Tax Working Group
Te Awheawhe Tāke

Tax Working Group Information Release

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This paper has been prepared by the Secretariat to the Tax Working Group for consideration by the Tax Working Group.

The advice represents the preliminary views of the Secretariat and does not necessarily represent the views of the whole Group or the Government.

Some papers contain draft suggested text for the Final Report. This text does not constitute the considered views of the Group. Please see the Final Report for the agreed position of the Group.

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Coversheet: **ETCI: Administration implications, paper #1**

Position Paper for Session 20 of the Tax Working Group
12 October 2018

Purpose of discussion

The Group has requested two papers on administrative considerations as they relate to extending the taxation of capital income (ETCI). This paper is pitched at a high level to introduce some of the concepts and linkages between them, and facilitate a discussion with the Group. As a result, it generally does not draw any conclusions on preferred approaches.

Any subsequent paper (for the meeting of 8 and 9 November) will attempt to respond to more detailed administrative matters following a more solid understanding of the design principles, (e.g., the impact on administration consideration of issues like roll-over relief). The decisions made on those design principles will need to be taken into account when recommending administration approaches, as well as the impact on implementation and compliance costs.

The purpose of this paper is to ensure that officials correctly understand if the Group have strong views on any of these topics and to determine if the Group sees value in a second administration paper being prepared.

Proposed wording for final report is not included, as that would be more appropriate for any subsequent paper.

Key points for discussion

To that end, Officials request that the Group:

- identify any administrative issues where they would like further advice;
- identify administrative issues that the Group would prefer Officials to consider without further reference to the Group; and
- discuss information reporting and how the Group would like to progress work on that.

Recommended actions

We recommend that you:

a. **discuss** the application of withholding tax and how, or if, the Group would like to progress work on that;

b. **discuss** information reporting and how, or if, the Group would like to progress work on that;

c. **discuss** excluding one-off capital gains from a person's provisional tax calculations;

d. **discuss** the supply of cost base information by taxpayers and how, or if, the Group would like to progress work on that; and

e. **inform** Officials whether a follow-up paper is necessary or whether details of administration are best left for any subsequent generic tax policy process.

ETCI: Administration implications, paper #1

Discussion Paper for Session 20
of the Tax Working Group

October 2018

Prepared by Inland Revenue Department and the Treasury

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1. Introduction

1.1 Purpose

1. The Group has requested two papers on administrative considerations as they relate to extending the taxation of capital income (ETCI). This paper is pitched at a high level to introduce some of the concepts and linkages between them and to other workstreams. Any later administration paper would be prepared for the meeting of 8/9 November. Neither paper will contain an emphasis on the implementation detail (e.g., return design).

2. Officials would appreciate guidance from the Group on whether a follow-up paper is necessary or whether, given the policy issues still to be considered by the Group, details of administration are best left for any subsequent generic tax policy process.

1.2 Content and scope

3. This paper discusses the following administrative considerations:

- annual returns;
- in-year third party information reporting requirements;
- withholding taxes;
- the implications for provisional tax;
- use of money interest; and
- taxing capital gains at marginal rates.

4. This paper discusses the current administration environment and our thinking to date on how the ETCI could be incorporated. Any subsequent paper would attempt to respond to more detailed administrative matters following a more solid understanding of the design principles, (e.g., the impact on administration of issues like roll-over relief).

5. The following areas are linked to administrative consideration:

- roll-over relief;
- loss ring-fencing;
- the impact on Māori collectively-owned assets;
- the ongoing compliance costs for taxpayers; and
- implications for social policy schemes (also being considered at this meeting).

6. Any second administration paper (for discussion at the meeting of 8/9 November) will cover the administrative implications of decisions the Group has made (by that point) on these topics.

2. Problem definition and objectives

2.1 Context

7. The annual returns process, in-year third party information requirements, withholding taxes, and provisional tax are all interrelated. This section sets out the dependencies between those administrative considerations.

Annual returns process:

8. Taxpayers are subject to annual income tax return requirements. Individuals are required to provide information to Inland Revenue on the total amount of assessable income they derive for the corresponding income year to the extent to which the amount is not required to be reported to Inland Revenue by a third party. Non-individuals are required to file returns to provide information about the income they have earned to Inland Revenue.

9. When the annual income tax return process is completed, Inland Revenue can establish whether the taxpayer has paid the right amount of tax or has a refund owing. In the event the person has further tax to pay, this is generally payable in February following the end of the tax year and is commonly referred to as the taxpayer's "terminal tax date" (but is earlier for taxpayers with early balance dates and is two months later for taxpayers that have a tax agent with an extension of time).

Third party in-year information reporting:

10. The effect for taxpayers of a third party reporting information about income the taxpayer has earned is that, depending on the level of specificity the third party provides, the taxpayer may not have to provide any information at year-end. In these circumstances, taxpayers can confirm the amounts that are pre-populated in their returns are correct and submit that confirmation to Inland Revenue (or if they do not earn other sources of income, they will not need to confirm the prepopulated information).[1] Third party reporting tends to be used in respect of income earned by individuals, more so than by non-individuals. In general, this will only be possible for third party information held by New Zealand based parties and it will not be possible for offshore based assets.

11. Types of income that are currently subject to some form of in-year information reporting include salary/wages, schedular payments, interest, residential property disposals, employee share schemes and, shortly, in-year information reporting will be extended to dividends and Māori Authority distributions.

12. The benefits of third party information reporting, compared to simply having the taxpayer declare the income in their return, are:

[1] This paper assumes that the changes proposed in the *Taxation (Annual Rates for 2018-19, Modernising Tax Administration, and Remedial Matters) Bill* that is currently before the Finance and Expenditure Committee is passed without substantial amendments.

- It makes it harder for the taxpayer to not comply with their obligations (whether intentional non-compliance or simply forgetting/not understanding their obligations), as Inland Revenue knows ahead of time who ought to be completing a return, and can prompt the taxpayer to do so;
- Where the third party has a "one to many" relationship (i.e., one person deducts tax on behalf of many people), it means that the onus of information provision is on them, "the one", rather than "the many" who receive the income. This can reduce compliance and administrative costs overall; and
- It enables the pre-population of gross income in a return which the taxpayer can then amend by including relevant deductions against that income.

13. The downsides are that:

- It imposes compliance costs on the third party which is required to provide the information;
- If not coupled with a withholding tax, the taxpayer still has to pay the tax; and
- It can have definitional issues depending on the subset of those who are reported (i.e., where the boundary of who is and is not required to be reported).

Withholding taxes on income:

14. While income tax liabilities are generally determined on an annual basis, some form of tax payment is required on most types of income during the year. Withholding taxes impose an obligation on a third party (e.g., an employer or financial institution) to withhold an amount of tax from a payment of income. Tax withheld and paid during the year is credited towards the final income tax liability.

15. The underlying policy principle for in-year payments to Inland Revenue is that tax should be paid as income is earned. Withholding taxes provide perhaps the best example of this principle in operation, with income tax deducted at the time the income payment is made.

16. The effect for taxpayers of earning income which has been subject to withholding during the year is that either the correct, or some, amount of tax will already have been withheld and remitted to Inland Revenue during the year. This is creditable against the amount the taxpayer has to pay at their terminal tax date. The taxpayer is liable to pay a "top-up" tax amount or eligible for a refund depending on their circumstances.

17. Existing withholding tax regimes often exempt certain non-individuals from withholding (e.g., non-profit organisations, taxpayers with income over $2 million, taxpayers with losses to carry forward and financial institutions can get a certificate of exemption, which means tax is not withheld from interest or dividends paid to them). Taxpayers that qualify for exemptions will need to notify (or, if required, apply to) Inland Revenue for verification of their exemption.

18. Income that is commonly subject to withholding includes:

- PAYE income such as salary and wages;
- Schedular payment rules such as withholding taxes on income through labour hire firms;
- Interest and dividend income;
- Non-resident royalty income;
- Non-resident sale of residential land;
- Some employee share scheme income; and
- Some Māori Authority distributions.

19. The benefits of withholding taxes, compared to information reporting, are:

- The money (either an accurate, or flat amount) is remitted to Inland Revenue during the year (leaving the taxpayer with a post-tax amount of income to spend);
- It reduces the likelihood of non-payment that might otherwise arise where the taxpayer reports the income but is unable to pay some or all of the tax assessed;
- The payment to Inland Revenue is closer in time to the taxable event - given how far after the end of the relevant income year the terminal tax date falls, this can be a difference of close to a year;
- Where the third party has a "one to many" relationship, it means that the onus of withholding and remitting tax is on, "the one", rather than "the many" who receive the income. This can reduce compliance costs overall;
- Money is paid to Inland Revenue in stages rather than all at terminal tax date, which smooths the government's revenue collection;
- Because a third party is paying the tax rather than the affected taxpayer, the actual payment obligation is removed from the taxpayer;
- Applying withholding taxes allows a class of taxpayers to remove themselves from provisional tax through adopting a system that provides for payment of tax as they earn their income - where the withholding rate used is appropriate;
- There may be a stronger case for withholding taxes for sales by non-residents, given the collection risks; and
- Administration costs are reduced.

20. The downsides are:

- It imposes compliance costs on the third party who is required to withhold and remit the tax;
- It can be difficult to get an accurate rate of withholding as only partial information is likely to be held by the withholder (e.g., the gross sale price);

- If the withholding is:
  - too high, absent a mechanism which facilitates refunds during the income year before the annual income tax return process, a taxpayer can be subject to significant tax deductions that they have to wait a significant amount of time to get refunded, or
  - too low, a taxpayer still has an obligation to pay the remainder and could be subject to provisional tax or use of money interest.

21. Withholding taxes, and third-party information reporting, regimes generally involve a trade-off between reducing the compliance burden on the payee and increasing the compliance burden on the payer, with the aim of reducing compliance costs in the system overall. Information or withholding requirements would increase the obligation on payers to report payments, however, it is generally accepted that there would be lower compliance rates if the onus to report was only on payees instead. Withholding also substantially reduces administrative costs.

Provisional tax:

22. Where no tax is remitted to Inland Revenue during the year, or it is an insufficient amount to cover the taxpayer's final liability, the provisional tax regime may apply. The outstanding amount of tax to be paid is called "residual income tax". When residual income tax is more than $2,500 in a year, the taxpayer becomes subject to the provisional tax regime.

23. The consequence of being a provisional taxpayer is they must choose one of the available methods and, generally, make three payments of tax during the year based on their prior year residual income tax[2] or an estimate of their current year residual income tax.

24. It is difficult to determine who currently does not have to file an income tax return but may have to after the ETCI. The majority of salary and wage earners do not currently file a return (or otherwise engage with Inland Revenue). As Inland Revenue does not generally hold asset information on those taxpayers we are unable to estimate the numbers who may have an obligation to file returns under ETCI. However, we do not anticipate that this will be a large number on the basis that the ETCI will mainly affect the higher income earners who are likely to be filing returns currently because of other non-source deducted income such as rental or business income. To the extent it does impact on low/middle income-earners, this may be through managed funds, such as KiwiSaver, where the reporting and taxpaying obligation sits at the fund level in any event. In addition, any extension of withholding taxes or information reporting to ETCI will also reduce the numbers who ultimately may have to file returns in the future.

[2] Residual income tax is the tax liability remaining after deduction of any tax credits such as PAYE and RWT. In essence it is the amount of tax that a person has to pay to square-up their tax liability for a year.

2.3 Stakeholder considerations

25. The reason that officials are not seeking recommendations from the Group in relation to withholding and the collection of information is that we would recommend that before decisions are made on that we undertake consultation with interested parties as to how these systems might work in practice. This will particularly focus on those who may end up providing information or withholding tax to ensure that those parties actually hold the information that might be sought.

26. This would also include talking to those who may derive capital gains as to how they might prefer information to be provided to Inland Revenue and the appropriate channels to do that.

27. Given the Group's timeframes, it is unlikely that meaningful consultation down to the technical level of information reporting and withholding could be completed in time for the Group to make firm recommendations. However, if the Group is comfortable that information reporting and/or withholding taxes are generally desirable, this is a process that Officials could commence now and continue in the event that the Group does recommend an ETCI that applies to relevant assets. The next section sets out some of the options Officials have identified to date and our current thinking on them.

3. Options identification

28. This section looks at options for how, in an ETCI environment, you might administer:

- annual income return obligations;
- annual provision of information about changes to cost base;
- in-year reporting by third parties;
- withholding taxes;
- provisional tax; and
- application of use of money interest.

Policy considerations:

29. In determining which option is to be preferred, it is helpful to take into account various policy considerations. These considerations can then be weighed and decisions can be made about which are more important in this context. Officials have identified the following factors that appear to be relevant for the design of administration rules:

- be simple to understand;
- facilitate compliance, by making it easy to comply, and difficult not to;
- offer predictability/certainty for taxpayers;
- minimise unnecessary compliance costs;
- maintain integrity of the tax system; and
- leverage/replicate existing business processes and systems (if appropriate).

Annual income tax return obligations:

30. Much like any other type of income tax, officials' view is that taxable events for ETCI should be included in the annual income tax return process, subject to whichever rules already apply to either individuals or non-individuals on their return filing obligations. The exact nature of those return filing obligations will be dependent on what the Group recommends about third party information reporting, and withholding taxes.

31. Because of the link between the year-end income tax process and the access to entitlements and obligations under social policy schemes, including ETCI in the same year-end process would be preferable from an administrative perspective than separate reporting.

Annual provision of information about changes to cost base:

32. The Group's interim decision (as included in Appendix B to the Interim Report) was that:

> *"it may be desirable for some kind of contemporaneous documentation to be required to be filed with Inland Revenue on an annual basis, itemising the cost of the assets subject to the rules, in order to ease compliance at the time of sale. It need not be the case that this documentation creates any kind of obligation on the Commissioner to confirm it until the time when the relevant asset is sold. The Commissioner would also have ready access to the cost information should an audit be required."*

33. We see (at least) three options:

- Reporting about cost base information only occurs at the time of realisation[3];
- Information is reported to Inland Revenue in the year costs are incurred, but Inland Revenue does not do anything other than hold the information (i.e., no verification exercise on the cost base);
- Information is reported to Inland Revenue, and Inland Revenue reviews/ 'assesses' the information (annually, regularly or on a risk assessed basis).

34. With the latter two options it will also be necessary to discuss an appropriate penalty regime to cover the situations where cost information is not provided to Inland Revenue. Denying a deduction would be the ultimate penalty but this would need to be considered as the penalty may outweigh the severity of the offence.

35. Naturally any information collection will need to be digital in design and be able to be delivered electronically to minimise the potential for loss of information on hard copy forms and allow ease of retrieval for taxpayers and Inland Revenue.

36. Each of the options is discussed in some more detail below:

Reporting about cost base information only occurs at the time of realisation:

Features:

- Taxpayers keep all records (the cost of asset, and cost of capital improvements);
- Inland Revenue only considers when the gain or loss is realised.

Pros:

- Lower compliance cost, no annual reporting (especially for taxpayers who would not otherwise have to provide information to Inland Revenue for any other purpose);

[3] This is the option the Australians use in their capital gains tax. Cost base information is required to be held by the taxpayer until the sale of the asset and for five years after that date.

- A better fit with New Zealand's self-assessment model.

Cons:

- Significant lapse of time before gain or loss is realised may reduce accuracy (depending on robustness of record keeping);
- If the taxpayer does not retain evidence to support their claim of an increase to the cost base, they face a larger gain, or smaller loss than their actual gain/loss;
- Reliability of historic valuation information and the ability for Inland Revenue to challenge that valuation;
- Taxpayers would not receive certainty about the appropriateness of their increases to cost base;
- Risk that Inland Revenue in time will feel it needs to accept historic values with little back up to make progress with a case.[4]

Information is reported to Inland Revenue in the year the costs are incurred, but Inland Revenue does not do anything other than hold the information:

Features:

- Inland Revenue acts as a repository to upload valuation or expense information;
- Inland Revenue stores (only) and does not review the information;
- It would need to be made clear to taxpayers that the provision of information in relation to an asset's cost base does not constitute the making of an "assessment" for the purposes of the time bar, which prevents the Commissioner from increasing the amount of tax payable under an assessment after a certain amount of time has lapsed.

Pros:

- The taxpayer does not need to store records (note – this would mean IR is the ONLY source of the cost base information);
- Inland Revenue has access to cost base information;
- Might avoid reconstruction of records (seems common in other countries);
- Forces the taxpayer to contemporaneously turn their minds to the correct value;
- Reduced risk of records being lost, especially in instances of rollover relief); and
- Provides information to government on the cost base of assets acquired which could be useful for forecasting or other statistical information.

Cons:

- The taxpayer would not receive certainty about the appropriateness of their

[4] Officials disagree with this comment that was inserted by the Group's advisor. The Commissioner continues to have a duty to ensure that taxpayers pay the correct amount of tax and this will include being satisfied that the correct cost base has been used.

increases to cost base which may create a false expectancy of certainty;

- Could still encounter historic 'valuation' disputes, as the information will not be considered until the gain or loss is realised;
- Cost to build and maintain a repository system will increase administration costs;
- If providing this information is mandatory, what action should Inland Revenue take for non-compliance, remembering that it would not know that there had been non-compliance;
- If Inland Revenue does nothing with the information, would storage with a third party be a better option; and
- the least preferred option from an administrative viewpoint as it provides the least certainty to taxpayers.

Information is reported to Inland Revenue, and Inland Revenue reviews/ 'assesses' the information (annually, regularly or on a risk assessed basis):

Features:

- Inland Revenue considers information annually/regularly, and either accepts (actively or passively), or challenges/queries;
- After a time period, the information is considered to be accepted, and an "assessment" for the purposes of the tax Acts, which means Inland Revenue would not be able to challenge the assessment to the extent that the challenge related to the asset's cost base once the asset had been sold for a gain or a loss (unless it did so within the statutory time bar or could look beyond the time bar, such as where the return is fraudulent or misleading).

Pros:

- Taxpayer receives certainty about the appropriateness of their increases to cost base;
- Reduces reliance on historic information, and need for ongoing record keeping;
- Information (and certainty) would be available at time of rollover relief;
- Inland Revenue has access to information;
- Forces the taxpayer to contemporaneously turn their minds to the correct value
- Could be incorporated into the annual income tax return cycle; and
- Provides information to government on the cost base of assets acquired which could be useful for forecasting or other statistical information.

Cons:

- High cost and effort for Inland Revenue if the Commissioner was to apply her mind to each expense to validate, even on a risk based selection;
- Rate of compliance might be low, for taxpayers who would not otherwise have

to provide information to Inland Revenue for any other purpose;

- Increased compliance cost for taxpayers.

In-year information reporting by third parties:

37. There are multiple options about the detail of information which could be reported, each with their own pros and cons. The specific pros and cons will differ for different asset classes which would be subject to ETCI.

38. To a large extent this will be driven by the level of information that is held by third parties. For example, there are a number of parties to particular transactions who all hold different parts of information relating to the same transaction but no person may hold all of the information.

39. There is a question of whether information should be obtained from one or more persons and combined to give a more complete picture of the transaction or whether partial information is sufficient to be used as a prompt in the pre-population process.

Withholding taxes:

40. There are also a number of different options for the imposition of withholding tax on transactions. Again these are dependent on the level of information that a person has in relation to a transaction. If the withholder does not hold all the relevant information, which is likely to be the case, then the level of withholding will be inaccurate.

41. Where perfect information is held, the withholding is likely to be more accurate but the chances of that occurring are low. Current withholding rates are designed to approximate the net tax liability relating to the particular source of income and new rules allow the taxpayer to choose the rate of withholding but again this requires some forethought.

42. If withholding is recommended, there are other things officials would like to factor in, for example:

- certificates of exemption, or exempt-status, for situations where withholding is inappropriate (e.g., a person sells their excluded home);
- the ability for the taxpayer to provide Inland Revenue with information that would lead to a more accurate withholding rate (through the usual special rate certificate process); and
- permitting refunds during the income year if withholding was clearly inappropriate (e.g. a person has withholding tax deducted from a sale early in the year and makes a loss later in the year which offsets that gain which therefore results in the withholding being over-deducted).

43. There will be different compliance costs associated with being a withholder depending on whether the payer is already running a withholding tax system or not. This is not to say that running any form of withholding tax system now would mean that a withholding system for ETCI would be inexpensive.

44. In a number of cases withholding and or the provision of information by third parties on transactions that may fall within the ETCI may be straightforward but in a number of other cases it will be impossible.

45. Where there is a single person who has the information relating to a sale and the funds relating to that sale then the provision of both withholding tax and information would be relatively easy. The sale of real property would fit within this category where funds flow through an agent, this gives the opportunity to both supply the information and deduct a withholding tax from the proceeds paid to the vendor.

Withholding taxes are currently applicable on the sale of some residential land sold in New Zealand (RLWT). In general, the sale of residential land that is subject to the brightline test (i.e., sold within five years of acquisition) by non-residents. The vendor's conveyancer has the primary responsibility to withhold and return to Inland Revenue the lesser of:

- RLWT rate[5] x (current purchase price-outstanding rates); or
- 10% x current purchase price; or
- Current purchase price – security discharge amount – outstanding rates.

That withholding tax is due to Inland Revenue on the 20th of the month following the month in which the RLWT is deducted. This is not a final tax but will be creditable when the taxpayer files a tax return including the particular sale.

Although we do not hold information on the number of property transfers relating to the withholding tax the amounts deducted in RLWT have averaged $6.75m in 2017/18 on an average of 159 assessments per year.

46. However, where the person is acting as a facilitator and taking a commission as in some marketplace situations where the facilitator does not handle the funds then an information reporting option will generally be the only option available. Share transactions on the NZX are an example of this where the exchange facilitates the trade taking a commission but does not handle the funds. In this case it would be compliance cost intensive to require withholding but maybe quite simple to obtain transactional information.

47. A third class of transactions will be compliance cost heavy to obtain either information or withholding on particular transactions. An example of this would be the sale of some plant by a business on which a capital gain is made. To require information

[5] 28% for companies and 33% for all others (including companies acting as trustees of a trust).

and/or withholding on such a transaction which will normally be reported as part of the tax return process would be counterproductive.

48. The general theme of information reporting and withholding tax regimes is to target non-compliance. In general, those who have the greatest ability to underreport income are those who are self-employed and do not have tax deducted at source. In the case of the ETCI it may be preferable to think of non-compliance attaching to the particular asset that is sold rather than the type of taxpayer.

49. The following table lists the main asset classes that could generate capital income and the Secretariat's current thinking about the information reporting/withholding which could most likely suit those particular classes of income, however, this is not a complete or, necessarily, accurate representation of the information that parties may hold and officials would like to test the various situations with interested parties to see how information reporting and withholding could be implemented under ETCI.

Asset Class	Potential treatment	Rationale
Real Property	Information and withholding	The funds and information flow through single point – legal agent (currently operational for RLWT)[6]
New Zealand Listed Shares	Information	The marketplace has information but is not a single touch point for funds and information.
Overseas Listed Shares (not subject to FDR)	Information (if possible)	Same as NZ shares but obtaining information from foreign registries may be problematic
Personal property plant and equipment (PPE)	Neither	Transaction would normally be reported as part of the tax return process in any case for depreciation recovery purposes and to require information would impose significant compliance costs.
Intangible Property	Neither	As for PPE above.
Privately held shares (including group subsidiaries)	Information	Although the disposal of privately held shares are returned as part of the tax return process currently (in most cases they are reversed from taxable

[6] Residential Land Withholding Tax

		income) as these transactions are irregular it may be worth obtaining information as the compliance costs of doing so may not be as high as for public shares.

Provisional tax:

50. For most people who realise one-off capital gains, this should not, in theory, give rise to provisional tax obligations in the future. This is because provisional tax liabilities should only arise where there are continuous amounts of income with no corresponding tax credits.

51. For people who already pay provisional tax, because of self-employment, for example, a one-off capital gain is likely to inaccurately disrupt the person's provisional tax obligations for the following income year. This is because a one-off spike to a person's income will affect the provisional tax calculation under the standard uplift method for the following year, which is premised on an expected increase of 5% of the person's residual income tax liability for the previous income year.

52. Where one-off types of income are included in this calculation it will artificially inflate the following year's provisional income. This issue exists now when employees derive one-off employee share scheme income or income from taxable land sales.

53. One-off capital gains could be excluded for the purposes of determining the following years' provisional tax obligations. This would ensure that the liability to provisional tax is limited to regular recurring non-source deducted income. This is the type of income the provisional tax regime is designed to capture.

54. Without excluding one-off capital gains from the calculation in situations like these, a person will be forced to use another method to calculate their provisional tax (which could cause unnecessary exposure to use-of-money interest) or pay amounts which far-exceed the amounts that should be payable based on expected income.[7]

55. The provisional tax rules also apply to student loan borrowers that derive income which is not subject to student loan deductions at source, provided the borrower has a student loan repayment obligation from non-salary or wage income of $1,000 or more for a year. The appropriateness of any changes to the provisional tax rules will also need to be considered for student loan repayment obligation purposes

56. Officials recommend that one-off capital gains should be excluded from a person's provisional tax calculations. This will have the following benefits:

[7] Or, a person may just not pay provisional tax at all.

- for those that make a one-off capital gain who are not already paying provisional tax, it will exclude them from the rules and they will not need to consider the implications of a capital gain from a provisional tax perspective; and
- for those that are paying provisional tax, it will ensure that the standard method is still fit-for-purpose, and will not drastically increase the person's payments for future income years where the person will not have future capital gains that justify an increase in provisional tax payable.

57. A distinction can be drawn between ETCI and other types of lumpy income in that in most cases where one of payment are received tax is deducted at source (such as bonuses). There are a number of other cases where one off income can distort provisional tax uplift amounts and one of these is large amounts of depreciation recovery. In those cases the person deriving the income is likely to be paying provisional tax now and can adjust for those lumpy amounts. ETCI will have a wider application to taxpayers who are generally unsophisticated and should be treated differently.

Use of Money Interest:

58. Use of money interest (UOMI) is not a penalty it is a charge for the use of funds by either the taxpayer or the government. In general, UOMI will apply from the day after an amount of tax is due. For income tax that is generally after terminal tax date, however, for provisional taxpayers that rule can differ and UOMI can be charged over the three provisional tax instalments of the taxpayer.

59. As noted, we do not consider that one off capital gains income should put a taxpayer into the provisional tax regime but there is a question as to whether UOMI should apply to a taxpayer who makes a capital gain. Again this is an issue that is faced currently with those who derive share scheme income and are thrown into provisional tax. Depending on their level of residual income tax they may incur UOMI from their first provisional tax instalment date even though they had no obligation to pay provisional tax in that year.

60. Changes made to the UOMI rules and the standard method of provisional tax in 2017 now mean that for most taxpayers in this situation they will only incur UOMI from the date of the final instalment of provisional tax (if they had one). The final instalment date is around five weeks after the end of the taxpayer's income year. At this point the taxpayer should be aware of the gain that has arisen.

61. To be consistent officials consider that UOMI apply to those who derive capital gains that result in residual income tax of greater than $60,000[8] from the final instalment of provisional tax date for that taxpayer as if they were a provisional

[8] This is the current safe-harbour threshold from use of money interest. Taxpayers who have less than $60,000 of residual income tax will only be charged use of money interest from terminal tax date – this applies to both individuals and non-individuals.

taxpayer. This date will leave them sufficient time to calculate the gain and determine the tax liability to enable them to make a payment so that they do not incur any UOMI.

Taxing capital income at marginal rates:

62. The Group has already decided that income from the realisation (or deemed realisation) of included assets should be taxed at the taxpayer's marginal rate, with no indexation for inflation.

63. *Example:* Romesh is a superannunitant who works part time as a waiter. He earns $46,000 a year. He decides to sell the shares that he has owned for 15 years, and makes a $30,000 one-off gain. That gain will be taxed as follows:

- $2,000 at 17.5%,
- $22,000 at 30%; and
- $ 6,000 at 33%.

64. People might think it is unfair that a person whose "usual" average tax rate is 15.4% ends up paying tax on a capital gain at a higher rate than that. It is important to remember that if Romesh had earned that extra $30,000 from salary or wages, it would also have been taxed like that under the progressive income tax regime in New Zealand.

65. The *Interim Report* addressed the issue of fairness in the tax system, pointing out that the tax system is currently inconsistent in its treatment of capital income because it does not generally tax gains from the disposal of capital assets. One measure of inconsistency it raised was that of horizontal equity - that individuals earning the same amount of income face different tax obligations, depending on whether they earn capital gains or other forms of income.

66. If Romesh only had to pay tax at 15.4% on that income from capital, he would still be taxed more favourably than someone earning all of their income from salary and wages.

67. Another good example that illustrates using a person's "usual" marginal rate may be unfair is the situation where a taxpayer operating a business has been in a tax loss position for a number of years and sells a portfolio of property they have been holding which, say, results in a capital gain of $3m. In that case the person's "usual" marginal rate is zero and following the logic of using that rate the significant capital gain they make on the sale of their portfolio would also be taxed at zero. This does not seem a fair result as if you had taxed that income over the time they held the property they may have had a "usual" tax rate that was much higher.

68. In addition, if the tax on a capital gain was calculated based on a person's marginal/average tax rate excluding capital gains, this could increase "lock-in", people not selling assets until they were on a lower average tax rate (e.g., when they retired), or ceasing to work in order for their average tax rate to decrease.

4. Conclusion

69. There are a number of administration implications for the ETCI and whilst a number of these flow naturally from the current settings for tax there are a number of unique challenges specific to the ETCI.

70. Further development of the administration implications would benefit from consultation, with parties that may be appropriate to undertake either the provision of information or withholding, to ensure the party who is best placed to undertake those functions is correctly identified.

71. Officials would appreciate guidance from the Group on whether a follow-up paper is necessary or whether, given the policy issues still to be considered by the Group, details of administration are best left for any subsequent generic tax policy process.