermine the integrity of the tax system and ultimately pose a risk to the domestic tax base. Accordingly, I support retention of the ten-year non-residence rule proposed in the discussion document. I acknowledge that from time to time this may produce a result that seems arbitrary in a particular case. However, a strict rule will enhance perceptions of equity in the long run.

Extending the employee exemption to spouses and children

38. The discussion document proposed that the employee exemption be available for a spouse of a person who met the employee exemption requirements.

39. Submissions argued that:

- The exemption should extend to defacto relationships.
- The exemption should extend to spouses, children and parents.

- The exemption should continue to apply for the duration of the original exemption. Some submissions also stated that the proposal does not consider the impact of dissolution of a relationship and the Property (Relationships) Act 1976.
- In addition, one submission said that the exemption should apply to both the worker and the spouse, if either the worker or the spouse is a first-time resident or an eligible returner, and the work test is satisfied by either spouse as opposed to the employee spouse.

40. It is intended that the employee exemption would apply to defacto relationships.

41. I agree that the five-year exemption should extend to dependent children of the employee, regardless of whether or not they have been non-resident in New Zealand for the ten-year period.

42. However, I believe that the spouse and parents of an eligible employee should be only eligible for the three-year exemption, provided that they had been non-resident for at least ten years. (Of course, either might qualify for the employee exemption on his or her own account.) I do not consider that it is desirable to make any further special rules for spouses and parents because of the scope for manipulation and abuse.

43. I also believe that, in order to qualify for the employment exemption, the relevant *employee* must meet the ten year non-residence rule. This is consistent with the aim of the proposal, which is to reduce the costs to New Zealand business of employing skilled, mobile employees. It should also reduce the potential for manipulation and abuse.

Qualifying for the "employee exemption"

44. The discussion document proposed that people must either be in full-time employment or earn a minimum of $70,000 in part-time employment. The key issues raised by submissions were:

- whether there should be exceptions to the "work test" when the work test is breached owing to circumstances beyond an employee's control (such as redundancy or failure to find work);
- whether the threshold of $70,000 for part-time employees is too high, particularly if there is no adjustment for part-year earnings for people arriving part way through the year;
- whether the requirement that the employee not be associated with the company employing him or her is an unnecessary restriction that will be a disincentive to business people.

45. As a general comment, I note that the original proposal in the discussion document did not contain a general three-year exemption. Extending the exemption to all new migrants for three years would alleviate some of the complexity associated with the design of the employee exemption. For example, it allows for those people qualifying under the employment test who fall out of employment after arrival, for legitimate reasons, to qualify for the general exemption for the remaining period (if any).

46. Moreover I expect the majority of people would qualify under the full-time work test, for which there is no minimum income requirement. The minimum annual salary

requirement of $70,000 pro rata would apply only for part-time employees.[2] I believe it is important to keep that threshold reasonably high to ensure the exemption is appropriately targeted. There is a concern that if the threshold were dropped the employee exemption would be much more widely available than intended.

47. A requirement that the employer not be associated with the migrant employee should be imposed for the employee exemption.[3] It should ensure that people who are effectively self-employed or are in retirement are not covered by the employee exemption. However, these individuals would still benefit from the application of the three-year exemption.

Exclusion from Family Support

48. Family assistance entitlements are determined by a modified form of net income. If an individual derives offshore income that is exempted under the proposals their net income is reduced. Potentially, individuals deriving exempt offshore income could receive family assistance payments that they would not otherwise be entitled to, or receive higher payments than they would otherwise be entitled to, if this income was not exempt.

49. I do not believe that an individual should be able to claim a tax exemption on the one hand, and at the same time be receiving financial help from the Government in the form of family assistance payments. Any assistance should be based on the family's total income.

50. I therefore recommend that if an individual has a certificate of exemption they should not be eligible to receive family assistance payments.

51. Furthermore, not declaring foreign-sourced income has implications for student allowances, student loans and child support. However, the compliance and administrative costs of ensuring the exempt income is taken into account for student loan, student allowance[4] and child support purposes outweighs any equity concerns from not taking into account such income. Additionally, the problem with child support is mitigated somewhat by a provision in legislation that would allow a custodian to seek a departure from the formula assessment to have any income that is exempt under the proposals taken into account in calculating a child support obligation.

Multiple exemptions for new migrants

52. Some submissions said that it should be possible to receive the benefit of the exemption more than once. They said that this would recognise the work patterns of people who are truly mobile and continuously shift their residence for employment.

53. My preference, at this stage, is that the exemption applies only once. A multiple exemption rule may adversely affect public perceptions of equity. It also gives rise to the concern that skilled individuals would leave New Zealand in order to keep refreshing their exemption. This policy issue could be re-visited once we have gained some insights into the practical application of both exemptions.

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[2] The LisNZ Pilot Survey showed that 18 months after taking up residence in New Zealand, 6 percent of individual migrants specified their personal gross income from all sources in New Zealand to be more that $70,000 per annum.

[3] In the tax context "association" refers to family connections and companies controlled by the relevant party.

[4] Even though the numbers of affected individuals are likely to be very low, there is still a risk of adverse public reaction if a student feels that they are being treated unfairly when compared to a student in a similar financial position. As this is a risk that may increase as the numbers grow over time, the situation will be monitored and reviewed at a later date.

Retrospective application

54. One submission suggested that the exemption should be backdated to apply to current residents where it is proved that there will be a direct reduction in the remuneration costs to the employer. Others stated that there should be no retrospective application because the people who are already in New Zealand would have negotiated their salary before the changes and are unlikely to go back to their employer and seek to renegotiate a reduction in their salary after the introduction of the exemption.

55. I do not consider that retrospective application of the exemptions can be justified in policy terms. It would only provide a "windfall gain" to the recipients. There is no obvious historical date from which it should apply. It would be administratively difficult to determine whether a person met the criteria. Moreover, it would give rise to practical difficulties where returns had already been filed and where Commissioner's assessments have been issued.

CONSULTATION

56. The Treasury, the Inland Revenue Department, the Department of Labour, the Ministry of Education and the Ministry of Social Development were consulted in the preparation of this report.

57. Following the release of the discussion document, there was consultation with tax professionals and other interested parties.

FISCAL AND ADMINISTRATIVE COSTS

58. These proposals give rise to a fiscal cost. This cost arises because tax will no longer be imposed on those foreign migrants who would have come to New Zealand in the absence of the exemption. The fiscal cost of package is estimated to be in the order of $10 - 13 million. The inclusion of retirees is not expected to represent a significant portion of these costs.

59. The one-off total administrative cost of this proposal is estimated at $1.1 million (GST inclusive). This includes a one-off capital cost of $221,000 and a one-off operating cost of estimated at $850,000 in 2005/06. Furthermore there are ongoing operating costs estimated at $330,000 in 2006/2007 and out-years. Additional funding is required to fund this administrative cost.

HUMAN RIGHTS

60. There are no inconsistencies between the proposals and the Human Rights Act 1993.

LEGISLATIVE IMPLICATIONS

61. The policy proposals in this paper will result in amendments to the Income Tax Act 2004.

62. The legislation required to implement the proposed changes should be included in the tax bill scheduled for introduction in November 2004.

REGULATORY IMPACT AND COMPLIANCE COST STATEMENT

63. A Regulatory Impact Statement is attached to this paper. A Business Compliance Cost Statement has not been prepared as there is no business compliance cost. The Business Compliance Cost Unit of the Ministry of Economic Development has been consulted on the Regulatory Impact Statement.

PUBLICITY

64. A press statement referring to the changes will be made at the time the legislative amendments are introduced. Also, Inland Revenue will publish details of the new rules in a *Tax Information Bulletin* once it is enacted.

RECOMMENDATIONS

65. I recommend that the Economic Development Committee:

1. **Agree** to the introduction of a five-year tax exemption for new migrants that are employed in New Zealand.

2. **Agree** to the introduction of a three-year exemption for all other new migrants to New Zealand.

3. **Agree** to the repeal of similar specific exemptions from the foreign investment fund rules and the accrual rules.

4. **Agree** that a returning New Zealander can qualify for the exemption provided they have not been tax resident in New Zealand for at least ten years.

5. **Agree** that both exemptions will relieve eligible migrants from tax on all foreign income except dividends, interest, employment income and business income relating to services performed offshore.

6. **Agree** that a person will be eligible for the five year exemption only if the person is employed full time or, alternatively, is employed part time at a salary of at least $70,000 per annum (pro rata).

7. **Agree** that an individual with a certificate of exemption would not be eligible to receive family assistance payments.

8. **Agree** that the exemption is available only once in a person's lifetime.

9. **Agree** that the exemptions will not apply retrospectively.

10. **Note** that the one-off total administrative cost of this proposal is estimated at $1.1 million (GST inclusive), with ongoing operating costs estimated at $330,000 in 2006/2007 and out-years.

11 **Note** that these recommendations will have the following funding implications and will be reflected in a future Budget bid:

	$ (millions) GST inclusive where applicable	
Vote Revenue	2005/06	2006/07 and out years
Operating costs	0.850	0.330
Capital cost	0.221	nil

Hon Dr Michael Cullen
Minister of Finance and Revenue

REGULATORY IMPACT STATEMENT

Background

The Government is committed to developing New Zealand's economy so that it becomes more innovative and flexible and able to compete successfully in international markets. In 2001 the Tax Review in its *Final Report* recommended that individuals with no previous connection to New Zealand who become resident for tax purposes should be taxed only on their New Zealand sourced income for the first seven years.

Statement of the nature and magnitude of the problem and the need for government action

People whose skills and experience are in demand internationally can choose where they want to work. Differences in tax systems are one factor they may take into account when choosing where to work.

New Zealand's taxes on foreign income are higher than in some other countries. This is partly because some of New Zealand's tax rules relating to foreign income are more comprehensive than those of most other countries. It is also because a few countries, including the United Kingdom and Hong Kong, for various reasons, have very wide exemptions from tax on foreign income for new migrants.

Individuals recruited from overseas may therefore face extra tax costs in coming to New Zealand, compared with what they will face at home or in other countries. The result is that extra costs are imposed on New Zealand businesses, which recruit them, when the recruits negotiate a higher level of remuneration, to compensate for the tax burden, or are deterred from taking the job at all. Anecdotal evidence accumulated in the course of consultation confirmed this view however it is not known how widespread this problem is.

Statement of public policy objective

The public policy objective is to remove tax barriers that may be inhibiting international recruitment to New Zealand and to thereby promote global connectedness, the growth of a skilled workforce, and the development of an innovative, competitive economy

Statement of feasible options (regulatory and/or non-regulatory) that may constitute viable means for achieving the desired objective(s)

<u>Status Quo</u>

Currently a person who has been in New Zealand for an aggregate of 183 days in any 12 month period is deemed to be a New Zealand resident and therefore is liable to pay tax on their worldwide income. This means that highly skilled individuals coming to New Zealand have to pay tax in New Zealand on their world wide income if they exceed this 183 day threshold, although tax credits and DTA relief may be available.

It is not appropriate to remain the status quo as it does not meet the policy objectives.

<u>Option one: narrow exemption</u>

Under this option the Income Tax Act 2004 would be amended to provide a seven year exemption from the most comprehensive aspects of our international tax rules including

controlled foreign company rules, the Foreign Investment Fund rules, non-resident withholding tax, and the approved issuer levy regimes and possibly trust rules, accrual rules and share options for migrant employees and returning New Zealanders.

This option was discarded because of the ability of individuals to structure their affairs to avoid taxation, the complexity of its nature and the perception of fairness with the seven year exemption being to long.

Option two: the broad exemption

Under this option the Income Tax Act 2004 would be amended to provide a three year exemption from all foreign-sourced income for migrant employees and returning New Zealanders.

This option was discarded following consultation as the majority of submitters stated that the three year period was too short and because of concerns that the exemption was too broad and would give migrants a tax advantage over New Zealanders.

Option three: Temporary tax exemption for people coming to New Zealand (preferred option)

It is proposed to amend the Income Tax Act 2004 to provide a temporary exemption from all foreign-sourced income (except dividends, interest, employment income and business income relating to services performed offshore). The exemption will last for five years for people coming to New Zealand in full-time employment or part-time employment earning a minimum of $70,000 per annum.

It will be available to all new residents and returning New Zealanders who have been non-resident for at least ten years.

Those who come, or return, to New Zealand who are not in an employment situation will receive the same exemption for three years. This will include such people as independent contractors, self-employed, and entrepreneurs. It will also potentially apply to retirees due to the inability under the current law to draw a clear line between independent contractors and others.

Statement of net benefits of the proposal, including the total regulatory costs (administrative, compliance and economic costs) and benefits (including non-quantifiable benefits) of the proposal, and other feasible options

Government

It is estimated that this proposal will have a fiscal cost of approximately $10 - 13 million per annum. However, a potential small increase in productivity resulting from skilled migrants coming to work in New Zealand will increase the tax take by an amount which could offset (and potentially exceed) the fiscal cost of this exemption.

The one-off total administrative cost of this proposal is estimated at $1.1 million (GST inclusive), with ongoing operating costs estimated at $330,000 in 2006/2007 and out-years.

The new legislation will promote global connectedness, the growth of a skilled workforce, and the development of an innovative, competitive economy.

Recent arrivals (including returning New Zealanders)

Recent arrivals will receive a temporary tax exemption from all foreign-sourced income (except dividends, interest, employment income and business income relating to services performed offshore). Therefore, it will decrease their tax burden and the associated compliance costs.

The three year option will provide genuine independent contractors, who are analogous to employees, relief from our international tax rules. Therefore, it will decrease their tax burden and the associated compliance costs. It also allows recent arrivals sufficient time to organise their offshore investments to minimise the effect of New Zealand's international tax rules.

Society/economy

The new legislation aims to provide New Zealand businesses with highly skilled employees whose expertise and experience should enable them to maximise efficiency, resulting in positive effects for the New Zealand economy.

The proposal does not contain any compliance costs for business.

Statement of consultation undertaken

The Inland Revenue, Treasury, Department of Labour, the Ministry of Education and the Ministry of Social Development were consulted in the preparation of this proposal. A Government discussion document was also released on 11 November 2003. One submission considered that the extent of the tax problem had not been satisfactorily identified and called for more compelling theoretical and empirical analysis. Another opposed the proposals on equity grounds, which was taken into account when formulating the preferred option.

Officials from the Inland Revenue and Treasury have also consulted with the major submitters including the Institute of Chartered Accountants of New Zealand and the New Zealand Law Society. Generally, the groups consulted support the reforms.

Report Check Sheet

PAD Report No:

Report Title:

	Name	*Date*
Report created by:		
Peer review by:		
Manager review by:		
Edited by:		
External parties involved:		
Date report sent out as final:		

Analyst to complete: Does the report consider the following?

	Yes	**No**	**N/A**
Economic implications	☐	☐	☐
Compliance costs	☐	☐	☐
Revenue implications	☐	☐	☐
Administrative implications	☐	☐	☐

Manager to complete: Does the report meet the following standards?

Purpose	☐	☐	☐
Logic	☐	☐	☐
Accuracy	☐	☐	☐
Options	☐	☐	☐
Consultation	☐	☐	☐
Practicality	☐	☐	☐
Presentation	☐	☐	☐

(To check the box, right click before the box, select properties and then checked)

Other comments