Taxation (Annual Rates for 2019–20, GST Offshore Supplier Registration, and Remedial Matters) Bill

Bill Number 114-1

Regulatory Impact Assessments

Prepared by Policy and Strategy, Inland Revenue

December 2018

Impact Summary: GST on low-value goods

Section 1: General information

Purpose
Inland Revenue, the New Zealand Customs Service and The Treasury are responsible for the analysis and advice set out in this Regulatory Impact Statement, except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing key policy decisions to be taken by Cabinet and stakeholders to be consulted on a Government discussion document.

Key Limitations or Constraints on Analysis

Completeness of analysis

The analysis of the options presented in this document is not yet complete. However, this analysis will be completed before final policy decisions are made. Consultation with stakeholders, including through the Government discussion document, will inform the analysis.

A key gap in the analysis to date is that estimates of potential GST revenue collections have not yet been completed for options 3 and 4.

Evidence of the problem

There are some uncertainties about the scale of the problem in terms of estimating the foregone GST on imported low-value goods under the current *de minimis*[1] threshold.

Quality of data used for impact analysis

It is not possible to accurately determine how many offshore suppliers could be required to register and return GST under the preferred option.

It is also not possible to determine exactly how much GST revenue is foregone on low-value goods imported under the *de minimis* from offshore and consumed in New Zealand. Officials estimate, based on a 'bottom up' approach (using 2016 data from New Zealand Post and couriers on numbers of low-value consignments and Customs' sample data and Australian estimates on values), that around $80 million of GST was foregone in 2016 on these purchases. This amount could be growing at a rate of 10% per annum, based on a 12% five-year average rate of growth in volumes of low-value goods and taking into account that the majority of the growth in volumes is at the lower-value end.

The estimated impact is dependent on the behavioural response of offshore suppliers and New Zealand consumers to the introduction of an offshore supplier registration system for collecting GST on low-value goods.

Assumptions underpinning impact analysis

We have assumed that larger offshore supplier of goods and e-marketplaces would voluntarily comply with the proposed requirement to register and return GST, given the reputational risk involved in not complying. For the purposes of the analysis, the "compliance rate" does not refer to the proportion of offshore suppliers who would have a liability to register for GST under the preferred option, but instead the percentage of goods (by dollar value) that would be supplied by offshore suppliers who would register and voluntarily comply with the rules. For these reasons, a 75 percent compliance rate is thought to be reasonable. This assumption has been used in calculating the estimated GST revenue collections under the preferred option shown in the table in Section 4.

We note that New Zealand applied GST to offshore suppliers of services in October 2016 and there has been a high level of compliance with the new rules. However, we also note that consumption of online services is more concentrated among a small number of large suppliers compared to the market for low-value goods.

[1] The Protocol of Amendment to the International Convention on the Simplification and Harmonization of Customs Procedures requires setting a *de minimis* and New Zealand is a party to this Protocol. The current *de minimis* is $60 duty owing. It means no duty is collected on low-value imported goods if the total duty is less than $60.

If offshore suppliers and marketplaces perceive the compliance costs of registering for and returning New Zealand GST to be unreasonably high, there is a risk that they may not comply with the rules or may not continue to supply goods to New Zealand. Table 1 below shows the effect of relaxing the above compliance assumption and assuming instead a level of compliance of 50%. This is considered to be a very low compliance rate, given the proposed inclusion of rules to require e-marketplaces (some of which have a large share of the goods market) to register and return GST on goods sold to New Zealand consumers through their distribution platforms.

Based on a range of compliance assumptions (50%, 75% and 100%), the numbers in Table 1 represent the estimated additional amount of GST that may be returned under the preferred option, over and above the amount of GST that would otherwise be collected at the border if the status quo was retained. These figures do not take into account the tariff revenue and border fees that are currently collected on goods valued at or below $1,000.

Table 1: Additional GST revenue that may be returned by registered offshore suppliers ($ millions - fiscal year)

Assumed compliance	2019/20 *Application at 1 October*	2020/21	2021/22	2022/23
50%	20	31	35	41
75%	43	64	72	81
100%	66	97	108	121

Based on our data and assumptions, the break-even rate of compliance (where the GST returned by offshore suppliers is equal to what would otherwise be collected if the status quo is retained) would be 28 percent for the 2019/20 fiscal year.

Estimated coverage rates of 85% (by value) of low-value goods sent through the fast freight stream and 70% through the postal stream have been used to take into account the effect of including rules which require marketplaces to register and return GST in respect of goods sold through those marketplaces to New Zealand consumers.

The total foregone GST revenue has been calculated based on an assumption that the total value of goods under the current *de minimis* is growing at 10% per annum. The forecasted potential GST collections under option 2 have also been calculated on the basis of this assumption as well as the assumption that the value of GST that would otherwise be collected by Customs under the status quo collection system will continue to grow at 5% per annum on average.

It is assumed that the application of GST to low-value imported goods would not have a significant impact on consumers' purchasing behaviour.

The extent to which consumers would bear the incidence of the tax if the preferred option is implemented is unknown and will depend on the rate of compliance and on whether, if registered, the offshore supplier passes the cost on to the consumer. This may be industry or firm specific and will depend on factors such as business practices and the elasticity of demand for products. It is assumed that in most cases the consumer would bear most of the incidence of the tax.

Consultation and testing

We have undertaken a limited consultation at this stage and plan to undertake a fuller consultation with stakeholders through submissions on the discussion document and targeted meetings with key stakeholders.

Responsible Managers (signature and date):

Chris Gillion Policy Manager Policy and Strategy Inland Revenue 20 July 2017	Anna Cook Director Policy Policy, Legal and Governance New Zealand Customs Service 20 July 2017

Section 2: Problem definition and objectives

2.1 What is the policy problem or opportunity?

In principle, GST should apply to all consumption that occurs within New Zealand, including imported goods, as this helps to ensure GST is fair, efficient and simple. However, GST is currently collected on imported goods when duty (including tariffs and GST) of $60 or more applies. This threshold is called the *de minimis* and equates to a consignment value that varies between $226 and $400 according to whether tariffs are payable. The rationale behind having a *de minimis* is to achieve a balance between the cost of collection and revenue collected, as well as to facilitate the free flow of goods across the border.

Non-collection of GST on low-value imported goods

Historically, the majority of imported goods have been imported by businesses in consignments valued above the *de minimis*. When GST was introduced in 1986, few New Zealand consumers imported goods below the *de minimis*. Therefore, the compliance and administrative costs involved in taxing imported goods below the *de minimis* were considered to outweigh the benefits of taxation at that time.

However, the growth in online purchases means that the volume of low-value imported goods on which GST is not collected is becoming increasingly significant. The implication of this is that domestic businesses are at a disadvantage compared with offshore businesses supplying products with no GST added to the price of the goods. It also obviously means that the Government is foregoing GST revenue on goods that are consumed in New Zealand; based on a five-year average, the number of imported low-value goods is growing at about 12 percent per annum and the Government is foregoing an increasing amount of GST.

Foregone revenue

Estimates of the foregone revenue vary. In 2015, Inland Revenue estimated, using a top-down approach based on credit card data, a 'maximum potential' foregone GST revenue figure of approximately $140 million per annum. Officials have done further work using a 'bottom-up approach' which indicates a lower potential foregone GST revenue figure of approximately $80 million for the 2016 calendar year. The growth of business-to-consumer imports is a relatively recent development and the amount is expected to continue to grow – estimates vary but assuming the growth in the total value at 10 percent per year[2], the amount of foregone GST is forecasted to grow to $127 million by 2021.

Competitive neutrality

The extent to which the current non-collection influences consumers' purchasing decisions is unclear, as there are a number of reasons why New Zealand consumers may purchase goods from offshore, including overall cheaper prices, product availability and convenience. However, ideally, the tax treatment should not be a factor in consumers' purchasing decisions.

International developments

The non-collection of GST on low-value imported goods is an international issue faced by countries that have a GST or Value Added Tax (VAT) system.

[2] The growth in the total value of low-value goods imported by New Zealand consumers would be less than the annual growth in volumes of 12%, as the majority of the growth in volumes is at the lower value bands.

From 1 July 2018 Australia will require offshore suppliers to return GST on low-value imported goods (valued at AU$1,000 or less). However, the Australian Productivity Commission is undertaking a review of the effectiveness of this model and of other possible GST collection models.

The European Union has indicated that it intends to introduce an offshore supplier registration scheme to collect VAT on low-value goods from 2021.

Singapore also announced a proposal to introduce an offshore supplier registration model for collecting GST on imported goods (valued at or below S$400) and cross-border services and intangibles. No details have yet been provided for the intended application date.

The broad framework of Singapore's proposed rules is consistent with Australia's new rules and with the systems for cross-border intangibles and services that operate in the EU Member States, New Zealand, Iceland, Japan, Korea, Norway, Switzerland and South Africa.

2.2 Who is affected and how?

The preferred option involves requiring offshore suppliers to register and return GST on their supplies of goods to New Zealand consumers valued at or below $1,000. At the same time, the *de minimis* for collecting GST and other duties on imported goods at the border would be increased to $1,000 to reflect the fact that GST would now be collected on these goods at the point of sale (rather than at the border).

Government

The New Zealand Government would collect additional GST and forego tariffs. Cost recovery fees which fund Customs' and the Ministry for Primary Industries' risk management activities at the border would also be foregone and would presumably be replaced by additional Crown funding. In 2016, the amount of tariffs collected was $5.2 million and cost recovery fees were $17 million.

Domestic businesses

New Zealand-based retailers are in favour of levying GST on low-value imported goods as they are concerned that the non-collection of GST places them at a competitive disadvantage compared with offshore suppliers of low-value goods.

Footwear and clothing manufactures would be affected by the removal of tariff duty on footwear and clothing under the proposed $1,000 threshold.

The impacts on the different parties along the supply chain (offshore suppliers, fast freight New Zealand Post and consumers) are detailed below.

Offshore suppliers and online marketplaces

Offshore suppliers (including e-marketplaces) meeting the $60,000 GST registration threshold would bear the compliance costs of registering and returning GST. Smaller suppliers who fall below this registration threshold would be unaffected (provided that they are certain that they are below the threshold).

It is possible that some smaller suppliers may not know if they might realistically make supplies to New Zealand consumers exceeding the $60,000 registration threshold and therefore may prefer to stop supplying to New Zealand customers rather than go through the exercise of figuring out whether they are liable to register (and then registering for GST if they are). However, it is expected that a lot of these smaller suppliers would sell their goods through an e-marketplace, in which case the marketplace would bear the compliance costs of registering and returning GST. E-marketplaces may be more likely to accept these compliance costs due to their greater resources and larger overall share of the market.

Fast freight

Courier companies would no longer collect GST, tariffs and fees on behalf of the Government on goods between the current *de minimis* and $1,000. This would generate some administrative cost savings for the industry.

New Zealand Post

Like courier companies, New Zealand Post would no longer be involved in collecting revenue on goods valued at or below $1,000 which may lead to some cost savings.

Consumers

Costs and savings

Under the preferred option, consumers would pay GST on imported goods under the current *de minimis* (which they currently would not pay any GST or other duty on) where these goods are supplied by a registered offshore supplier. This means that in some instances they would pay more overall for a low-value good purchased from an offshore business. However, this will not be the case if they purchase a low-value good from a supplier that does not meet the $60,000 registration threshold.

Some imported goods valued between $400 and $1000, on which GST and other duty is currently collected, would become cheaper for consumers as a result of the proposal to not collect tariffs and border fees. As a result of foregoing tariffs and border fees on goods with a value of $1,000 or less, low-value goods will also be processed through the border faster, resulting in consumers seeing improvements in the timeliness of delivery.

Access to goods

As long as offshore suppliers' compliance costs are kept to an acceptable minimum through simplified rules, it is not expected that the preferred option would significantly restrict consumers' access to goods from offshore.

However, there is a possibility of reduced access to goods if offshore suppliers and e-marketplaces refuse to supply goods to New Zealand customers as a result of the proposal. During the May 2017 Australian Senate inquiry on Australia's new offshore supplier registration system, e-Bay expressed opposition to the proposal and noted that it might geo-block Australian consumers from buying goods on its platform.

It should be noted, however, that the then-proposed implementation date for the proposal was 1 July 2017 which, according to submitters, did not allow offshore suppliers and e-marketplaces enough time to prepare for the changes so that they could comply with the new rules. As a result of the concerns expressed by submitters and the lack of consideration of other options, the application date for the legislation was delayed to 1 July 2018.

Increased certainty and simplicity

The elimination of tariff duties and border fees on goods valued at or below $1,000 coupled with the supplier charging GST at the point of sale would provide consumers with greater certainty of the total cost of their imported goods compared with the status quo.

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

An option where financial intermediaries are responsible for returning GST on credit card purchases of low-value goods from offshore was briefly considered and quickly ruled out. The previous work on GST on cross-border services and intangibles considered this option and it was thought to be not feasible because financial intermediaries would be unlikely to have the information necessary to determine if a good or service was supplied by an offshore supplier (and if they did, they likely would not to be able to tell if it was consumed overseas or in New Zealand).

Options 1, 3 and 4 (see below) were being analysed by Customs, Inland Revenue and the Treasury as part of the policy development process, but Ministers decided that the Government discussion document would focus only on the offshore supplier registration option (option 2). The main reason for this is because it is the most efficient method of collecting GST on low value goods, and because other countries, particularly Australia, seem to be moving towards offshore supplier registration as an option for collecting GST/VAT on low-value imports (which means that New Zealand may benefit from following these early adopters). The benefits to New Zealand of international consistency in the adoption of an offshore supplier registration system are discussed further in Section 3.

One interdependency is with the Ministry for Foreign Affairs and Trade's ongoing work on tariffs. Under the preferred option, tariffs would be not be collected on imported goods with a value of $1,000 or less.

Customs' border risk management and the Ministry for Primary Industries' current biosecurity processes are reliant on information about the content of low-value goods. For example, courier companies provide information on low-value goods prior to their arrival at the border for risk management. Data from tariff codes are used by the Ministry for Primary Industries and Customs to risk assess consignments at the border.

There are also cost recovery implications for Customs and the Ministry for Primary Industries, associated with the proposed removal of the Import Entry Transaction Fee and the Biosecurity Systems Entry Levy (which fund Customs' and the Ministry of Primary Industries' risk and biosecurity assessment activities at the border, as well as Customs' revenue collection activities) from goods with a value of $1,000 or less.

Section 3: Options identification

3.1 What options have been considered?

The overarching objectives of this project are to improve the collection of GST on low-value imported goods and, in doing so, to ensure competitive neutrality, so that the GST treatment of low-value imported goods is no different to goods sold domestically. This requires the consideration of the usual tax policy objectives such as the broad-base, low rate framework, efficiency of collection and sustainability of GST revenue.

This work also requires the balancing of wider Government objectives against these tax policy objectives. These wider Government objectives include minimising as far as is practicable any reduction in consumer welfare associated with the broadening of the GST base, as well as Customs' and the Ministry of Primary Industries' objective of maintaining the current levels of border protection.

To be effective in addressing the problem identified, it is necessary that the chosen solution must perform well against our tax policy objectives. However, because of the Government's wider objectives, strong performance against the tax policy objectives is not sufficient in itself; therefore, possible impacts related to consumer welfare, border risk management and biosecurity must also factor into the analysis.

The following key has been used for assessing how well the options perform against these objectives, compared with the status quo:

✓✓ Significantly better than the status quo

✓× Better than the status quo

×× Worse than the status quo

Three policy options and the status quo were considered for addressing the policy problem and meeting the objectives. These were:

- **Option 1:** Retain the current GST and tariff duty collection processes where no GST or tariff duty is collected at the border on goods below the *de minimis*. This is the status quo option which the other options are being assessed against.
- **Option 2:** Require offshore suppliers to register for, collect and return GST on low-value goods supplied to New Zealand resident customers and remove tariff duty and border fees from goods valued at or below $1,000.
- **Option 3:** Require the New Zealand resident customer to return the GST and tariff duty on low-value goods purchased from offshore suppliers (known as a "pay after delivery" or "reverse charge" mechanism).
- **Option 4:** Require fast freight courier companies and New Zealand Post to collect GST and tariff duty on imported goods above a lowered *de minimis*.

The criteria against which the options have been assessed are:

- **Certainty and simplicity:** The rules should be clear and simple to understand, so that taxpayers are aware of the GST treatment of a particular supply and their GST obligations.
- **Efficiency of compliance:** Compliance costs for taxpayers should be minimised as far as possible.
- **Efficiency of administration:** Administrative costs for government departments should be minimised as far as practicable.

- **Fairness and equity:** Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation.
- **Sustainability and neutrality:** The option must have the ability to meet the objectives of collecting the foregone GST revenue and reducing the distortions the current treatment brings about. Counteracting measures should be kept proportionate to the risks involved.

Option 1: Status quo

Assessment against objectives

Foregone GST (2016)	Competitive neutrality	Maintaining consumer welfare	Maintaining the current levels of border protection
$80 million	**Does not meet**	**Meets**	**Meets**

Assessment against criteria

Certainty and simplicity

Under the status quo, consumers pay GST on imported goods to Customs if the total duty on the good (including GST and tariffs) is $60 or more. $400 is commonly understood as the value at which a parcel is likely to be assessed for revenue by Customs and is based on the assumption that GST is the only duty applying to the good.

In some instances, the current system is not simple or certain for consumers to interact with. For example, a consumer that imports a good valued between $226 and $400 on which tariff duty of 10% applies might be surprised to discover that they are liable to pay GST, tariff duty and a cost recovery fee to Customs if they want their good to be released.

Efficiency of compliance

The status quo does not impose compliance costs on offshore suppliers of goods.

When consumers import goods above the *de minimis*, they are required to enter into a second transaction to pay the GST and border fees (and tariff duty, if applicable) on their goods to Customs. They are also likely experience delays associated with the collection of revenue on their goods.

Fast freight courier companies currently collect GST on goods above the *de minimis* where these goods are sent through the fast freight stream, which imposes some administrative costs on them.

New Zealand Post incurs costs in checking consignments over the *de minimis*.

Efficiency of administration

Increasing volumes of low-value goods place pressure on the current revenue collection processes, some of which are manual and resource intensive. Unless better information, particularly in the postal stream, becomes available, there are logistical challenges and costs involved with managing increasing volumes.

Fairness and equity

The current tax collection process places domestic businesses at a competitive disadvantage compared with offshore businesses that can supply low-value goods directly to New Zealand consumers without the imposition of GST.

Sustainability and neutrality

The issues of competitive neutrality would remain unaddressed and are likely to worsen over time if the growth in online shopping for low-value goods continues to grow more rapidly than domestic spending on consumer goods.

Incremental improvements to efficiency of collection under the current system will become possible over time with better data availability (including advance parcel data from the postal system); however, it is uncertain that this will be enough to be sustainable in the long term, given the existing pressures on the system and the rate of growth in parcel volumes.

In the medium term, increased system pressures (including delivery delays for consumers) are likely if investment in border processing capacity is not made or lags behind the growth in online shopping.

Option 2: Offshore supplier registration (preferred option)

Assessment against objectives and status quo

Estimated additional GST collections	Competitive neutrality	Maintaining consumer welfare	Maintaining the current levels of border protection
$43 million in 2019/20, expected to grow to $81 million in 2022/23	✓×	××	✓×

Under this option, tariff revenue and border fees would not be collected on goods with a value of $1,000 or less.

GST would not be collected from offshore suppliers who make total supplies to New Zealand consumers below the $60,000 GST registration threshold in a 12-month period. The collection would also be impacted by the level of compliance.

Assessment against criteria

Certainty and simplicity

This system is widely used internationally for taxing cross-border services and domestic supplies. It should therefore be familiar to international suppliers who supply both services and goods or who are resident in countries with a VAT or GST.

Australia has recently enacted legislation which will apply GST to low-value goods supplied by non-residents using an offshore supplier registration system from 1 July 2018. If this option is implemented in New Zealand from 1 October 2019, a number of suppliers may have already registered and returned GST under Australia's rules by this time, so they would already be familiar with such a system for goods.

New Zealand's GST system is broad-based, with a single rate and almost no exemptions for goods, and therefore should be relatively simple for offshore suppliers to comply with.

However, there will be more GST collection entities compared to the status quo.

The charging of GST by the supplier at the point of sale, coupled with the removal of tariff duties and border fees on imported goods valued at or below $1,000 would provide increased upfront certainty for consumers regarding the total cost to them of the goods they import.

Efficiency of compliance

This option would impose compliance costs on offshore suppliers, most of whom would not be required at present to interact with New Zealand's GST system. However, compliance costs to offshore suppliers should be relatively minimal because New Zealand's GST system is simple compared to other VAT/GST systems around the world. However, there could be significant upfront IT system upgrade costs. Implementing simplified registration processes and other rules aimed at minimising compliance costs are expected to keep compliance costs to an acceptable minimum for the majority of the large offshore suppliers who are well-resourced and who are more likely to have IT systems in place that have the capability to account for GST on supplies to New Zealand consumers.

There would be administration cost savings to courier companies, who would no longer collect GST on goods between the current *de minimis* and $1,000, but will have to provide information to Customs for border and biosecurity risk management.

Efficiency of administration

This option is relatively efficient to administer given systems are already in place to register offshore suppliers of cross-border services as well as domestic suppliers. There would be modest administration cost savings to Customs.

Fairness and equity

Offshore suppliers would be subject to the same rules as those applying to domestic businesses. Consumers should be indifferent as to whether they purchase low-value goods from a domestic or offshore supplier as both suppliers would be required to return GST on that supply.

Sustainability and neutrality

From a tax policy standpoint, this option is neutral because offshore suppliers would be subject to the same GST rules that apply to domestic suppliers (including the $60,000 registration threshold which applies in the domestic context). The sustainability and neutrality of this option in practice depends on the extent to which liable offshore suppliers comply with the rules. Failure on the part of large international suppliers of low value goods (including the prominent marketplaces) to comply with their tax obligations would pose a significant reputational risk to these suppliers.

Where similar rules have been applied in other countries to tax cross-border services and intangibles, offshore suppliers have demonstrated a willingness to comply. This has been the experience in New Zealand so far with the new GST rules for cross-border services and intangibles. It is therefore expected that the majority of the largest offshore suppliers would voluntarily comply.

We do not know yet if consumers' access to goods would be significantly reduced. Delivery times may also be shorter, or at least would not be any slower than under the status quo.

Option 3: Pay after delivery/reverse charge

Assessment against objectives

Estimated additional GST collections	Competitive neutrality	Maintaining consumer welfare	Maintaining the current levels of border protection
Not estimated	✓✗	✗✗	✗✗

Because of the compliance and administrative costs involved with this option, it is likely that a *de minimis* threshold would still be required. GST would be collected on all goods above the *de minimis* which, it is expected, could be set at a much lower level than the effective *de minimis* (where GST is the only duty applying) under the current collection system of $400. Under this option, all goods above the *de minimis* are liable to GST (unlike option 2). However, because consumers receive their goods before they make payment, the level of compliance could potentially be low.

Assessment against criteria

Certainty and simplicity

A large number of taxpayers would be required to return GST, compared with the status quo and with options 2 and 4 where a relatively small number of offshore suppliers or postal/freight carriers would be required to return the GST. At present, most individuals are not required to file personal income tax returns because their income (for instance, from salary, wages or interest) is withheld at source. Given that a large number of individual taxpayers are not currently required to interact with the tax system by filing tax returns or by directly making payments of tax themselves to Inland Revenue, this option may not be simple for some individuals to comply with.

This option could potentially be as simple as paying a parking ticket or a road toll, but compliance may be a major issue.

Efficiency of compliance

As mentioned above, this option would impose compliance costs on a relatively large group of consumers and for relatively small amounts of GST.

Efficiency of administration

Administrative costs are also likely to be significant as this option would involve the development of a new system of receiving GST payments. Resources would also need to be allocated to ensuring consumers complied with their tax obligations, by promoting awareness, providing guidance materials and dealing with enquiries, errors and refunds.

Fairness and equity

The fairness of this option depends on the extent to which consumers comply with the rules, and, where there is non-compliance, whether the penalties are proportionate to the offence. If there is widespread non-compliance, then this option would do little to address the existing fairness issue where domestic retailers are at a competitive disadvantage because of the non-collection of GST on imported goods.

Whether consumers would be required to pay GST on gifts they have received from overseas and the fairness implications of requiring them (or not requiring them) to do so would also need to be considered.

Sustainability and neutrality

If applied consistently and successfully, GST would be returned on both goods provided domestically and from offshore. However, the method of collection would differ significantly depending on whether the supplier was offshore or onshore.

This option would at least not reduce consumers' access to goods supplied from offshore and would not lead to any revenue-related delays in delivery. However, when this option has been applied in other jurisdictions to tax cross-border services received by consumers, its success has been limited. This is likely due to a number of factors such as lack of awareness of the requirement to return GST given that consumers are accustomed to GST being included in the purchase price, and the potential difficulty of enforcing a reverse charge on such a large taxpayer base.

In some cases, the New Zealand purchaser may not realise they are buying from a non-resident supplier. For example, an offshore supplier could have a New Zealand domain name (.co.nz) or a separate chain of New Zealand retail stores. A system could however be put in place where parcels on which GST is required to be paid are identified by Customs at the border and stickers instructing the recipient how to pay the GST are placed on the parcels.

Option 4: Post and courier companies collect the GST

Assessment against objectives

Estimated additional GST collections	Competitive neutrality	Maintaining consumer welfare	Maintaining the current levels of border protection
Not estimated	✓✗	✗✗	✓✗

Under this option, tariff revenue and border fees would continue to be collected on low-value goods above a *de minimis* threshold. GST would be collected on all goods above the *de minimis*, and it could be lowered at some point in time; however, the magnitude and timing of a potential reduction in the *de minimis* is not yet clear. Under this option there is expected to be relatively high collection above the *de minimis* for goods sent through the fast freight stream; however, undervaluation of goods shipped through the postal stream (of which there are a significant number) is rife and, in the medium term, is likely to go undetected due to the lack of advance data for these parcels.

However, where goods are identified as requiring payment of duty, compliance by consumers in paying the GST and other duty would be high like it is under the status quo, since the goods are not delivered until payment is made.

Assessment against criteria

Certainty and simplicity

The rules should be simple for couriers to understand and comply with, as they already have systems in place for collecting and remitting the GST to government. However, such a system would not be simple for New Zealand Post to comply with in the medium term. As postal systems do not currently provide for the collection of advance data on imported goods, the postal system cannot yet efficiently implement this option, although there are a number of developments occurring that will allow for this in the future. Therefore, this option would not be likely to lead to increased simplicity and certainty compared with the status quo.

Efficiency of compliance

A reduced *de minimis* under this option would increase administrative costs for couriers, and for New Zealand Post in particular. Post and fast freight would likely collect a similar amount of revenue at a similar cost to the status quo collection mechanism with a lowered *de minimis*. Therefore, while this option would reduce administration costs for government, these costs would be shifted to courier companies and New Zealand Post.

Efficiency of administration

Administration costs for Customs would be lower than under the status quo.

Fairness and equity

The extent to which this option would improve competitive neutrality is dependent on the extent to which the *de minimis* can be reduced.

Sustainability and neutrality

If the *de minimis* could be reduced significantly to a low level, this approach may capture a high proportion of the foregone GST revenue and could therefore go a long way towards addressing the current distortion. However, as stated above, a significant reduction to the *de minimis* would not be feasible in the medium term.

This option is likely to result in further delivery delays for consumers compared with the status quo.

3.2 Which of these options is the proposed approach?

The preferred option is option 2, offshore supplier registration. It is the preferred option because it is a low-cost option for collecting GST on low-value goods (in terms of both administration and compliance costs), and because it meets the objectives of simplicity and certainty, neutrality, effectiveness, fairness and sustainability and is coherent within the overall GST framework. It also follows the international precedent being set by Australia, which Singapore intends to follow and which the EU intends to implement in 2021.

The proposed approach would address the problems identified by making offshore suppliers of low-value goods subject to the same GST rules as those that domestic suppliers and offshore suppliers of cross-border services are required to comply with. This would therefore ensure that GST is liable to be charged on imported goods below the current *de minimis* if the goods are supplied by a supplier who is liable to register.

However, the level of compliance could potentially be an issue. Compliance might be better assured under the option where courier companies and New Zealand Post collect duty on goods above a lowered *de minimis*, as the consumer would not receive the goods until payment is made. However, it is likely that there would be more foregone revenue as a result of undervaluation under this option, compared with option 2.[3] Implementing this option with a lower *de minimis* would also be challenging without new technology and systems, including advance data in the postal stream, and it is not certain how much the *de minimis* could be reduced by and when.

The proposed approach is not incompatible with the Government's *'Expectations for the design of regulatory systems'*.

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[3] Where GST might not be collected at present as a result of undervaluation by the supplier, this currently foregone GST revenue may be collected under an offshore supplier registration system in cases where an e-marketplace is responsible for returning the GST instead of the underlying supplier.

Section 4: Impact Analysis (Proposed approach)

4.1 Summary table of costs and benefits

Affected parties	Comment:	Impact
Additional costs of proposed approach, compared to taking no action		
Regulated parties	The costs to offshore suppliers would include registering for GST (one-off), altering business systems to account for GST on goods sold to New Zealand consumers (one-off), and returns filing (ongoing). It is assumed that compliance would be high, based on the experience so far with the GST rules for cross-border services and intangibles.	Potentially high upfront systems and low ongoing compliance costs for offshore suppliers above the $60,000 of NZ sales registration threshold
Regulators	The implementation costs to Inland Revenue are estimated to be up to $460,000. This includes the costs to change the current registration form for suppliers of cross-border services to accommodate offshore suppliers of low-value goods and other minor systems changes. It also allows for an increase in the volume of work for staff currently processing registrations. Loss of revenue from border fees to Customs and the Ministry for Primary Industries	Up to $0.46m Approximately $17m in border fees and likely to increase in coming years with the increasing volume of low-value goods.
Wider government	The government would forego tariff revenue collected on low-value goods and Crown funding would be required for border fees foregone by the Ministry for Primary Industries and Customs.	Approximately $5.2m per year and likely to increase in coming years with increasing volume of low-value goods.
Other parties	Consumers would likely pay more for imported goods that are currently below the *de minimis*. Some consumers may pay less because of the proposed removal of tariff duty and border fees. The availability of some goods from overseas may also decrease.	$43m of additional GST imposed on NZ consumers for the 2019/20 fiscal year $64m of additional GST imposed on NZ consumers for the 2020/21 fiscal year $72m of additional GST imposed on NZ consumers for the 2021/22 fiscal year $81m of additional GST imposed on NZ consumers for the 2022/23 fiscal year

Total Monetised Cost		Up to $66m for the 2019/20 fiscal year Up to $87m for the 2019/20 fiscal year Up to $95m for the 2019/20 fiscal year Up to $104m for the 2019/20 fiscal year
Non-monetised costs	Potential lower efficiency of the domestic retail market due to reduction in competitive advantage to offshore suppliers, which may lead to reduced competition from offshore.	Unable to estimate

Expected benefits of proposed approach, compared to taking no action		
Regulated parties	N/A	N/A
Regulators	Additional GST revenue Improved risks management for Customs and the Ministry for Primary Industries	$43m of additional GST revenue for the 2019/20 fiscal year $64m of additional GST revenue for the 2020/21 fiscal year $72m of additional GST revenue for the 2021/22 fiscal year $81m of additional GST revenue for the 2022/23 fiscal year
Wider government	Reduction in administration costs for Customs associated with no longer collecting GST and other duties on goods between the current *de minimis* and $1,000.	Low
Other parties	Reduction in administration costs for fast freight couriers associated with no longer collecting GST and other duties on goods between the current *de minimis* and $1,000. Reduction in costs to New Zealand Post Possible reduction in delivery delays and increased simplicity and certainty for consumers regarding the total cost to them of their imported low-value goods. Increased competitive neutrality between domestic retailers and offshore suppliers.	Unable to estimate

Total Monetised Benefit		$43m for the 2019/20 fiscal year $64m for the 2020/21 fiscal year $72m for the 2021/22 fiscal year $81m for the 2022/23 fiscal year
Non-monetised benefits		Medium

4.2 What other impacts is this approach likely to have?

Offshore suppliers would be subject to the same rules as those applying to domestic businesses. This will be a new compliance regime for offshore suppliers.

The application of GST to imported goods below the current *de minimis* may reduce the demand for such goods. A study by UMR Research shows that consumers are price sensitive, particularly at the lower-value end.[4] However, the extent to which the collection of GST on these goods would reduce consumer demand is likely to be influenced by other factors, such as the domestic availability of the goods.

Where the GST-exclusive price of a good (including delivery costs) is the same regardless of whether it is supplied domestically or from offshore, consumers should be indifferent as to whether they purchase it from the domestic retailer or from the offshore supplier, assuming no difference in quality and delivery times. This is because both suppliers would be required to return GST on the supply of that good if both suppliers are above the registration threshold (which, due to the proposed inclusion of marketplace rules, is likely to be the case in most instances).

The removal of tariff and cost recovery charges on some goods and faster processing times may increase demand for goods valued between $400 and $1,000.

The preferred strategy, as with the rest of the New Zealand tax system, is to rely primarily on voluntary compliance. It is however recognised that some consumers may be incentivised to buy from suppliers who do not charge GST on their purchases.

Some suppliers may try to avoid detection as being liable to register by shifting their method of transporting their goods from freight to the postal system where the quality of parcel data is much poorer than in the fast freight stream.

[4] http://www.customs.govt.nz/news/resources/legal/Documents/UMR-Report-NZ-Customs-consumer-motivation-for-purchases-of-low-value-goods.pdf

Section 5: Stakeholder views

5.1 What do stakeholders think about the problem and the proposed solution?
Meetings with some stakeholders, including New Zealand Post, the Conference of Asia Pacific Express Carries (CAPEC[5]), Consumer NZ and Retail NZ have been held. At the time of drafting this Regulatory Impact Assessment, these stakeholders are not aware of the upcoming release of a discussion document proposing an offshore supplier registration system. CAPEC and New Zealand Post have not been consulted specifically on the analysis and the proposed approach. However, they have flagged their opposition to immediately lowering the *de minimis* under the status quo. Retail industry groups such as Booksellers NZ and Retail NZ are in favour of an offshore supplier registration system, however the proposed waiver of tariffs and border clearance levies may influence their position. Officials also met with representatives from a technology company in July 2017 which has developed a system that could be used for collecting GST from consumers after the delivery of the goods. This company is therefore in favour of the pay after delivery/reverse charge option. Offshore suppliers of low-value goods and domestic consumers have not been consulted yet. Their views about the analysis of the problem and proposed option will be sought through the submission process for the discussion document.

[5] An industry body representing four courier companies – DHL, FedEx, TNT and UPS

Section 6: Implementation and operation

6.1 How will the new arrangements be given effect?
The proposed option will require legislative change and would be largely based on the system that has applied to cross-border services and intangibles since 1 October 2016. The option will also require regulatory changes to the current border management arrangements. This will be considered as part of final policy decisions, and will be considered further in a later Regulatory Impact Assessment. Subject to consultation and final policy decisions, the proposal is likely to come into effect in 2019 which is expected to provide sufficient preparation time for offshore suppliers.

Section 7: Monitoring, evaluation and review

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

Inland Revenue will monitor the outcomes pursuant to the Generic Tax Policy Process ("GTTP") to confirm that they match the policy objectives. The GTPP is a multi-stage policy process that has been used to design tax policy in New Zealand since 1995.

Customs and the Ministry for Primary Industries will monitor the impact on the management of border and biosecurity risks.

If the preferred option is implemented and compliance with the new regime is lower than expected after 12 months of its implementation, Inland Revenue will explore options for increasing compliance. This could include joint compliance initiatives with other jurisdictions that have similar rules, including possible data matching programmes with other jurisdictions and Customs.

This will be considered further in a later Regulatory Impact Statement after final policy decisions have been made.

7.2 When and how will the new arrangements be reviewed?

The final step in the GTPP is the implementation and review stage, which involves post-implementation review of legislation, and the identification of remedial issues. Post-implementation review is expected to occur around 12 months after implementation. Opportunities for external consultation are built into this stage.

Any necessary changes identified as a result of the review would be recommended for addition to the Government's tax policy work programme.

Coversheet: GST on low-value imported goods

Advising agencies	Inland Revenue, New Zealand Customs Service
Decision sought	Final policy approval
Proposing Ministers	Hon Grant Robertson (Minister of Finance), Hon Stuart Nash (Minister of Revenue) and Hon Kris Faafoi (Acting Minister of Customs)

Summary: Problem and Proposed Approach

Problem Definition

What problem or opportunity does this proposal seek to address? Why is Government intervention required?

The Government has made a decision to implement an offshore supplier registration system for collecting GST on low-value imported goods (refer CAB-18-MIN-0143). The problem under consideration is how to implement the proposed system in a way that imposes as little deadweight cost as possible on the parties involved and in the least distortionary way possible, while also maximising voluntary compliance.

Proposed Approach

How will Government intervention work to bring about the desired change? How is this the best option?

The taxing point for imported goods valued at or below $1,000 is proposed to be the point of sale (as opposed to being at the border, as is presently the case for consignments between the Customs *de minimis*[1] and $1,000). This means that non-resident suppliers (as well as electronic marketplaces and "re-deliverers")[2] would be required to register for, collect, return and remit GST on their sales of goods valued at or below $1,000. This is considered to be the most feasible and cost-effective collection option at this time.

Requiring offshore suppliers to collect GST on imported goods valued at or below $1,000 is Inland Revenue's preferred approach. The reason for this preference is that Inland Revenue has placed a higher weighting on making the rules as simple as possible for the parties involved in order to minimise aggregate compliance costs.

[1] The Customs *de minimis* is defined as the minimum amount of "duty" collectable (which includes GST), as opposed to the maximum value of a consignment on which duty is not collected. The *de minimis* is $60, meaning that if the amount of GST and duties on a consignment is less than $60, revenue and cost recovery charges are not collected on that consignment.

[2] An electronic marketplace, such as a website, app or internet portal, is commonly used by sellers to market and sell their products to buyers. Re-deliverers are used by consumers when the supplier of the goods (or the marketplace) does not offer shipping to New Zealand. The most common scenario is that the goods are instead shipped to an overseas mailbox from which the re-deliverer collects the goods and ships them to New Zealand, but the re-deliverer definition would also include businesses providing personal shopper services.

Customs prefers an approach whereby offshore suppliers would be required to collect GST on imported goods valued at or below $400. Under Customs' preferred approach, Customs would continue to collect GST and other charges on imported consignments valued above $400.

Customs prefers this approach because it is estimated to collect $303 million of additional GST over the forecast period compared with $278 million under a $1,000 threshold. The Crown would also forgo up to $8.8 million in tariff duty under a $1,000 threshold, and Customs and the Ministry for Primary Industries would forgo at least $48.9 million of departmental revenue over the forecast period if alternative funding arrangements are not put in place. A $1,000 threshold may also reduce the incentive for importers to provide accurate information, potentially impacting on the effectiveness of border and biosecurity risk management.

Section B: Summary Impacts: Benefits and costs

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

Key beneficiaries are expected to be:

- Government: The New Zealand Government would collect additional GST, estimated to be $66 million for the 2019/20 fiscal year (assuming a 1 October 2019 application date). However the Government may incur a fiscal cost of approximately $17.795 million per annum (based on the 2017/18 year) in replacing funding for Customs and the Ministry for Primary Industries (MPI) that is currently cost-recovered by the two agencies under existing arrangements, depending on final decisions. The Government would also forgo tariffs (of up to $3.2 million per annum based on the 2017/18 year) on consignments valued at or below $1,000.
- Domestic retailers: Collecting GST on low-value imported goods may in some cases help to improve New Zealand-based retailers' ability to compete with offshore suppliers of low-value goods.
- Fast freight: Courier companies would no longer collect GST, tariffs and cost recovery charges on behalf of the Government on goods between the current *de minimis* and $1,000. This is expected to generate some administrative cost savings for the industry.
- New Zealand Post: Like courier companies, New Zealand Post would no longer be involved in collecting revenue on goods valued at or below $1,000 which may lead to some cost savings.
- Consumers: While consumers as a whole are unambiguously worse off, some consumers would benefit from the removal of tariffs and cost recovery charges from imported consignments between the *de minimis* and $1,000.
- Businesses importing low-value goods: Businesses that import low-value consignments would also benefit from the removal of cost recovery charges and tariffs on imported consignments valued at or below $1,000.

Where do the costs fall?
Costs are expected to fall on: • <u>Consumers:</u> Consumers would pay GST on imported goods valued at less than $400 which they previously would not have paid any GST or duties on under the current border collection system. Suppliers' compliance costs may also be passed on to consumers in the form of higher prices (over and above the amount of the tax itself). There is also a risk that consumer choice may be adversely affected if suppliers cease to offer shipping of goods to delivery addresses in New Zealand. Consumers may also experience delays in receiving goods if Customs and MPI require increased physical inspections as a consequence of a potential decrease in the reliability of information provided to Customs for border and biosecurity risk assessment. • <u>Suppliers (including electronic marketplaces and re-deliverers):</u> Suppliers meeting the $60,000 GST registration threshold would bear the compliance costs of making the necessary systems changes and implementing new processes, registering, filing GST returns and remitting the GST to Inland Revenue. Suppliers selling through electronic marketplaces would not be required to register and return GST to Inland Revenue if their non-marketplace sales to New Zealand consumers are less than $60,000, as the operator of the electronic marketplace would be the entity responsible for registering and returning GST on sales made by third parties through its marketplace. In these situations, the marketplace operator may pass its compliance costs on to the underlying suppliers. • <u>New Zealand-based manufacturers:</u> Footwear and clothing manufacturers may be adversely affected by the removal of tariffs on imported footwear and clothing under the proposed $1,000 threshold (given that the few remaining tariffs are mostly on clothing and footwear manufactured in certain countries). However, these industries have already had to adapt to the increasing non-collection of tariffs, as the phased implementation of New Zealand's free trade agreements mean that the amount of tariffs that would otherwise be collected if no action is taken would be decreasing over time anyway. • <u>Customs and MPI:</u> Cost recovery charges[3] which fund Customs' and MPI's risk management activities at the border would be forgone on imported consignments valued at or below $1,000. This would exacerbate an existing funding shortfall for Customs and MPI until a new cost recovery regime is put in place, unless Crown funding is provided to replace the lost cost-recovered funding. Customs and MPI may also incur costs should the quality of data associated with entries diminish resulting in increased physical inspection of goods.

What are the likely risks and unintended impacts, how significant are they and how will they be minimised or mitigated?
Key risks and unintended impacts include: • <u>Risk of suppliers and electronic marketplaces ceasing to offer shipping to New Zealand delivery addresses:</u> If the compliance costs are disproportionately high or are perceived by the relevant collection entities to be too high, there is a risk that some non-resident suppliers or operators of electronic marketplaces may not comply with the rules or may

[3] The Import Entry Transaction Fee and associated Biosecurity Systems Entry Levy.

not continue to ship goods to New Zealand delivery addresses.

This risk is thought to be more significant for smaller suppliers that make supplies to New Zealand consumers near or above the $60,000 registration threshold.[4]

The inclusion of rules that impose the liability to register for and return GST on operators of electronic marketplaces in respect of low-value goods sold through their marketplaces to New Zealand consumers by non-resident suppliers should help to mitigate the risk of smaller suppliers ceasing to ship to New Zealand, as many of these suppliers would be selling to New Zealand through an electronic marketplace. Officials' preferred options that are outlined in this Regulatory Impact Assessment include measures that are intended to simplify the requirements for non-resident suppliers, operators of electronic marketplaces and re-deliverers as much as possible, which should help to reduce this risk.

- Competitive disadvantages for compliant businesses: There is a risk that the addition of GST to the prices of goods offered to consumers by compliant businesses may result in a competitive advantage for other businesses that would not be required to register and return GST (or that would not comply with the rules if liable to register).

  The inclusion of rules that would deem operators of electronic marketplaces to be the suppliers of low-value goods sold through their marketplaces by non-residents should help to minimise this risk by improving compliance with the rules.

  This would however result in GST being collected on goods supplied by non-residents that would not otherwise be required to be returned if these suppliers sold goods to New Zealand consumers through their own website. It is a possibility that this may potentially create a competitive disadvantage for compliant marketplace operators. However, this risk is not thought to be significant given the market dominance of the large electronic marketplaces.

- Quality of import entry information for biosecurity and border risk assessment: The preferred option may reduce the incentive for importers to enter accurate information (as there will be no requirement to pay revenue on consignments below $1,000), which may have adverse consequences for the management of biosecurity and other border risks. Customs and MPI will monitor any impacts on the management of border and biosecurity risks.

- Undervaluation of goods by suppliers or importers for Customs purposes: Compared with the existing *de minimis*, a $1,000 threshold may exacerbate the existing issue of undervaluation in relation to high-value consignments. This may not have a significant impact on net GST collections on imported consignments valued above $1,000 (as the vast majority of imported goods above $1,000 are imported by GST-registered businesses), but this could have adverse implications for the collection of tariffs and

[4] It is assumed that non-resident suppliers with annual sales to New Zealand consumers in excess of $60,000 would predominantly be large (or at least medium) entities, given that the $60,000 registration threshold applies to their supplies to New Zealand consumers rather than their worldwide sales, and that in most cases their sales to New Zealanders would be a small proportion of their total worldwide sales. However, it is likely that there would be some smaller suppliers that would nevertheless have sales to New Zealand consumers in excess of $60,000.

cost recovery charges on high-value consignments. • <u>Potential behavioural changes by consumers:</u> Compared with the existing *de minimis*, the $1,000 threshold may also incentivise consumers to purchase goods valued between $400 and $1,000 free of GST/VAT from offshore retailers that would be below the registration threshold. It is difficult to say how significant this risk may be, since it is expected that many larger offshore retailers that ship goods to New Zealand would be above the registration threshold, and it is unclear how many smaller offshore suppliers below the registration threshold would sell goods to New Zealand consumers through their own website or mail order. Consumers may also be incentivised to arrange for friends or family members in foreign countries to buy goods for them and reimburse the friend or family member. However, whether this would necessarily be cost-effective is uncertain, as it is likely to be the case that the consumer would end up paying foreign VAT, GST or sales tax if they arrange for a friend or family member to buy the goods and ship the goods to them.

Identify any significant incompatibility with the Government's 'Expectations for the design of regulatory systems'.
The proposed approach 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?
Analysing the impact of the proposals on offshore suppliers has been constrained by the lack of data and information available. Fiscal impact estimates have been modelled using retail banking data for the 2017/18 fiscal year supplied by Datamine. Online transactions were identified using a range of methods, including by identifying whether a card was present for a transaction and isolating transactions with known e-commerce only retailers. To exclude services and intangibles and the likes of tax payments, only transactions with merchant category codes clearly related to goods retail were included.

Quality Assurance Reviewing Agency:
The Treasury, Inland Revenue Department and New Zealand Customs
Quality Assurance Assessment:
A joint panel from The Treasury, Inland Revenue and Customs considers that the Regulatory Impact Assessment partially meets the quality criteria.
Reviewer Comments and Recommendations:
The RIS could probably be clearer and more concise, particularly as to the nature and implications of the agency disagreement as to the value threshold below which offshore

suppliers would be required to collect GST.

However, it seems unlikely that this would make the decision itself any more clear-cut, since the adoption of either threshold will entail downsides as well as upsides. It is also evident that consumer and supplier behaviour will be a major driver of the outcome in practice, particularly in terms of revenue collected. It will therefore be important, as set out in the RIS, to collect data and information from different sources, including experience in other jurisdictions, to inform ongoing monitoring and possibly review of the new approach.

Impact Statement: GST on low-value imported goods

Section 1: General information

Purpose
Inland Revenue and the New Zealand Customs Service are 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
The key limitations and constraints on the analysis are as follows: • Range of options considered: The Government has already made a decision that it intends to implement an offshore supplier registration system for collecting GST on imported goods valued at or below $400 (refer CAB-18-MIN-0143). Options considered are therefore focussed on the key design settings for that particular collection model (as opposed to considering alternative collection models), including the level of the low-value goods threshold. • Evidence of the problem: There are some uncertainties about the scale of the problem in terms of estimating the forgone GST revenue. Retail banking data supplied by Datamine suggests a potential forgone revenue figure on imported goods below the *de minimis* for the 2017/18 fiscal year of approximately $130 million, which is assumed to be growing at a rate of around 11.9 percent each year. • Quality of data used for impact analysis: It is not possible to accurately determine how many offshore suppliers may register and comply under the preferred option. A crude estimate may be obtained by reference to the number of entities that have registered under Australia's new GST legislation (which is based on essentially the same collection model). However, registrations are continuing to be processed in Australia, which means that the eventual number of registrants in Australia may be significantly more than the 721 entities that had registered as of 10 July 2018. While there is data on how much GST is collected by Customs on imported goods, it is not possible to determine the net amount of GST collected on imported goods as many consignments are imported by GST-registered businesses that are able to claim the GST back from Inland Revenue. This means the potential fiscal risk of increasing the threshold above which GST is collected on consignments at the border and below which non-resident suppliers, electronic marketplaces and re-deliverers are responsible for returning GST cannot be precisely quantified. • Assumptions underpinning impact analysis: The Government's proposed approach is estimated to increase GST revenue by approximately $66 million for the 2018/19 fiscal year, increasing to $100 million and $112 million in the 2019/20 and 2020/21 fiscal years respectively. The primary caveat to this revenue forecast is that it assumes static behaviour on the part of both suppliers and consumers. However, the imposition of GST on low-value imported goods may decrease consumers' propensity to buy goods from offshore, and may also decrease suppliers' willingness to ship goods to New Zealand, further increasing costs of importing goods for consumers. Another key limitation is that the revenue forecast assumes for simplicity a 100 percent collection rate under the existing border collection system in relation to consignments valued between $400 and $1,000. The limitation of this assumption is that it is clear that undervaluation by suppliers is an issue to some extent, but the exact scale of the problem and the amount of GST forgone as a result are unknown. • Time constraints: Ministers have decided to plan for the introduction of the proposed rules on 1 October 2019. The proposals are therefore required to be included in a bill introduced before the end of 2018 to give affected businesses sufficient certainty about how the rules will operate.

Responsible Managers:	
Chris Gillion Policy Manager Policy and Strategy Inland Revenue 5 September 2018	Anna Cook Director Policy Policy, Legal and Governance New Zealand Customs Service 5 September 2018

Section 2: Problem definition and objectives

2.1 What is the context within which action is proposed?
Historically, the majority of imported goods have been imported by businesses in consignments valued above the *de minimis*. When GST was introduced in 1986, few New Zealand consumers imported goods below the *de minimis*. Therefore, the compliance and administrative costs involved in taxing imported goods below the *de minimis* were considered to outweigh the benefits of taxation at that time. However, the growth in online purchases means that the volume of low-value imported goods on which GST is not collected is becoming increasingly significant (retail banking data supplied by Datamine indicates that New Zealand consumers spent approximately $870 million online on goods from offshore suppliers in 2017/18). The implication of this is that domestic businesses may be at a disadvantage compared with offshore businesses supplying products with no GST added to the price of the goods. It also means that the Government is forgoing GST revenue on goods that are consumed in New Zealand, and this forgone revenue is increasing over time. Based on a seven-year average, the number of imported consignments valued below $400 is growing at about 17 percent per annum. In response to these issues, the Government has made a decision to implement an offshore supplier registration system for collecting GST on low-value imported goods (refer CAB-18-MIN-0143).

2.2 What regulatory system, or systems, are already in place?
Border collection system GST is currently collected by the New Zealand Customs Service on imported consignments on which at least $60 of “duty” (including GST) is collectable. In practice this means that GST is not collected on imported consignments with a value below $400 (including freight and insurance) if GST is the only duty owing (which is typically the case). However, where the goods are subject to tariffs, the insurance and freight-inclusive value of the goods may be as low as $226, depending on the applicable tariff rate and the amount of international freight and insurance charges.[5] Customs’ and MPI’s border risk and biosecurity activities are funded by the collection of cost recovery charges on imported consignments above the *de minimis*. Work to date has shown that a substantial reduction in the current *de minimis* (from $60 of duty) is not feasible in the short term as the marginal costs of collection under the existing system would outweigh the additional revenue collected. The extent to which the *de minimis* may eventually be reduced in a cost-effective way under the current system or under a model where fast freight carriers and New Zealand Post collect the GST is also uncertain, as is the likely timing of such a reduction in the *de minimis*. Other interested agencies (from a trade, competition or consumer affairs standpoint) are the Ministry for Foreign Affairs and Trade (MFAT) and the Ministry of Business, Innovation and Employment (MBIE), who were all consulted during the process of drafting this Regulatory

[5] This consignment value of $226 assumes that the applicable tariff rate is the maximum 10 percent rate and that there are no clearly separable freight and insurance charges.

Impact Assessment.

Offshore supplier registration system for collecting GST on remote services

The preferred option builds upon the existing system that has been successfully implemented since 1 October 2016 for the collection of GST on cross-border supplies of "remote" services, including supplies of digital services and intangibles such as streaming services and software.

At the time of designing the rules, policy officials had conservatively estimated the total forgone GST revenue to be around $40 million and that around 100 businesses might register. Since implementation, the rules have been performing better than initial expectations, with $131 million in revenue being collected under these rules for the 2017/18 tax year (the year covering 1 April 2017 to 31 March 2018) with over 200 businesses registered to date. This more than favourably compares with other jurisdictions' experience with implementing similar rules for the collection of consumption taxes on cross-border services and intangibles.

2.3 What is the policy problem or opportunity?

GST as a broad-based consumption tax should apply to all consumption that occurs within New Zealand, including imported goods. This helps to ensure GST is fair, efficient and simple, as opposed to being a tax that distorts competition by creating biases in consumers' or businesses' behaviour or which collects little revenue by only collecting on a narrow tax base.

At present, GST is collected on imported goods when duty (including tariffs and GST) of $60 or more applies. This threshold is called the *de minimis*[6] and equates to a consignment value that varies between $226 and $400 according to whether or not tariffs are payable. The non-collection of GST is problematic because the growth in online purchases from offshore suppliers means that the volume of low-value imported goods on which GST is not collected is large and growing, and so is the amount of forgone revenue.

Forgone revenue

Estimates of the forgone revenue vary. In 2015, Inland Revenue estimated a 'maximum potential' forgone GST revenue figure of approximately $140 million per annum using credit card data. Officials did further work in 2016 using a mixed dataset including Customs sample data on import values, as well as data on volumes from New Zealand Post and fast freight carriers and Australian estimates of the split between business and consumer purchases. This work indicated a lower potential forgone GST revenue figure of approximately $80 million for the 2016 calendar year. More recently, Inland Revenue has estimated using retail banking data that approximately $130 million in GST revenue was forgone in 2017.

This more recent figure is considered to be more robust than previous estimates, as the use of merchant category codes and proxies for identifying online-only transactions should mean that the dataset roughly consists only of online purchases of goods from offshore suppliers. A limitation of the 2015 estimate is that an assumption had to be made about the split between spending on goods versus spending on services and intangibles. The main limitation of the

[6] The rationale behind having a *de minimis* is to achieve a balance between the cost of collection and revenue collected, as well as to facilitate the free flow of goods across the border.

2017 estimate (based on a mixed dataset including Customs' sample data) is that its reliance on declared values may produce an estimate that is lower than the actual forgone revenue, as suppliers may be incentivised under the current system to under-declare values.

The growth in direct consumer imports is a relatively recent development and the amount of forgone GST is expected to continue to grow – estimates vary but assuming the growth in the total value of goods imported below the *de minimis* is 11.9 percent per year[7], the amount of forgone GST is forecasted to grow to $183 million by 2021 if no action is taken.

Competitive neutrality

The extent to which the current non-collection influences consumers' purchasing decisions is unclear, as there are a number of reasons why New Zealand consumers may purchase goods from offshore, including overall cheaper prices, product availability and convenience. However, ideally, the tax treatment should not be a factor in consumers' purchasing decisions.

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

The following options were considered and ruled out by ministers:

- **Collection between the point of sale and delivery by transporters:** fast freight carriers and New Zealand Post would collect GST, tariffs and cost recovery charges on goods above a lowered *de minimis* ("extended status quo" or "transporter model").

- **Collection after delivery:** consumers would pay GST directly to the government after delivery of the goods ("pay after delivery" or a "consumer reverse charge").

These options were also considered by officials in a previous Regulatory Impact Assessment in July 2017 and by the Tax Working Group (the TWG). The TWG recommended that the Government implement an offshore supplier registration system for collecting GST on low-value imported goods, noting that practical concerns with options to collect GST between the point of sale and delivery and after delivery mean these two options may not be feasible in the short term.

The previous work on GST on cross-border services and intangibles considered an option where financial intermediaries, such as credit card companies and other payment processing intermediaries, would be responsible for remitting GST on online purchases of low-value imported goods. This option was considered to be unlikely to be feasible because financial intermediaries would be unlikely to have the information necessary to precisely determine in all cases whether the payment was for goods or services (or both), or whether the goods or services were purchased while the consumer was overseas. Another limitation is that where the payment for the goods is made to a New Zealand-based entity (such as a resident marketplace), there would not be sufficient information about whether the underlying supplier of the goods is based offshore or not.

Interdependencies with ongoing work

Customs' border risk management and MPI's current biosecurity processes are reliant on

[7] The growth in the total value of low-value goods imported by New Zealand consumers would be less than the annual growth in volumes of 17%, as the majority of the growth in volumes is at the lower value bands.

information about the content of low-value goods. For example, courier companies provide information on low-value goods prior to their arrival at the border for risk management. Import entry data are used by MPI and Customs to risk-assess consignments at the border. This means that these existing information requirements would need to remain in place under the preferred option, even though this information would not be used for the collection of GST or tariff duty on low-value imported goods.

There are also cost recovery implications for Customs and MPI, associated with the proposed removal of the Import Entry Transaction Fee and the Biosecurity Systems Entry Levy (which fund Customs' and MPI's risk and biosecurity assessment activities at the border) from imported consignments with a value of $1,000 or less. Customs is currently reviewing its cost recovery arrangement and will report back on the financial implications of its lost cost-recovered funding in the context of that review. MPI expects to report to Cabinet on the financial implications of its lost cost-recovered funding at the time of final policy decisions by Cabinet on the GST on low-value imported goods proposals.

Both MFAT and MBIE carry out work which has implications for New Zealand's tariff policy.

2.5 What do stakeholders think?

The main stakeholders are consumers, non-resident suppliers of low-value goods, operators of electronic marketplaces, re-deliverers, the fast freight industry and customs brokers, New Zealand Post, domestic retailers, tax advisors and domestic clothing and footwear manufacturers.

A government discussion document *GST on low-value imported goods: An offshore supplier registration system* was released in May 2018 for full public consultation on key design issues. Inland Revenue received 32 submissions in response to the discussion document. A further 49 submissions to the Tax Working Group that mentioned the GST on low-value imported goods issue were also forwarded to Inland Revenue officials to consider. The submissions received were from private sector tax advisors, goods transporters and customs brokers, New Zealand business groups, electronic marketplaces and a number of private individuals.

Most submissions were generally favourable at a high level of the proposed offshore supplier registration system. However, some submissions indicated a preference for a different collection model to the one proposed in the discussion document, or otherwise stated that other collection models should be given further consideration before being discounted. A couple of submissions from tax advisors considered that the proposed offshore supplier registration system may only be an interim step until technological advancements make an alternative collection model feasible.

The New Zealand retail industry groups that made submissions on the discussion document agreed with the analysis of the problem presented in the discussion document and were strongly in favour of the proposed solution. New Zealand Post, fast freight carriers and customs brokers were also broadly supportive of the proposed approach but expressed some concerns about the finer details of how the system would be implemented, particularly in relation to the lack of detail provided in the discussion document as to how the proposals would interact with customs processes at the border and any potential changes to these processes.

Most private individuals (the bulk of whom submitted to the TWG rather than on the discussion document) supported the collection of GST on low-value imported goods. However, as most of these submissions were made to the TWG prior to the release of the discussion document, these submissions tended not to comment on any specific details of the proposals, such as the proposed collection model. A small number of submissions (including those on the discussion document and to the TWG) from private individuals were opposed to the collection of GST on low-value imported goods regardless of the collection model.

Submitters' views on the design options are noted in the discussion of those options in section 5.

Section 3: Options identification

3.1 What options are available to address the problem?

The options analysed in section 5 consist of the following packages of key design options:

- Option one: Design options proposed in the government discussion document (with some gap-filling design options added in for where the discussion document was silent on a specific design detail).
- Option two: Design options reflecting submissions received on the discussion document, with a low-value goods threshold of $400.
- Option three: Design options reflecting submissions received on the discussion document, with a low-value goods threshold of $1,000.

Option one: Design options proposed in the government discussion document (status quo option)

In April 2018, Cabinet decided to implement an offshore supplier registration system for collecting GST on imported goods valued at or below $400 and to release a government discussion document to consult on the design details of the proposed system (refer CAB-18-MIN-0143).

This option reflects the package of design features that were proposed in the government discussion document released for public consultation in May 2018.

Scope of the rules and registration requirements

The proposed offshore supplier registration system would only apply to goods supplied by non-residents with a customs value of $400 or less.[8]

Goods would be covered by the proposed regime where either the actual supplier of the goods (or the supplier for GST purposes if not the same person) arranges, assists or facilitates the delivery of the goods to a New Zealand address.[9]

Supplies to GST-registered businesses would be excluded from the scope of the rules. Rules for determining whether the supply is made to a consumer or to a GST-registered business would apply. However, where GST is charged on a supply to a GST-registered business, the supplier would be allowed to issue the recipient with a tax invoice (thus allowing the GST-registered recipient to claim a deduction for the GST in its GST return), provided that the value of the supply does not exceed $1,000 – otherwise the supplier would be required to

[8] The calculation of the customs value is set out in Schedule 4 of the Customs and Excise Act 2018. In the case of low-value imported goods, the customs value would generally be the transaction value of the goods (being the price paid or payable when they are sold for export to New Zealand), subject to a number of adjustments including deductions for the costs of transportation, insurance and other charges and expenses related to the handling and transportation of the goods from the time they have left the country of export. For the purposes of determining whether GST applies at the point of sale, a supplier would be able to self-assess the customs value using a reasonable estimate as at the time of supply, rather than being required to determine it strictly in accordance with schedule 4 of the Customs and Excise Act.

[9] The discussion document was silent on whether or not this $400 threshold would be based on the customs value or the freight and insurance-inclusive value of the goods. Basing the threshold on the customs value of the goods has been chosen on the basis of feedback received in submissions.

provide a refund of the GST.

Non-resident suppliers would be required to register for GST and collect and return GST on goods that have a customs value of $400 or less if their taxable supplies of goods and services exceed (or are expected to exceed) $60,000 in a given 12-month period. However, where low-value goods are sold through an electronic marketplace, the operator of the electronic marketplace would be deemed to be the supplier of the goods for GST purposes and would therefore have the responsibility for registering and returning GST. Suppliers that only sell through GST-registered electronic marketplaces (or who make less than $60,000 in taxable supplies outside of a GST-registered electronic marketplace) would not be required to register.

A re-deliverer would only be deemed to be the supplier of low-value goods imported by a consumer if neither the supplier nor an operator of an electronic marketplace assists in bringing the goods to New Zealand.

Interaction with border collection system

GST, tariffs and cost recovery charges would not be collected at the border on imported consignments with a customs value of $400 or less. However, GST (along with tariffs, cost recovery charges and other applicable levies) would continue to be collected at the border by Customs on consignments with a customs value in excess of $400.

Double taxation (where both the supplier and Customs collect GST) may arise when multiple low-value goods are sent in a single consignment valued above $400, or if low-value goods are sent in a consignment with goods valued above $400. Double taxation could also arise where the exchange rate used by the supplier at the time of supply differed from that used by Customs at the time of importation.

The supplier would be required to issue a receipt to a New Zealand consumer in relation to a supply of low-value imported goods. The receipt would be required to include the name and GST registration number of the supplier, the date of issue and a description of the goods supplied. If GST has been charged on all of the goods, the receipt should show the amount paid for the supply along with a statement that this includes GST, or alternatively, the receipt could identify the GST charged for each of the goods separately. If GST has been charged on only some of the goods (for instance if some are valued above $400), the receipt should include information showing whether GST has been charged on each of the goods. Monetary amounts detailed on the receipt would not need to be in New Zealand dollars. To prevent Customs from collecting GST on the importation of the goods, the consumer would provide their receipt to Customs when asked by Customs to pay the GST.

Where double taxation does arise, the supplier would be responsible for providing the consumer with a refund of the GST.[10]

Electronic marketplace operators' and re-deliverers' liability for underpaid GST

[10] The discussion document was silent on who would provide a refund. Placing the responsibility for providing refunds on the supplier is included as one of the design options here as it is officials' preferred option in relation to who is responsible for providing refunds.

Operators of electronic marketplaces and re-deliverers need to use information from either underlying suppliers or consumers to determine the GST treatment of supplies. A marketplace operator would need to have information about the residency of an underlying supplier, as the proposed marketplace rules only apply to supplies made by non-resident underlying suppliers. Re-deliverers would rely on information provided by consumers about the value of the goods.

Marketplace operators and re-deliverers would still be liable for GST and any associated interest or penalties in situations where the supplier or consumer provides incorrect or misleading information which results in a GST shortfall.

Operators of electronic marketplaces would also be liable for GST on goods sold by non-resident suppliers through their marketplaces to New Zealand consumers in situations where:

- The payment for the goods is made directly to the supplier instead of to the marketplace operator, or when there is not a split payment mechanism allowing the amount of the GST to be remitted by the payment processor to the marketplace operator; and
- The supplier defaults on paying the amount of the GST to the marketplace operator.

Option two: Design options reflecting submissions received on the discussion document, with a low-value goods threshold of $400

Scope of the rules and registration requirements

With the exception of two additions, the design features relating to the scope of the proposed rules are the same as those described under option one.

To reduce compliance costs for some suppliers (including re-deliverers and operators of electronic marketplaces), these businesses would be able to charge GST on goods valued above $400 supplied to New Zealand consumers if:

- The supplier (or deemed supplier) self-assesses that their total sales of goods individually valued above $400 are no more than 5 percent of the value of their total supplies of goods to New Zealand consumers; or
- The Commissioner of Inland Revenue exercises her discretion to allow a supplier not meeting the above 5 percent test to charge GST on goods valued above $400.[11]

To reduce compliance costs for suppliers in distinguishing between supplies to consumers and to GST-registered businesses, suppliers would also be able to agree with the Commissioner on an alternative method for determining whether a supply is made to a GST-registered person. This could apply in situations where the nature of the supply or the total value of the supply is such that it would be expected to be received only by a GST-registered business. For example, if the supply is of a large number of low-value imported goods (for

[11] The proposed discretion could cover circumstances where the 5 percent test is not met due to a minor or one-off discrepancy, where it is too difficult for the supplier to determine precisely whether or not their supplies of goods above the threshold to consumers are less than 5 percent of their total sales of goods to consumers (but it is likely to be the case that they would be less than 5 percent) and the Commissioner is satisfied that the supplier represents a low compliance risk.

instance, hundreds of t-shirts or hundreds of hard copies of a book), either the nature or the value of the supply (or both) would likely indicate that the customer is not a consumer.

The design features relating to registration requirements are the same as in option one.

Interaction with border collection system

Aside from one addition relating to the prevention of double taxation, the design features for how the proposed offshore supplier registration system would interact with the existing border collection system are the same as those described under option one.

The supplier would be required to take reasonable steps to ensure that GST information is included on Customs documents.[12] The supplier could do this by providing the fast freight carrier with a copy of the receipt described under option one, or by instructing the person that undertakes the fulfilment of the goods to do so. If the value of the consignment is above the low-value goods threshold, the fast freight carrier or customs broker would include the supplier's GST registration number and information about which goods had GST collected by the supplier on the Customs documentation. If this information is included on Customs documents then Customs will only collect GST on the items in the consignment on which GST was not collected at the point of sale.

Electronic marketplace operators' and re-deliverers' liability for underpaid GST

The Commissioner would be provided with the ability to prescribe or agree to a method for a marketplace operator or a re-deliverer to make conclusions relevant to whether they are the deemed supplier of low-value goods and the amount of GST that is payable. When exercising the discretion, the Commissioner would take into account the commercially relevant information that is available to the marketplace operator and the reliability of this information, the compliance costs of the marketplace operator and the mechanisms the marketplace operator has to prevent and address situations where incorrect information is provided. Where the marketplace operator or re-deliverer has a safe harbour agreement, they would not be liable for additional GST if they have relied on incorrect information and as a result have underpaid GST. If this happens, the underlying supplier or consumer may be required to register and pay the GST instead.

Operators of electronic marketplaces would be able to claim a bad debt deduction in circumstances where the supplier defaulted in paying the GST to the marketplace operator, provided the marketplace's commission or facilitation fee was also not collected.

Option three: Design options reflecting submissions received on the discussion document, with a low-value goods threshold of $1,000 (Ministers' proposed option)

Scope of the rules and registration requirements

The proposed offshore supplier registration system would generally apply to goods supplied by non-residents with a customs value of $1,000 or less. With the exception of the change in

[12] At present this would only be feasible where goods are being delivered by fast freight, as there is currently insufficient electronic data on parcels sent through the international postal system. Hence this would not be a requirement where goods are sent to New Zealand by post.

the proposed low-value goods threshold from $400 to $1,000, the other design features relating to the scope of the proposed rules and registration requirements would be the same as those described under option two.

Interaction with border collection system

GST, tariffs and cost recovery charges would not be collected at the border on imported consignments with a customs value of $1,000 or less. However, GST (along with tariffs, cost recovery charges and other applicable levies) would continue to be collected at the border by Customs on consignments with a customs value in excess of $1,000.

The design features for the prevention of double taxation are the same as those under option two, as is the process for GST refunds where double taxation does arise.

Electronic marketplace operators' and re-deliverers' liability for underpaid GST

The design features for marketplace operators' and re-deliverers' liability for underpaid GST (where the supplier or consumer provided incorrect or misleading information or where the supplier defaulted in paying the GST to the marketplace operator) are the same as those in option two.

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 criteria against which the options have been assessed are:

- **Certainty and simplicity:** The rules should be clear and simple to understand, so that taxpayers are aware of the GST treatment of a particular supply and their GST obligations.
- **Efficiency of compliance:** Compliance costs for businesses and consumers should be minimised as far as possible.
- **Efficiency of administration:** Administrative costs for government departments should be minimised as far as possible.
- **Fairness and equity:** Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation.
- **Sustainability and neutrality:** The preferred option must have the ability to meet the objectives of collecting the forgone GST revenue and reducing the distortions the current treatment brings about, without unduly restricting trade and consumer choice or creating new distortions. Counteracting measures should be kept proportionate to the risks involved.

Efficiency of compliance, sustainability and neutrality and fairness and equity are the most important criteria. It is generally worth trading off increased administration costs for gains in these three areas.

The certainty and simplicity criterion would generally be positively correlated with the efficiency of compliance criterion, in that the more certain and simple the rules are, the lower compliance costs should be. However, there are some instances where increased simplicity and certainty for one group may come at the cost of increased uncertainty or complexity for another group. There may also be instances where having more flexible as opposed to prescriptive rules makes the rules simpler for some parties (and thus reduces their compliance costs) but results in the rules being more complex or less certain for other parties.

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

No low-value goods threshold

An option where offshore suppliers, electronic marketplaces and re-deliverers would be required to charge GST on all supplies of imported goods to New Zealand consumers (with or without GST collection at the border by Customs on consignments above a certain value) was ruled out. This option was discounted because of concerns about the potential revenue risks involved with replacing the existing collection of GST at the border on high-value consignments with collection at the point of sale by offshore suppliers, being that offshore suppliers may not return the GST that they had collected (or had purported to have collected on the customs documentation).

Defining the low-value goods threshold with reference to the value of the transaction

Defining the low-value goods threshold in terms of the value of the total transaction, as opposed to the value of an individual good, was also ruled out. This is because multiple low-value goods could be sold together in the same transaction with a total value in excess of the low-value goods threshold. Non-taxation would therefore arise where the goods were shipped separately in multiple consignments each valued below the low-value goods threshold, thus creating an avoidance opportunity.

Preventing double taxation

The discussion document asked for submissions on whether a reasonable belief exception similar to that legislated in Australia may be an appropriate way to avoid double taxation. Under a reasonable belief exception, the supplier would not charge GST on a supply of low-value goods if it had a reasonable belief that the goods will be shipped together in a single consignment with a total value above the low-value goods threshold. A reasonable belief exception was ultimately ruled out on the basis that it would likely be only very rarely used by suppliers, based on the experience so far in Australia. It may also be potentially quite subjective, which could create difficulties for suppliers pose and potentially pose an integrity risk.

Refunds where double taxation arises

Options where either Customs or Inland Revenue would be responsible for providing GST refunds to consumers where double taxation arises were considered and ultimately ruled out. This is mostly because having Customs provide refunds would be disproportionately costly and would likely be difficult for consumers (at present the provision of one refund takes two hours of staff time). Given that the instances of double taxation should be rare, having Inland Revenue set up an entirely new process is likely to also be disproportionately costly. It would also not be intuitive for consumers to approach Inland Revenue for a refund (being a party that they had not otherwise had any interaction with in relation to the transaction).

It is expected that placing the responsibility for providing refunds on suppliers would provide suppliers with more incentive to take reasonable steps to prevent double taxation.

Business-to-business supplies

Options where offshore suppliers would be required to register and return GST in respect of business-to-business supplies or where suppliers would have the option of charging GST on business-to-business supplies valued above $1,000 were ruled out owing to the revenue risks associated with high-value supplies, which naturally pose a greater fraud risk.[13]

Electronic marketplaces

A "pure" vendor collection model (where the only persons that would have a liability to register and return GST would be suppliers that have legal title over the goods sold to consumers) was not considered. Officials consider that the level of compliance with a pure vendor collection model would not be likely to be good enough to warrant serious consideration of such a model, as it is expected that a large proportion of revenue would continue to be forgone while also meaning that there would not be a level playing field for suppliers that do comply.

A joint and several liability model, similar to the one introduced in the United Kingdom for tackling non-compliance by suppliers selling through online marketplaces, was not given much consideration primarily because it is similar to the rebuttable presumption model described below, and hence there are similar concerns with it in relation to compliance costs, enforcement and administration costs.

Consideration was given to two exceptions to the "deemed supplier" approach behind the proposed marketplace rules:

- Rebuttable presumption model: The default position would be that the marketplace would be deemed to be the supplier, but this presumption of liability can be rebutted if the marketplace agrees to meet the requirements of a "recognised marketplace". A recognised marketplace would be required to provide Inland Revenue with information about their underlying suppliers, including their trading names, contact details and the total value of supplies of low-value goods that each of their underlying suppliers is making through the marketplace to New Zealand consumers.

  A recognised marketplace would also endeavour to ensure that liable suppliers have registered and are returning the GST on supplies made to New Zealand consumers, and would be required to block suppliers that are continuously non-compliant from selling to New Zealand where the marketplace is aware or should be aware of this non-compliance. For low-level compliance with their responsibilities, a recognised marketplace would be subject to warnings, ultimately leading to monetary penalties. For significant or ongoing non-compliance the marketplace would lose its "recognised" status even if, despite its best efforts to ensure compliance from suppliers, the suppliers selling through the marketplace are largely non-compliant.

[13] Although the goods covered by the proposals are by definition of a low value, multiple low-value goods may nevertheless be supplied together as a single high-value supply.

- Commissioner discretion: The Commissioner would have a discretion to allow a given electronic marketplace to not have the responsibility for registering and returning GST in respect of goods sold through its platform. This discretion would apply where the Commissioner considers the marketplace has a compelling case that it cannot be reasonably expected to be able to comply with the deemed supplier requirements.

These two options were ultimately ruled out for the following reasons:

The rebuttable presumption model (and the Commissioner discretion if exercised) would shift compliance costs to underlying suppliers. Aggregate compliance costs are therefore likely to be higher as a result of there being more collection entities, some of whom may have less sophisticated systems and may not be as well-resourced.

The model would rely on ongoing commitment of resources by Inland Revenue and operators of recognised marketplaces to continually educate suppliers and enforce compliance. It is questionable that these responsibilities and the information requirements for recognised marketplaces would be less onerous than their obligations under the deemed supplier model. Inland Revenue and operators of recognised marketplaces would also need to deal with the risk of underlying suppliers continually creating new identities to avoid GST. If compliance is perceived to be low, this may reduce the willingness of other suppliers to comply.

It would be difficult to assess the point at which the recognised marketplace would need to revert to being deemed to be the supplier for GST purposes where there is persistent non-compliance by underlying suppliers. Compliant underlying suppliers may be disrupted by potential deregistration.

The rebuttable presumption model (and the Commissioner discretion option) would create uncertainty for electronic marketplaces and underlying suppliers in the lead-up to the implementation date, as it may take a considerable amount of time to reach an agreement with the Commissioner (or for the Commissioner to reach a conclusion as to whether her discretion should be exercised). Given the relatively short lead-in time from the intended legislative enactment date and 1 October 2019, it is desirable that all parties have certainty about their obligations so that they can make adequate preparations to comply.

The use of the Commissioner's discretion would be likely to distort competition between electronic marketplaces. There may also be risks that the Commissioner may be perceived as applying the discretion unfairly where it is available only to some electronic marketplaces, which would have an adverse effect on the integrity of the tax system.

It may be difficult for the Commissioner to apply the discretion consistently and assess whether the marketplaces are capable of collecting GST. It may be especially difficult for the Commissioner to respond to assertions that a marketplace may withdraw from the New Zealand market if the discretion is not applied.

Many of the prominent electronic marketplaces would already be registered in Australia under their equivalent legislation. In many cases the systems already implemented by these marketplaces for Australia could be extended to comply with New Zealand's rules, as the rules would be broadly similar.

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?

	Option one **Status quo (Design options proposed in the government discussion document)**	**Option two** **Design options reflecting submissions, with a low-value goods threshold of $400**	**Option three** **Design options reflecting submissions, with a low-value goods threshold of $1,000**
Certainty and simplicity	**0**	+ The addition of simplifying design details post-consultation should simplify compliance for suppliers, electronic marketplaces and re-deliverers compared with option one.	++ Suppliers that only sell goods valued at or below $1,000 or who fall into the 5 percent rule as a result of the $1,000 threshold can charge GST on all of their supplies to New Zealand consumers rather than being required to distinguish between goods valued below or above the threshold. Greater price transparency for consumers compared with options one and two as GST is charged at the point of sale and tariffs and cost recovery charges are removed from imported consignments valued at or below $1,000.
Efficiency of compliance	**0**	+ Some compliance cost savings compared with option one.	+ This option is expected to have the least compliance costs overall compared with the other options owing to the $1,000 threshold.
Efficiency of administration	**0**	+ Some administrative cost savings for Customs in relation to preventing double taxation, owing to the requirement for suppliers to ensure that GST information is included on Customs documents where goods are delivered by fast freight. Administration costs for Inland Revenue would be the same as those under option one.	+ Administrative cost savings for Customs in relation to the prevention of double taxation. Administration costs for Inland Revenue would be the same as those under options one and two.
Fairness and equity	**0**	+ Reduced compliance costs for suppliers and consumers, including reduced potential for double taxation (since the supplier would be required to provide a refund if double taxation occurs).	+ More suppliers are likely to be liable to register under this option, increasing the coverage of imported goods that are subject to GST compared with options one and two. Reduced potential for double taxation owing to $1,000 threshold and the proposed mechanisms for preventing double taxation. There is however less fairness for retailers importing consignments valued above $1,000 that are subject to tariffs compared with options one and two (up to $2.6m

			more in tariffs p.a. would be forgone).
Sustainability and neutrality	**0**	**+** Estimated GST collections are the same as under option one. However, the reduction in compliance costs for suppliers compared with option one may mean that less suppliers cease to ship to New Zealand or refuse to comply.	**++** Estimated to collect $25m less in GST over the forecast period than options one and two. However, this option is considered to be the most sustainable over the longer term, as it is considered that it may result in a better compliance outcome than options one and two whilst minimising the number of suppliers that cease shipping to New Zealand (and therefore may actually result in more GST being collected). Approx. $14.9m p.a. in cost recovery charges for Customs and MPI would be forgone compared with options and two. Any resulting funding shortfall may have to be funded through a changed cost recovery structure or through replacement Crown funding.
Overall assessment	**0**	**+** This option is an improvement over option one with respect to all of the considerations.	**++** Sustainability and neutrality and efficiency of compliance outweigh the other considerations. This option is an improvement over option two with respect to most of the other considerations and is therefore Inland Revenue's preferred option.

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?
Inland Revenue officials consider the preferred option is **Option three: Design options reflecting submissions received on the discussion document with a low-value goods threshold of $1,000**. Customs officials prefer **Option two: Design options reflecting submissions received on the discussion document with a low-value goods threshold of $400**. The reason for Inland Revenue's preference is that Inland Revenue has placed a higher weighting on the efficiency of compliance criterion (in particular the compliance costs imposed on offshore suppliers and electronic marketplaces, as well as the freight and logistics industry). It is acknowledged that the additional benefits to offshore suppliers, electronic marketplaces and the freight and logistics industry of the $1,000 threshold compared with a threshold of $400 cannot be valued with certainty, whereas the estimated impacts on the government's financial position are better understood. There is also uncertainty in predicting possible unintended behavioural changes by consumers (as well as other importers and their agents) as a result of a $1,000 threshold. To mitigate these factors and their associated risks, specific monitoring of implementation and compliance will be established, and a post-implementation review of the level of the threshold will be conducted after three years. Customs' preference is for a low-value goods threshold of $400 (as in options one and two), as this is estimated to collect $303 million of GST over the forecast period compared with $278 million under a $1,000 threshold (option three). The Crown would also forgo up to $8.8 million in tariff duty under option three, and Customs and MPI would forgo at least $48.9 million of departmental revenue over the forecast period if alternative funding arrangements are not put in place. A $1,000 threshold may also reduce the incentive for importers to provide accurate information, potentially impacting on the effectiveness of border and biosecurity risk management. **Trade, competition and consumer choice issues** Some private submitters expressed concerns that consumers' access to goods from offshore may be significantly reduced as a consequence of the proposals if they go ahead. These sentiments were echoed by Business NZ and KPMG, who while being broadly supportive of the proposals noted that there is a risk that implementation of the policy will affect consumer choice and trade. Business NZ warned against making the rules overly complicated, noting that a pragmatic and reasonable approach is needed to ensure the impacts on trade, competition and consumer choice are minimal. It was also pointed out there could be reciprocal problems for New Zealand exporters if New Zealand is perceived to be a country to avoid selling to. Private submitters expressing concerns about possible adverse impacts on consumer choice tended to disagree with the analysis of the problem or expressed some reservations about it. In particular, these submitters pointed out that many goods that are being imported by consumers cannot be purchased from New Zealand retailers – or, where they can be purchased domestically, the price difference compared with an overseas supplier tends to be significantly more than 15%. Two submitters expressed

particular concern in relation to clothing and shoes in less common sizes that they could not easily source from domestic retailers and stated that they have little other choice than to purchase these goods from overseas suppliers.

A submission from an industry group representing three electronic marketplaces stated that the extraterritorial application of GST will create additional costs for overseas businesses which would serve as a barrier to trade. They considered this to be contrary to both New Zealand's advocacy for free trade and the spirit of various free trade agreements. They stated that the policy risks reciprocation by other governments on New Zealand exporters, which could stifle entrepreneurship and innovation and decrease exports.

As discussed below, a number of design features have been incorporated into option 3 (Customs' preferred option) and option 4 (Inland Revenue's preferred option) that are designed to minimise compliance costs for suppliers and electronic marketplaces, and as such are intended to minimise the risk of adverse trade and consumer impacts.

Electronic marketplaces

Under the rules proposed in the discussion document for electronic marketplaces, where a supply of low-value goods is made through an electronic marketplace, the operator of the electronic marketplace would be deemed to make the supply for GST purposes. The $60,000 registration threshold would therefore apply to the marketplace operator's deemed supplies to New Zealand consumers, as well as any other taxable supplies the marketplace operator makes. Where the operator of the electronic marketplace is deemed to be the supplier, whether or not the actual supplier of the goods is above the $60,000 registration threshold is irrelevant for determining whether or not GST applies to the supply.

The design and scope of the marketplace rules were commented on in many of the submissions received. A number of submissions noted that business models for marketplaces vary widely and as such, a simple extension of the existing rules for cross-border services and intangibles to marketplaces for goods may not be appropriate. Submissions noted that clarity, simplicity and flexibility would be crucial to ensuring the marketplaces rules are workable. Discussions with stakeholders also indicated that clear and simple rules would be crucial to making the marketplace rules workable.

Submissions from electronic marketplaces were strongly opposed to the proposed offshore supplier registration system and in particular the proposed rules for electronic marketplaces. Submissions from electronic marketplaces raised the following objections:

- The proposed electronic marketplace rules are onerous for marketplaces to implement and are more complex that the rules requiring operators of electronic marketplaces for services and intangibles to collect GST.

- Complying with the rules will result in significant compliance costs for marketplaces and it is unfair for the New Zealand Government to impose these costs on marketplaces. These costs may either be passed on to their suppliers, increasing the risk of these suppliers choosing not to ship to New Zealand, or will at least be partly borne by consumers, therefore imposing additional costs on consumers over and above the amount of the tax.

- Marketplaces may not have and may be unable to obtain sufficient information to correctly determine the amount of GST payable.

- Marketplaces that do not process transactions between buyers and sellers on their platform may have difficulties in collecting the GST they are liable to remit.

- Requiring marketplaces to collect GST on supplies made by third party suppliers below the $60,000 registration threshold would place these suppliers at a disadvantage, would be discriminatory, and would lead to market distortions.

- Compliant marketplaces will be at risk of third party sellers that are below the $60,000 registration threshold switching to selling through small or non-compliant marketplaces or to selling on their own websites.

- Consumers will seek out small or non-compliant marketplaces or suppliers to avoid the tax, giving an unfair competitive advantage to suppliers and marketplaces that are not complying with the rules and disadvantaging the marketplaces and suppliers that would comply. This may result in decreased compliance with New Zealand regulations in relation to consumer protections and dangerous goods.

- Electronic marketplaces that are only caught by the electronic marketplace rules because they set some of the terms and conditions under which offshore sellers make sales on the marketplace would be able to easily structure out of being deemed to be the supplier of the goods by simply ensuring they do not set any of the terms and conditions of sale. This would reduce the level of compliance with New Zealand regulations in relation to consumer protection and prohibited or dangerous goods.

As noted in section 3.3, two exceptions to the deemed supplier approach (a Commissioner discretion and the rebuttable presumption model) were considered but ultimately ruled out. The proposed rules for electronic marketplaces are considered to be crucial to the success of the offshore supplier registration system. Without such rules, it is expected that thousands of suppliers that sell through marketplaces would be required to register for GST, meaning that aggregate compliance costs may be higher, compliance would likely be lower and enforcement more difficult. Narrowing the scope of the proposed rules is also unpalatable as the creation of a new boundary would be likely to create opportunities for electronic marketplaces to structure out of the rules, and may distort competition between electronic marketplaces.

While still hypothetically possible, these risks are considered to be less significant under the proposed rules. Given the current market dominance of the most prominent electronic marketplaces, the extent to which having electronic marketplaces collect GST on sales by suppliers below the registration threshold would give a competitive advantage to small or non-compliant marketplaces is not entirely clear. For instance, in an online shopping environment, consumers already have strong incentives to purchase from trusted websites. It is not clear that avoiding GST of 15% on a low-value purchase (which may still be significantly cheaper than a similar item sourced domestically) would provide enough incentive for many consumers to switch to shopping on websites that may not be as well-known or reputable as the larger marketplaces, and therefore which may be less readily trusted by consumers.

It is also unclear whether the imposition of GST on what is likely to be only a small proportion of most suppliers' sales would be a large enough motivator for smaller suppliers to establish their own websites or switch to selling through a marketplace that would likely reach a smaller audience. If these suppliers consider that the revenue from these sales does not justify the costs to them associated with having the marketplace operator charge GST on their sales to New Zealand, a more likely possibility seems to be that these suppliers would simply stop shipping goods to New Zealand, rather than leave the electronic marketplace altogether (at least if they are selling through a global marketplace as opposed to a New Zealand-specific website). However, the extent to which this may eventuate is also unknown, given that the marketplace operator would be fulfilling the bulk of the GST compliance obligations for the supplier (although these compliance costs may be passed on to underlying suppliers).

Marketplace operators' concerns about being provided with incorrect or inadequate information to determine the GST treatment of supplies and any associated liabilities in respect of these supplies should be addressed by the Commissioner discretion to prescribe or agree to a method for determining the GST treatment of supplies. Concerns about bad debts risk for electronic marketplaces that do not actually collect the money from the consumer should also be addressed by the suggested bad debt deduction.

Low-value goods threshold

Several submitters commented on the $400 threshold that was proposed in the discussion document *GST on low-value imported goods: An offshore supplier registration system*. Most of these submitters expressed a preference for a $1,000 threshold, which was considered to reduce compliance costs for suppliers (since it is closer to Australia's low-value threshold of AU$1,000 than $400 is), as well as being better for consumers and for the freight and logistics industry.

In comparison, only two submitters expressed a strong preference for a $400 threshold. It appears that this preference was based on concerns about a potential fiscal risk in relation to goods valued between $400 and $1,000, on which GST is (or should be) collected at present.

Inland Revenue officials consider that the overall compliance costs to offshore suppliers, marketplaces and re-deliverers associated with a $1,000 threshold would be lower than the overall compliance costs to these businesses if a $400 threshold is chosen. Implementing a low-value goods threshold of $1,000 would also be more beneficial for New Zealand consumers compared with a $400 threshold. However, Customs has concerns about the potential impacts of a $1,000 threshold on the management of border risk.

Impacts on suppliers, electronic marketplaces and re-deliverers

While the vast majority of goods imported by consumers are of a very low value (consumer surveys and Customs import entry data show that the average value is less than $100), a number of e-commerce businesses will also stock goods that may be more expensive, such as certain types of clothing, jewellery, watches and electronics, which some New Zealand consumers may potentially import. The existence of a low-value goods threshold of any value therefore creates additional complexity for suppliers who supply goods both above and below the threshold, as their checkout systems would need to be set up to charge GST on goods individually valued at or below that threshold and not on those valued above that threshold. Also, because the threshold is defined in New Zealand dollars, the supplier's systems would also need to perform a currency conversion where the prices of the goods on their website are expressed in a foreign currency for the purposes of determining whether a given good is above or below the low-value goods threshold.

By increasing the proposed $400 low-value goods threshold to $1,000, the number of suppliers that may sell goods both above and below the threshold would be reduced. This would decrease the number of suppliers that would need to implement systems to differentiate between high and low-value goods and have differing GST treatments for high and low-value goods (since if they do not stock any goods valued above the threshold they will not need to distinguish and can simply add GST to all of their sales to New Zealand consumers without requiring complex foreign exchange conversions at the time of sale).

As Australia has a low-value threshold of AU$1,000 under their equivalent rules, there would be some suppliers that are already registered in Australia that only supply goods below Australia's threshold. At present, these suppliers do not need to build systems to distinguish between low and high-value goods, as these suppliers can simply add GST to all of their supplies made to Australian consumers. However, some of these suppliers would sell goods both above and below $400 – therefore if New Zealand sets a $400 low-value goods threshold these suppliers would need to build additional systems to those already implemented for Australia in order to comply. This may be much less of an issue with a higher threshold that is much closer to Australia's threshold, such as $1,000.

Impacts on consumers

Some submissions from consumers expressed support for removing cost recovery charges collected on consignments valued above the current *de minimis*. Increasing the proposed low-value goods threshold to $1,000 would see the removal of cost recovery charges and tariffs from most goods imported by consumers. This would mean that consumers importing goods between $400 and $1,000 would actually pay less overall for these goods than they do at present. This would also ensure the overwhelming majority of consumers are no longer surprised or inconvenienced by having to pay additional GST, tariffs and cost recovery charges. Further, Customs would continue to collect cost recovery charges on consignments of goods that have had GST is collected at the point of sale by the supplier where the total consignment is valued above the threshold. A $400 threshold may mean there would be more instances of consumers having to pay these cost recovery charges where they might have expected that they would not have to (as they had already paid GST).

Having offshore suppliers collect GST on a broader range of goods (in terms of value) would also provide greater price transparency for consumers, as offshore websites may be more likely to display a GST-inclusive price for all of their goods at the time of purchase.

This would provide a fairer price comparison with New Zealand retailers who generally display GST-inclusive prices.

A $1,000 threshold is also expected to be less distortionary than a $400 threshold. Anecdotally, many consumers at present limit their online purchases to a maximum of $400 to avoid having their goods stopped at the border. A $1,000 threshold may mean that less consumers would limit their spending to avoid having goods stopped at the border or to avoid the collection of duties and cost recovery charges. On the other hand, a $1,000 threshold may increase consumers' incentives to seek out and purchase from unregistered suppliers or to have items purchased and sent to New Zealand by friends and family overseas.

Double taxation

While the inclusion of the 5 percent rule in option two would be expected to help to reduce compliance costs for a number of suppliers associated with differentiating between low-value and high-value goods, one issue with combining this design option with a threshold of $400 is that it would be likely to further increase the incidence of double taxation. Increasing the proposed threshold to $1,000 however would greatly reduce the potential for double taxation to occur as much fewer consignments valued over $1,000 are imported by consumers, compared with the number of consignments valued over $400. Based on 2017/18 transactional banking data showing goods purchases by New Zealand consumers from offshore suppliers, there were 230,398 transactions between $400 and $1,000 and only 56,671 transactions between $1,000 and $2,000. Furthermore, the vast majority of consignments valued above $1,000 would be imported by GST-registered businesses and would not be subject to the proposed rules.

Border and biosecurity risks

Importers are incentivised by Customs' penalty regime to ensure that accurate imported entry information is provided in relation to imported consignments on which revenue is collectable. The penalties for providing inaccurate information for consignments on which no revenue is assessable are however smaller, and therefore provide less incentive for importers to ensure the accuracy of this information; consequently, the quality of information provided in relation to these consignments tends to be poorer. Customs and MPI consider that setting the low-value goods threshold at $1,000 may therefore reduce the incentive for importers to enter accurate information as there will be no requirement to pay revenue on consignments under $1,000. As well as potentially impacting on the effectiveness of border and biosecurity risk management, poor quality information may also impact on the efficiency of border processes.

Customs considers that non-compliance in the valuation of goods to evade duty will continue to exist under a $1,000 threshold. This may also increase costs to both agencies and slow down the clearance of goods at the border. Customs has a range of sanctions to encourage the provision of accurate information and will continue to work with customs brokers, fast freight carriers and New Zealand Post, but it will remain a challenge for both agencies to manage risks.

Impacts on goods transporters and customs brokers

Setting the low-value goods threshold at $1,000 may be beneficial for fast freight carriers, customs brokers and New Zealand Post, with fewer goods stopped at the border for revenue collection. This would reduce the costs that New Zealand Post, fast freight carriers and customs brokers currently incur in transporting consignments valued between $400 and $1,000. New Zealand Post noted in their submission that they currently incur a significant compliance cost burden in facilitating the collection of GST (and other charges) and holding goods in storage on behalf of Customs. New Zealand Post considered that having a $1,000 threshold would therefore reduce their compliance costs.

It is also noted that the effects of inflation and the expected continuation of the rapid growth in import volumes experienced over the last few years (and in particular the growth in the volume of low-value goods imported by post) will further exacerbate the existing pressures on border processing of low-value imported goods over time, which may mean that maintaining a low-value goods threshold of $400 may not be cost-effective in the medium term (at least not for New Zealand Post).

GST revenue

A risk with having a $1,000 threshold is that it may put at risk the GST currently collected by the Crown on imported goods valued between $400 and $1,000. In 2017/18 approximately $4.26 million of GST was collected by Customs on consignments imported by consumers valued under $400, and $22.40 million was collected on consignments valued between $400 and $1,000.[14]

While a $1,000 threshold does put more currently collected GST at risk, Inland Revenue considers that most of this currently collected GST would continue to be collected under option three. A $1,000 threshold may even have some benefits for GST revenue collection including:

- increasing the number of suppliers with a liability to register by increasing offshore suppliers' level of taxable supplies (as supplies of goods valued between $400 and $1,000 would also be taxable supplies);
- reducing the risk of GST not being collected on goods between $400 and $1,000 owing to undervaluation as, even if the supplier undervalued the goods, when the goods are supplied through a marketplace the marketplace will still collect the correct amount of GST; and
- reducing the reliance on New Zealand Post to identify when goods sent by post are above the *de minimis*.

[14] We have assumed that 30% of consignments between the *de minimis* and $400 and 44% of imported consignments between $400 and $1,000 are imported by GST-registered businesses. These estimates of the business share of imported goods are derived from Australian data, as we do not have any New Zealand data on this. It is possible that the business share of consignments between $400 and $1,000 is higher in New Zealand owing to New Zealand's lower *de minimis* (likely resulting in fewer consumers importing consignments above $400). If New Zealand has a higher business share of consignments between $400 and $1,000 then the net amount of GST collected by Customs on consignments imported by consumers would be lower.

Customs' and MPI's cost recovery charges

Setting the low-value goods threshold at $400 would result in a reduction in Customs' and MPI's cost-recovered funding of $2.92 million per year based on the amount collected in 2017/18. Setting the low-value goods threshold at $1,000 would result in Customs and MPI forgoing more cost-recovered funding.

In 2017/18 $17.795 million (GST exclusive) was collected through Customs' Import Entry Transaction Fee ($10.736 million) and MPI's Biosecurity System Entry Levy ($7.059 million) on consignments below $1,000. A low-value goods threshold of $1,000 would therefore require a greater amount of Crown funding to replace the additional cost-recovered funding forgone.

Customs' and MPI's costs of processing goods are also expected to increase due to expected volume growth and ongoing resource impacts. Therefore, regardless of what threshold is chosen, or even if no action is taken, Crown funding for Customs and MPI is likely to need to be increased over time in response to increasing import volumes.

Tariff revenue

Changing from the current *de minimis* of $60 duty owing to either a $400 or $1,000 low-value goods threshold will result in the loss of tariff revenue collected between the current *de minimis* and the low-value goods threshold. In 2017/18 $0.58 million was collected in tariffs on consignments between the current *de minimis* and $400 and $3.23 million was collected in tariffs on consignments valued at or below $1,000. These tariffs are mainly collected on clothing and footwear manufactured in certain countries.

MFAT does not consider that the loss of $0.58 million in tariffs from having a $400 threshold or of $3.23 million from there being a $1,000 threshold would significantly diminish the value of New Zealand's remaining tariffs as negotiating coin in current and future Free Trade Agreements. MBIE, the agency responsible for tariff policy, also does not consider the revenue collected from these tariffs to be significant and supports the removal of tariffs on consignments valued at or below $1,000.

If the low-value goods threshold is set at $1,000, the loss of tariff revenue on consignments valued between $400 and $1,000 may potentially be seen as unfair to New Zealand retailers. A retailer that imports a consignment valued above $1,000 containing goods subject to tariffs will need to pay these tariffs to Customs. The tariffs paid by these businesses would ultimately be passed on to their customers. In contrast, if a consumer buys one of those goods directly from an offshore supplier they will not have to pay any tariffs if the good is shipped in a consignment valued at or below $1,000.

Compared with setting the low-value goods threshold at $400, setting it at $1,000 does therefore further undermine the principle that taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation, but only in relation to a small subset of transactions. This is not considered to be likely to be significant in its impact as New Zealand has few remaining tariffs (mainly on clothing and footwear) and our free trade agreements have eliminated these tariffs for many countries including China, Australia and the 10 ASEAN countries. If no action is taken, the amount collected from tariffs is likely to continue to reduce over time as a result of current and future free trade agreements. On balance Inland Revenue considers that this concern is outweighed by the efficiency benefits of setting the threshold at $1,000 and relinquishing tariff duty on imported consignments valued at or below $1,000.

New Zealand businesses importing low-value goods would also benefit from the removal of tariffs (and cost recovery charges) on consignments valued at or below $1,000.

Net revenue impact

Table 1 below shows the estimated GST revenue net of forgone cost recovery charges over the forecast period under options one and two. Table 2 shows the estimated GST revenue net of forgone cost recovery charges over the forecast period under option three.

Table 1: Net revenue over the forecast period of 2019/20 to 2021/22 (in $m)

	$m – increase/(decrease)			
$400 threshold	**2019/20 (1 October start)**	**2020/21**	**2021/22 & out years**	**Total**
GST	73.000	109.000	121.000	303.000
Cost recovery charges	(2.190)	(2.920)	(2.920)	(8.030)
GST net of cost recovery charges	70.810	106.080	118.080	294.970

Table 2: Net revenue over the forecast period of 2019/20 to 2021/22 (in $m)

	$m – increase/(decrease)			
$1,000 threshold	**2019/20 (1 October start)**	**2020/21**	**2021/22 & out years**	**Total**
GST	66.000	100.000	112.000	278.000
Cost recovery charges	(13.346)	(17.795)	(17.795)	(48.936)
GST net of cost recovery charges	52.654	82.205	94.205	229.064

The estimates in the above tables do not account for any change in forgone cost-recovered funding over time. As noted earlier, the amount of additional Crown funding Customs and MPI would require under either low-value goods threshold option, or if no further action is taken, is likely to increase over time owing to growing import volumes.

The tables above also do not account for any tariff revenue forgone under options one, two and three. This is because tariff revenue is decreasing over time owing to the phased implementation of New Zealand's current and future free trade agreements, resulting in an annual reduction in the amount of goods that are subject to tariffs. In the 2017/18 year the amount collected in tariffs on consignments under $400 was $0.58 million and the amount collected under $1,000 was $3.23 million.

Proposed exclusion for business-to-business supplies

Under the proposed rules, only supplies of low-value imported goods to New Zealand consumers would be subject to GST. Supplies of low-value imported goods to GST-registered businesses would not be subject to GST. The rationale for excluding business-to-business supplies from the rules is to prevent a revenue risk arising from a resident business claiming a GST deduction for GST charged to them by an offshore supplier, but the offshore supplier not returning this GST to Inland Revenue.

Three submissions proposed allowing suppliers to charge GST on business-to-business supplies of low-value imported goods. Submitters noted that identifying a customer as a GST-registered business can be difficult for suppliers to do, and that compliance costs arise for both the offshore supplier and the New Zealand business when GST is incorrectly charged. Furthermore, some submitters noted that the revenue risk from allowing suppliers to charge GST on business-to-business supplies of low-value imported goods may be relatively low.

CA ANZ however was supportive of the proposed exclusion of business-to-business supplies. They noted that the exclusion of business-to-business supplies would mean some suppliers are outside the regime entirely because they only supply to businesses, which they agreed is desirable. They also considered that the exclusion would provide GST-registered recipients with an incentive to notify the supplier of their GST-registered status, which they considered would likely be easier than obtaining a valid tax invoice from the supplier.

As noted in section 3.3, allowing offshore suppliers to charge GST on high-value business-to-business supplies was ruled out due to the fiscal risks involved. However, officials consider that the proposed design options under options two and three (of allowing offshore suppliers to issue tax invoices in respect of business-to-business supplies of low-value imported goods where the value of such a supply does not exceed $1,000, and allowing suppliers to agree with the Commissioner of Inland Revenue on an alternative method for determining whether a supply is to a GST-registered persons) should help to reduce compliance costs for suppliers in distinguishing between supplies to consumers and to GST-registered businesses. Allowing suppliers to charge GST and issue tax invoices in respect of business-to-business supplies valued at or below $1,000 may mean that suppliers would be rarely required to distinguish in practice.

Compliance and enforcement

A number of submitters were concerned whether the proposed rules could be effectively enforced. The submission from the electronic marketplace industry group suggested that the proposed system would result in only 25 percent of the currently forgone GST being collected, based on the Australian Treasury's forecasted collection rate for the first year of the Australian legislation. Several submitters stated that where suppliers refuse to comply, it will be difficult and costly for Inland Revenue to enforce compliance from these suppliers.

Concern was also raised in some submissions that offshore suppliers would avoid collecting GST by splitting their business into multiple entities in order to get below the $60,000 registration threshold.

Based on the available evidence, officials consider that a relatively small number of suppliers and electronic marketplaces are likely to account for the majority of low-value goods imported by consumers. Retail banking data supplied by Datamine shows that 10 entities account for approximately 25 percent of the amount that consumers spent in 2017/18 on goods valued below $400 from offshore suppliers. Recent research by the International Post Corporation suggests that the five biggest electronic marketplaces account for around 50 percent of goods imported into New Zealand. On this basis, officials consider it is not unreasonable to assume that 75 percent of the GST that would be returned if all liable entities registered and complied will actually be collected (which is the assumption that was used in coming up with the revenue estimates).

Application date

A number of submissions discussed the proposed implementation date of 1 October 2019. Retail NZ and Booksellers NZ both expressed support for the earliest possible implementation date. In contrast, Alibaba, eBay and Etsy recommended that New Zealand should align our timeline with the European Union (EU), who will be extending their existing registration system for cross-border services to low-value goods imported from non-EU countries from January 2021. Business NZ recommended that the implementation date should be delayed if there are ongoing and persistent concerns over offshore suppliers blocking New Zealand buyers.

A number of other submissions did not directly comment on the implementation date, but noted that a sufficient period of time would be needed for the necessary changes to be made by marketplaces, suppliers and others. Amazon in particular submitted that there would need to be a lead time of 18-24 months to allow for businesses to implement changes to systems and processes. Deloitte also recommended that the implementation date be reviewed with marketplaces and suppliers to ensure they have sufficient time to make the required changes.

Officials still consider a 1 October 2019 implementation date to be feasible. However, any delays to the introduction or passing of legislation, or major changes to the legislation between introduction and the Royal assent would necessitate reconsideration of the implementation date.

To give suppliers sufficient time to make any necessary systems changes and register, officials recommend that suppliers be given the option of having a six month taxable period for the first six months of the rules. This would mean that they would not be required to file their first GST return and pay the associated tax liability until 7 May 2020, essentially giving suppliers a three-month extension of time to register.

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			
Regulated parties	The costs to offshore suppliers would include registering for GST	Potentially high upfront systems and	Low

	(one-off), altering business systems to account for GST on goods sold to New Zealand consumers (one-off), and returns filing and paying the GST collected to Inland Revenue (ongoing).	medium ongoing compliance costs for offshore businesses above the $60,000 registration threshold.	
Regulators	The implementation costs to Inland Revenue are estimated to be up to $460,000, with ongoing administration costs estimated to be approximately $120,000 in the first year and $70,000 per annum thereafter. This includes the costs to change the current registration form for suppliers of cross-border services to accommodate offshore suppliers of low-value goods and other minor systems changes. It also allows for an increase in the volume of work for staff currently processing registrations. Loss of funding from cost recovery charges to Customs and MPI.	Up to $0.7m over the forecast period (not discounted)[15]. Approximately $17.8m/yr in cost recovery charges (based on the 2017/18 year, not discounted) but likely to increase in coming years with increasing volumes of imported goods. $48.9m over the forecast period (not discounted), assuming the amount of cost recovery charges collected each year would remain the same if no action is taken.	High
Wider government	The government would forgo tariff revenue collected on low-value goods and Crown funding would	Approximately $3.2m/yr (based on the 2017/18 year,	High

15 Monetised costs and benefits in this table have not been discounted, since for revenue measures the undiscounted figures (as opposed to net present value figures) make more intuitive sense and are the figures that are included in Budget estimates.

	be required for border fees forgone by the Ministry for Primary Industries and Customs.	not discounted) and likely to decrease in coming years as a result of the phased implementation of existing free trade agreements and new free trade agreements. $8.8m over the forecast period (not discounted), assuming the amount of tariffs collected each year would remain the same if no action is taken.	
Other parties	Consumers would likely pay more for imported goods that are currently below the *de minimis*. The availability of some goods from overseas may also decrease. The potential reduced competition on the domestic retail industry may reduce the efficiency of the domestic retail market.	$278m of additional GST imposed on NZ consumers over the forecast period (not discounted).	Medium
Total Monetised Cost		Up to $336.4m over the forecast period (not discounted).	Medium
Non-monetised costs		Medium	Low/Medium

Expected benefits of proposed approach, compared to taking no action			
Regulated parties	N/A	N/A	
Regulators	May be minor administrative cost savings for Customs. However, possible increased border and biosecurity risks may increase administrations costs for Customs and MPI.	Unable to estimate.	Low
Wider government	Additional GST revenue collected on low-value imported goods.	$278m over the forecast period (not discounted).	Medium
Other parties	Some consumers and businesses would pay less overall for a good because of the proposed removal of tariff duty and cost recovery	$57.7m over the forecast period (not discounted).	High

	charges from imported consignments valued at or below $1,000. Possible reduction in delivery delays in some cases and increased simplicity and certainty for consumers regarding the total cost to them of their imported low-value goods. Reduction in costs for fast freight carriers associated with no longer collecting GST and other duties on goods between the current *de minimis* and $1,000. Reduction in costs to New Zealand Post associated with holding goods for revenue collection. Increased competitive neutrality between domestic retailers and offshore suppliers.	Medium	Low
Total Monetised Benefit		$335.7m over the forecast period (not discounted).	Medium
Non-monetised benefits		Medium	Low

5.3 What other impacts is this approach likely to have?
Other impacts: GST would be collected on goods from offshore suppliers that are below the \$60,000 registration threshold where the sale is made through a GST-registered electronic marketplace. From a revenue standpoint, this may be seen as an advantage, as it is expected that a significant amount of revenue would be collected on sales by offshore suppliers below the registration threshold though electronic marketplaces. Given the rationale of having a registration threshold is to balance compliance and administration costs against the revenue that would be generated if the supplier registered for GST, collecting GST on these supplies may be justified on the basis that the rationale behind the registration threshold is not as relevant, given that the marketplace operator would bear the bulk of the compliance costs. However, this may give rise to concerns about competitive disadvantages for marketplace operators and smaller offshore businesses selling through these marketplaces. Potential risks and uncertainties: If the compliance costs are disproportionately high or are perceived by the relevant collection entities to be too high, there is a risk that some non-resident suppliers or operators of electronic marketplaces may not comply with the rules or may not continue to offer shipping of goods to New Zealand. This risk is thought to be more significant for smaller suppliers that make supplies to New Zealand consumers near or above the \$60,000 registration threshold.[16]

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

[16] It is assumed that non-resident suppliers with annual sales to New Zealand consumers in excess of $60,000 would predominantly be large (or at least medium) entities, given that the $60,000 registration threshold applies to their supplies to New Zealand consumers rather than their worldwide sales, and that in most cases their sales to New Zealanders would be a small proportion of their total worldwide sales. However, it is likely that there would be some smaller suppliers that would nevertheless have sales to New Zealand consumers in excess of $60,000.

Section 6: Implementation and operation

6.1 How will the new arrangements work in practice?
The proposal will require amendments to the Goods and Services Tax Act 1985. These amendments are currently being drafted and will be included in an upcoming tax bill. The proposal will also require amendments to some Customs regulations. These regulations will be updated by Order in Council. Both Inland Revenue and Customs will be responsible for the ongoing operation and enforcement of the new arrangements. Inland Revenue and Customs have not identified any concerns with their ability to implement the proposals in a manner consistent with the Government's 'Expectations for regulatory stewardship by government agencies'. The proposed changes are due to come into effect from 1 October 2019. Inland Revenue and Customs are confident that the proposals can be implemented within the proposed timeline. Inland Revenue has estimated that the one-off costs to implement these proposals will be up to $460,000. Inland Revenue's on going administration costs are estimated to be approximately $120,000 in the first year and $70,000 per annum thereafter. Inland Revenue will self-fund the costs associated with the initiative. Customs expects the costs of systems changes for implementation at 1 October 2019 will be minimal in the short term. These costs will be met within existing baselines. Some offshore suppliers, marketplaces and re-deliverers have expressed concern that a 1 October 2019 enactment date may not give them enough time to implement the necessary systems changes to comply. However, many of these stakeholders would have had 15 months of experience complying with Australia's substantially similar rules and as such the systems changes required may not be substantial. It is also noted that the length of time between bill introduction and the application date for the GST on cross-border services and intangibles changes was similar to that now proposed for low-value imported goods.

6.2 What are the implementation risks?
The primary issue concerning implementation that has been raised through consultation is whether a 1 October 2019 application date gives offshore suppliers, marketplaces and re-deliverers enough time to make the necessary systems changes in order to comply. To mitigate this risk the proposed changes will be made as simple as possible for these stakeholders. Furthermore, the proposed optional six month filing period for the first six months of the new rules would give these stakeholders an extra three months to update their systems before they need to file their first GST return. Another implementation risk is that offshore suppliers, marketplaces and re-deliverers may not be aware of the new rules. To address this risk Inland Revenue will need to identify and communicate the legislative change to offshore suppliers, marketplaces and re-deliverers who might be required to register in New Zealand. A targeted marketing campaign would be needed to reach all the affected offshore suppliers and aid with compliance.

Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?
Inland Revenue will monitor the outcomes pursuant to the Generic Tax Policy Process ("GTTP") to confirm that they match the policy objectives. The GTPP is a multi-stage policy process that has been used to design tax policy in New Zealand since 1995. Customs and MPI will monitor the impact on the management of border and biosecurity risks. If the preferred option is implemented and compliance with the new regime is lower than expected after 12 months of its implementation, Inland Revenue will explore options for increasing compliance. This could include joint compliance initiatives with other jurisdictions that have similar rules, including possible data matching programmes with other jurisdictions and Customs. Officials will monitor the extent to which offshore businesses no longer ship goods to New Zealand by keeping a close watch over articles in the media. Talking with private sector advisors and re-deliverers may also provide some indication of the extent to which this occurs.

7.2 When and how will the new arrangements be reviewed?
The final step in the GTPP is the implementation and review stage, which involves post-implementation review of legislation, and the identification of remedial issues. Officials from Inland Revenue and Customs will undertake a post-implementation review of the level of the threshold three years after the new rules are implemented. Officials will also continue to monitor the future viability of other collection models to see if the practical issues with these models can be overcome. Any necessary changes identified as a result of the review would be recommended for addition to the Government's tax policy work programme.

Coversheet: Ring-fencing rental losses

Advising agencies	*The Treasury and Inland Revenue*
Decision sought	*Agreement to key design features of a rental loss ring-fencing policy*
Proposing Ministers	*Hon Grant Robertson (Minister of Finance) and Hon Stuart Nash (Minister of Revenue)*

Summary: Problem and Proposed Approach

Problem Definition **What problem or opportunity does this proposal seek to address? Why is Government intervention required?**
The Government's stated objective for ring-fencing rental losses is to reduce unfairness by levelling the playing field between property speculators/investors and owner-occupiers. Currently, investors can have part of the cost of servicing their mortgages subsidised by the reduced tax on their other income sources, helping them to outbid owner-occupiers for properties.

Proposed Approach **How will Government intervention work to bring about the desired change? How is this the best option?**
Ring-fencing rental losses reduces the tax benefits enjoyed by property investors who buy property in anticipation of capital gain.

Section B: Summary Impacts: Benefits and costs

Who are the main expected beneficiaries and what is the nature of the expected benefit?
Key beneficiaries are expected to be: • <u>First-home buyers</u>. Ring-fencing of rental losses could help improve first home buyers' ability to compete with investors, improving housing affordability for home buyers, and potentially increasing the share of New Zealanders who own their own homes; and • <u>Government</u>. Ring-fencing of rental losses is expected to increase tax revenue by approximately $190 million per annum.

Where do the costs fall?
Costs are expected to fall on: • Investors. Residential property investors who negatively gear could face higher tax liabilities on an ongoing basis, if they persistently make a loss. It could be the case that investors start experiencing positive rental cash flows after a period. Inland Revenue estimates that approximately 40 percent of taxpayers with rentals record rental losses at any given time, with an average estimated annual tax benefit of $2,000; and • Renters. Rental loss ring-fencing will reduce after tax rental returns for some landlords. This could encourage the transfer of housing stock from investment housing (ie, rental housing) to owner-occupier housing, putting pressure on the remaining rental stock. On average, owner-occupied housing tends to have fewer people per house. This suggests that the transfer of housing stock from rental to owner-occupied may reduce the amount of housing available for each remaining renter unless there is an adequate flow of new housing onto the rental market. This may lead to increased rents. Landlords may also pass on their rental losses to tenants in the form of increased rents. There are other ways that this and other policies could impact the rental market, and officials note that there is significant uncertainty about the net impact.

What are the likely risks and unintended impacts, how significant are they and how will they be minimised or mitigated?
Key risks and unintended impacts include: • Uncertainty around the impact on the housing market. The Government is closely monitoring the performance of the housing market. However, given the number of other policy and regulatory changes to the housing market, it may not be possible to isolate the impact of this proposal on the housing market. • Implementation risks for Inland Revenue. Changes will be required to START (Inland Revenue's tax processing computer system). A detailed assessment of required changes and an execution plan is being made as part of returns planning for the 2019-20 income year.

Identify any significant incompatibility with the Government's 'Expectations for the design of regulatory systems'.
There is no incompatibility between this regulatory proposal and the Government's 'Expectations for the design of regulatory systems'.

Section C: Evidence certainty and quality assurance

Agency rating of evidence certainty?
Evidence supporting housing market impact analysis is limited, and suggests significant uncertainty as to the net impacts of the policy, especially on the rental market.

Fiscal impact estimates have been modelled using Inland Revenue data on negatively-geared rental properties. Significant simplifying assumptions have been made, on which the fiscal estimates are conditional.

To be completed by quality assurers:

Quality Assurance Reviewing Agency:
Inland Revenue
Quality Assurance Assessment:
The Quality Assurance reviewer at Inland Revenue has reviewed the Ring-fencing rental losses RIA prepared by the Treasury and Inland Revenue and considers that the information and analysis summarised in it partially meets the quality assurance criteria.
Reviewer Comments and Recommendations:
The RIA describes how ring-fencing rental losses will meet the stated objective and also provides excellent coverage of the main uncertainties and risks around its likely impact. The analysis summarised in the RIA is as good as could be expected in light of the constrained range of options considered and the uncertainties over the net impacts of loss ring-fencing on the housing market. Even so, the analysis only partially meets the quality assurance criteria primarily because it is not possible to be confident that the stated objective is being met in the best way and with the least unintended consequences.

Impact Statement: Ring-fencing rental losses

Section 1: General information

Purpose
1.1.1 The Treasury and Inland Revenue are 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 key policy decisions to be taken by Cabinet.

Key Limitations or Constraints on Analysis

1.1.2 The key limitations and constraints applying to this analysis are as follows:

a) <u>Constrained range of options considered:</u> The Government has already announced its intention to introduce ring-fencing of rental losses. Options considered are therefore focussed on key design settings for that policy, rather than consideration of alternatives to loss ring-fencing.

b) <u>Time constraints:</u> Ministers have decided to plan for the introduction of loss ring-fencing rules for the 2019-20 tax year. With that commencement date in mind, the proposals are required to be included in legislation introduced before the start of the 2019-20 income year to give taxpayers a degree of certainty about how the rules will operate.

c) <u>Lack of empirical data:</u> The analysis on the impact of this policy on the housing market is constrained by a lack of empirical data. There are few recent examples of countries implementing loss ring-fencing rules. In cases where such rules have been introduced (for example, in Australia in the 1980s), it has been difficult to tease out the effects of loss ring-fencing rules on observed changes in the housing market. When empirical evidence is not available, a theoretical assessment of the expected impact has been provided.

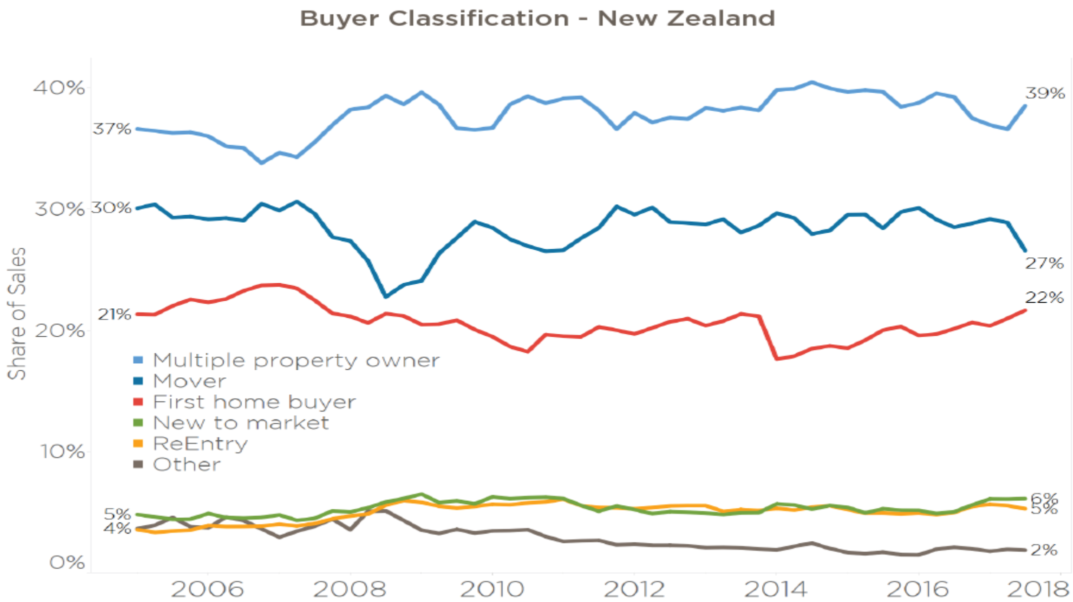
d) <u>Assumptions underpinning impact analysis:</u> Ring-fencing of rental losses is estimated to increase tax revenue by approximately $190m per annum once fully implemented. The primary caveat to this revenue forecast is that it assumes static behaviour. A change towards greater equity investment in rental housing, or a change away from investment in residential rental properties altogether, could displace revenue from other taxable investments. This impact is not captured in the revenue forecast.

Responsible Manager:
Peter Frawley Policy Manager Policy & Strategy Inland Revenue 1 August 2018

Section 2: Problem definition and objectives

2.1 What is the context within which action is proposed?

2.1.1 First home buyers account for 22% of home purchases in New Zealand, compared with 39% for multiple property owners. This may suggest that first home buyers can struggle to compete against investors and existing owner-occupiers in the market. Home ownership rates have now fallen to 63% - down from 74% in 1991.[1]



Source: CoreLogic NZ

2.1.2 Speculative capital gain is a likely driver for investor activity in the residential housing market. The average return on rental property excluding capital gains is low – the average gross rental yield on a three-bedroom Auckland property is 3% per annum.[2] This suggests investors are buying property in anticipation of capital gain. Other possible drivers for investor activity include the prospect of future increases in rents, or because it is perceived as safer than other types of investments.

2.1.3 Falling rates of home ownership, untaxed capital gains, and increasing house prices contribute to equity concerns around housing, and there is strong interest in measures to improve housing affordability, especially for first home buyers.

2.1.4 In this context, negative gearing has come under scrutiny. Negative gearing involves investors reducing their taxable income with rental losses. The practice is relatively widespread in the New Zealand rental market – 40% of taxpayers with residential investment property report rental losses, with an average tax benefit of $2,000 per annum.

[1] https://www.stats.govt.nz/information-releases/dwelling-and-household-estimates-december-2017-quarter

[2] https://www.barfoot.co.nz/market-reports/2017/december/changes-in-gross-yield

2.1.5 We expect the practice of negative gearing of rental properties to continue if no further action is taken. The magnitude of losses being claimed is likely to be dependent on changes in the housing market (for example, increases in rents will tend to reduce rental losses, all other things being equal), and interest rates.

2.1.6 Many overseas countries have some form of loss ring-fencing of residential property, including the United Kingdom and the United States.

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

2.2.1 Investment housing is currently taxed under the same rules that generally apply to other investments. This means that rents are income, and interest and other expenses (other than capital improvements) are deductible. Any capital gain realised on sale of the property is not taxed unless the property is held on revenue account. Revenue account land holders are predominantly dealers, developers, and people who acquire properties for resale (though there are a number of other rules that may mean a property is on revenue account, including the bright-line test, which taxes sales of residential properties within a defined time period). Most rental property investors hold their property on capital account and are not subject to tax on the capital gain.

2.2.2 Currently, investors (including those who hold their property on capital account and are not subject to tax on the capital gain) can use losses from the rental properties to offset their income from other sources, thus reducing their income tax liability.

2.3 What is the policy problem or opportunity?

2.3.1 The policy problem is that there is an uneven playing field between property investors who are buying property in anticipation of capital gain, and owner-occupiers. Currently, investors can have part of the cost of servicing their mortgages subsidised by the reduced tax on other sources of income, helping them to outbid owner-occupiers (whose mortgages are not tax-deductible) for properties.

2.3.2 Rental housing is not formally tax favoured. However, there is an argument that it may be under-taxed compared to other asset classes given that tax-free capital gains are often realised when rental properties are sold. The fact that rental property investors often make persistent tax losses is a possible indication that expected capital gains are an important motivation for many investors purchasing rental property. While interest and other expenses are fully deductible, in the absence of a comprehensive capital gains tax, not all of the economic income generated from rental housing is subject to tax. There is therefore an argument that, to the extent deductible expenses in the long-term exceed income from rents, those expenses in fact relate to the capital gain, so should not be deductible unless the capital gain is taxed. It is reasonable to suppose that there is a widespread perception of unfairness, especially in the context of falling rates of home ownership, untaxed capital gains, and increasing house prices (see above in section 2.1).

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

2.4.1 The Government has committed to implementing loss ring-fencing. Officials have therefore only considered options as to different broad approaches to ring-fencing, and have not considered alternatives to loss ring-fencing.

2.4.2 The Government has also established the Tax Working Group (the TWG) to look at the structure, fairness and balance of the tax system. The TWG's Terms of Reference include a requirement that particular consideration be given to "[w]hether a system of taxing capital gains or land (not applying to the family home or the land under it), or other housing tax measures, would improve the tax system."[3] Because consideration of a capital gains tax is within the purview of the TWG, it is not considered here as a possible option for addressing the issue that underlies the concern about investors who buy property in anticipation of capital gain having an unfair advantage over owner-occupiers – which is that not all of the economic income generated from rental housing is subject to tax. If a comprehensive capital gains tax were to be implemented, there could be a case for reconsidering whether rental loss ring-fencing is necessary. We note that the Government has stated that any significant changes legislated for from the TWG's final report will not come into force until the 2021 tax year.[4]

2.4.3 There are a range of Government policies and initiatives concerning housing. Supply-side initiatives include KiwiBuild, Special Housing Areas, and infrastructure financing and funding efforts. Demand side initiatives include extension of the bright-line test, restrictions on foreign buyers, and the Reserve Bank's loan-to-value ratio loan restrictions.

2.5 What do stakeholders think?

2.5.1 Prior to releasing an officials' issues paper for consultation, officials had initial discussions on the proposal with a number of key private sector advisors, including tax professionals and the New Zealand Property Investors' Federation. Those discussions were aimed at gathering private sector views on key design issues and potential implementation and compliance concerns.

2.5.2 An officials' issues paper *Rental loss ring-fencing* was released in March 2018 for full public consultation on key design issues. Inland Revenue received 106 submissions in response to this issues paper. Submitters' views on the design options are noted in the discussion of those options in section 5.

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3 https://taxworkinggroup.govt.nz/terms-of-reference/

4 https://www.beehive.govt.nz/release/towards-fairer-tax-system-tax-working-group-terms-reference-announced

Section 3: Options identification

3.1 What options are available to address the problem?

3.1.1 Our options analysis looks at the following packages of key design options for the proposed loss ring-fencing rules:

Option 1: Status quo.

Option 2: Design options proposed in the officials' issues paper.

Option 3: Design options reflecting submissions received on the officials' issues paper.

3.1.2 The options considered in relation to each of the above key design issues are as follows: (all options are mutually exclusive)

Option 1: Status quo

3.1.3 There are no rules which ring-fence rental losses, therefore any losses incurred on a rental property can be offset against the taxpayer's other income.

Option 2: Design options proposed in the officials' issues paper

3.1.4 This option reflects the package of design features which were proposed in the officials' issues paper released for public consultation in March 2018.

Land within the scope of the proposed rules

3.1.5 The proposed loss ring-fencing rules are to apply to residential land. There is already a definition of "residential land" in the Income Tax Act 2007, and the loss ring-fencing rules would apply to land within that definition. Using the definition already in the legislation would avoid the additional complexity of having different definitions for different rules. The options for what property the rules should apply to are around what residential land should be excluded from the scope of the rules.

3.1.6 The rules are not proposed to apply to residential land that is the taxpayer's main home, or residential land that is subject to the mixed-use asset rules.

3.1.7 The rules will not apply to residential land that is on revenue account because the taxpayer acquires the property for the purpose of a land-related business.[5]

3.1.8 Finally, the rules will apply to residential land that is owned by all persons, including companies and trusts.

Level at which the loss ring-fencing rules should apply (ie, at the individual property level or across a portfolio)

3.1.9 Losses are ring-fenced within a portfolio of residential property. If a taxpayer has a

[5] And in the case of a business of erecting buildings, the taxpayer or an associated person made improvements to the land.

portfolio of residential investment properties, losses from one property can be used to offset profits from another property within the portfolio.

Whether ring-fenced losses should be released on the sale of a residential property

3.1.10 Ring-fenced losses are able to be used on a sale of residential land that gives rise to taxable income; to the extent they reduce the taxable gain to nil, with any further unused losses remaining ring-fenced.

What rules should be put in place to minimise opportunities to structure around the loss ring-fencing rules

3.1.11 This option would include specific rules to address a structuring opportunity to get around the new rules. These concern interest allocation and the interposing of entities.

3.1.12 There will be specific rules to ensure that interposed entities cannot be used to circumvent the loss ring-fencing rules.

3.1.13 There should not be any specific rules for allocating a taxpayer's interest expenditure as between ring-fenced residential property and other assets.

Option 3: Design options reflecting submissions received on the officials' issues paper

Land within the scope of the proposed rules

3.1.14 In addition to the design features in Option 2 for property within the scope of the proposed rules, three further exclusions are proposed.

3.1.15 All land that will definitely be subject to tax on sale will be excluded from these rules.

3.1.16 The rules will not apply to widely-held companies, because any residential land they hold is assumed to be incidental to their business.

3.1.17 The rules also will not apply to accommodation provided to employees or other workers where it is necessary to provide that accommodation due to the nature or remoteness of the business.

Level at which the loss ring-fencing rules should apply (ie, at the individual property level or across a portfolio)

3.1.18 While the rules will generally apply on a portfolio basis, taxpayers will also be able to elect to apply the rules on a property-by-property basis if they wish, so if a property is taxed on sale any remaining losses for that property can be released and used to offset against other income. If such an election is not made, then the rules will continue to apply on a portfolio basis.

Using ring-fenced losses

3.1.19 Ring-fenced losses should be able to be transferred between companies in a wholly-owned group with rental income. It is not proposed that ring-fenced losses should be able to be carried back.

3.1.20 The usual shareholder continuity rules which apply to the use of losses by companies under the general corporate tax rules will continue to apply to ring-fenced losses. Losses should not be released and available to offset against other income if shareholder continuity is breached.

Whether ring-fenced losses should be released on the sale of a residential property

3.1.21 There is no change from Option 2 for this design feature. Ring-fenced losses are able to be used on a sale of residential land that gives rise to taxable income, but only to the extent those losses reduce the taxable income to nil.

What rules should be put in place to minimise opportunities to structure around the loss ring-fencing rules

3.1.22 There is no change from Option 2 for this design feature. There will be specific rules to ensure that interposed entities cannot be used to circumvent the loss ring-fencing rules, but no specific interest allocation rules.

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

3.2.1 The generic tax policy process (GTPP) includes a framework for assessing key policy elements and trade-offs of proposals. This framework is consistent with the Government's vision for the tax and social policy system, and is captured by the following criteria:

- *Efficiency and neutrality* – the tax system should bias economic decisions as little as possible;
- *Fairness and equity* – similar taxpayers in similar circumstances should be treated in a similar way;
- *Efficiency of compliance* – compliance costs for taxpayers should be minimised as far as possible; and
- *Efficiency of administration* – administrative costs for Inland Revenue should be minimised as far as possible.

3.2.2 Efficiency and fairness are the most important criteria. It is generally worth trading-off increased compliance costs or administration costs for gains in these two criteria.

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

3.3.1 As noted at section 2.4, because consideration of a capital gains tax is within the purview of the TWG, it is not considered here as a possible option for addressing the concern that investors who buy property in anticipation of capital gain, and who are able to deduct expenses, have an unfair advantage over owner-occupiers – which is that not all of the economic income generated from rental housing is subject to tax.

3.3.2 Therefore, options considered are focussed on key design settings for loss ring-fencing, rather than consideration of alternatives to loss ring-fencing.

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?

	Option 1 Status quo	Option 2 Design options proposed in the officials' issues paper	Option 3 Design options reflecting submissions received on the officials' issues paper
Efficiency and Neutrality	0	- The proposals would treat residential investment property differently to other investments.	- This option introduces further exclusions from the rules in appropriate circumstances.
Fairness and equity	0	++ This option helps even the playing field between investors and owner-occupiers.	++ This option more accurately targets property investors.
Efficiency of compliance	0	- This option would have required people other than property investors to apply new ring-fencing rules.	0 This option decreases compliance costs for people other than property investors compared to option 2 by excluding them from the new rules.
Efficiency of administration	0	0 There would need to be relatively minor changes to some Inland Revenue forms and systems.	0 The design features from this option would impose no significant additional administration costs compared to Option 2.
Overall assessment	0	+ As the objective was to increase the fairness and equity of the tax system, this consideration outweighs the other considerations and overall we think this option is an improvement over the status quo.	+ As with Option 2, fairness and equity outweigh the other considerations. This option is an improvement over Option 2 with respect to the other considerations and is therefore the preferred option.

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?

5.1.1 Officials consider the preferred option is **Option 3: Design options reflecting submissions received on the officials' issues paper**. The reasons this option is the preferred approach are discussed below.

Land within the scope of the proposed ring-fencing rules

5.1.2 As noted above, the proposed loss ring-fencing rules are to apply to residential land as already defined in the Income Tax Act 2007. For the reasons discussed below, we consider that the main home, mixed-use land, certain revenue account land, land owned by widely-held companies, and employee and farming accommodation should be excluded from the scope of the rules, and that land owned by companies and trusts should not be excluded.

5.1.3 It is noted that all of this option is generally neutral as compared to the status quo (no change from the current rules), because all of these options are around what land should be outside the scope of the proposed loss ring-fencing rules – which means the current treatment would remain applicable.

Main home

5.1.4 As noted above, the concern the proposed ring-fencing rules are aimed at addressing is the uneven playing field between property speculators/investors and owner-occupiers. This is because rental losses can be used by investors to reduce their tax on income from other sources – effectively subsidising part of the cost of their mortgages, and helping them to outbid owner-occupiers for properties.

5.1.5 The focus of the proposed rules is on loss-making rental properties, so it is recommended that a taxpayer's main home be specifically excluded from the scope of the rules. Submitters on the officials' issues paper have indicated that they agreed with this approach.

5.1.6 While part of someone's main home may be rented out, and this activity could generate a loss, it is not considered that such a situation contributes to an uneven playing field between investors who buy property in anticipation of capital gain and owner-occupiers.

5.1.7 We suggest that the concept of a "main home" mirror that used for the purposes of the bright-line test – which would mean that a person can have only one main home, and that to qualify for the exclusion the property has to be used predominantly as the person's main home. However, we suggest one difference from the bright-line main home exclusion, in that a qualifying property should be used predominantly as the person's main home for most of the income year in question, rather than for most of the time the person owns the property (which is the case for the bright-line main home exclusion). This makes more sense in the context of loss ring-fencing, as the focus is not on the length of ownership, but on the use of the property.

Mixed-use land

5.1.8 The existing definition of “residential land” would also include holiday houses that are sometimes used privately and sometimes rented out. Many such properties would be subject to the mixed-use asset rules.

5.1.9 The mixed-use asset rules provide for the apportionment of expenditure. Notwithstanding the apportionment formula, a tax loss can still arise for a mixed-use asset. This is more likely to occur when the income-earning use of the asset is low. Therefore, the mixed-use assets rules quarantine (or ring-fence) losses where there is low income-earning use of an asset. Under the quarantining rules, a person who is in an occasional loss position will not be able to offset their loss against other income in the current year, but will be able to use it against their future profits from the mixed-use asset. However, a person who is in perpetual loss will never have future profits to offset the losses against, and will therefore not be able to utilise them.

5.1.10 Property subject to the mixed-use asset rules should be scoped out of the ring-fencing rules, because the mixed-use asset rules will cover most if not all mixed-use asset losses.

Certain revenue account land

5.1.11 We suggest that the ring-fencing rules should not apply to taxpayers who hold land on revenue account because they are in a land-related business.[6] Taxpayers in certain businesses relating to land hold their land on revenue account, so the profits on sale will be taxed. This applies to people in the business of dealing in land, developing land, dividing land into lots, or erecting buildings. At balance date, such taxpayers may have a number of properties on hand, though they may not be currently rented out. The policy rationale for loss ring-fencing in these situations is weakened as the capital gains are already taxed. Submitters did not think the loss ring-fencing rules should apply to such taxpayers, as this could discourage new developments, which would be a barrier to increasing housing supply.

5.1.12 As discussed below, we suggest that rental losses are able to be used against taxable land sales to the extent they reduce the taxable gain to nil, with any further unused losses remaining ring-fenced to future rental income or taxable gains on other land sales. While developers, dealers, etc, may have losses in respect of properties on hand at balance date, those losses being able to be used against income from other sales or rental activity in the year would mean that their businesses would be unlikely to be disadvantaged by the ring-fencing rules. In most cases the income from their sale or rental activity would be expected to exceed their losses.

5.1.13 However, in any overall loss-making year, we do not consider it necessary to ring-fence losses for these taxpayers. This would enable those taxpayers to use losses

[6] As per section CB 7 of the Income Tax Act 2007.

arising in any year against other income – for example within their consolidated group (as they are likely to be companies). There is not the same concern in relation to these taxpayers about any of their deductible expenses relating to untaxed gains, as all of their land is on revenue account.

5.1.14 In addition to the exclusions for revenue account land described in Option 2, submitters commented that all land that will definitely be subject to tax on sale should be excluded from these rules. This includes for example, land that was bought with the intention of resale or land that had been subject to more than minor development or division work within 10 years of acquisition. We recommend that if land is identified to Inland Revenue as being on revenue account not subject to any contingencies (for example, being sold within a particular time period), that land should be considered to be definitely subject to tax and excluded from the scope of the ring-fencing rules, as all of the economic income will be subject to tax.

Land owned by companies and trusts

5.1.15 Some private sector advisers and submitters on the issues paper suggested that the ring-fencing rules should apply only to individuals (ie, natural persons) and look-through companies, and not to other companies or trusts. It was noted that company losses are effectively ring-fenced inside the company, as are losses in a trust. It was also noted that the rules would apply to some large companies (for example, large power companies that hold some residential rental property), imposing compliance costs on those companies, in circumstances that were unlikely to be the target of the reform.

5.1.16 While there is some argument that losses are ring-fenced within a company, so there is no need for the rules to apply to companies, officials do not consider that additional compliance costs for some large corporates would justify rules that apply only to individual taxpayers. This would leave open the possibility of holding rental properties in a company, trading trust, or family trust, and offsetting rental losses against other income. Limiting the ring-fencing rules to individuals would, therefore, significantly undermine the fairness of the rules. We therefore do not recommend this option.

Land owned by widely-held companies

5.1.17 The design features in Option 2 included within the scope of the proposed ring-fencing rules all land held by trusts and companies, including land owned by widely-held companies. A number of submitters on the officials' issues paper commented that applying the ring-fencing rules would create substantial compliance costs for large companies which are not the target of the proposal. It was noted that large companies often hold residential land incidentally to their business (for example as sites for future development, or for employee accommodation). In these circumstances, the mischief of offsetting property losses against labour or other income with the hope of capital gains from the properties is not present. For that reason we recommend that widely-held companies be excluded from the scope of the rules.

Employee and farming accommodation

5.1.18 The design features in Option 2 did not carve out land used to provide accommodation to employees, or as part of their farming business. A number of submitters have suggested that these should be carved out of the ring-fencing rules. Submitters considered that such properties have no connection to the mischief the ring-fencing rules are seeking to address, and including them would create compliance costs without any corresponding benefit.

5.1.19 We agree that it would not undermine the rules to exclude accommodation provided to employees (or other workers, as will often be the case in farming) where it is necessary to provide that accommodation due to the nature or remoteness of the business. In such situations the perceived mischief of offsetting property losses against labour or other income with the hope of capital gains from the properties is not present. We therefore recommend such an exclusion.

Level of ring-fencing

5.1.20 The proposed loss ring-fencing rules could be applied either on a property-by-property basis or on a portfolio basis. A portfolio approach would mean that investors could offset losses from one rental property against rental income from other properties, calculating their profit/loss on their overall portfolio. This may be seen as less equitable than a property-by-property approach, in that it may favour wealthier taxpayers with larger property holdings. A property-by-property basis would mean that each property is looked at separately, so losses on one cannot offset income from another.

5.1.21 A property-by-property approach could, in theory, be more effective in reducing tax benefits to investors. In practice, however, a property-by-property approach could result in de facto portfolio outcomes. Taxpayers could potentially rebalance their debt funding to avoid having loss-making properties, or at least minimise the extent to which any particular property is loss-making.

5.1.22 This taxpayer response would be inefficient, and may also mean that, in terms of the objective, a property-by-property approach may have no real advantage over a portfolio approach – adding complexity and increasing compliance costs for no gain.

5.1.23 Further, a property-by-property approach may be seen as unfair in that if a taxpayer has two properties and breaks even on the portfolio overall, the taxpayer’s tax position would depend on whether they break even on both properties or make a gain on one and a loss on the other.

5.1.24 Applying the rules on a portfolio basis would be significantly simpler than a property-by-property approach, from a compliance and administrative point of view, as this is how rental income is currently returned. The additional compliance costs a property-by-property approach would create, especially for investors holding many properties, was highlighted by private sector advisors.

5.1.25 We have looked at the approach to loss ring-fencing in other jurisdictions, and have not found any that apply an asset-by-asset approach. Typically, such rules are applied on a portfolio basis, or investments within particular categories are pooled (for example, in the United States, where ring-fencing applies to “passive activity” losses). However, a property-by-property approach could arguably be more aligned to addressing concerns that large-scale investors who own multiple rentals are able to use losses on new acquisitions to continually reduce their tax.

5.1.26 Most submitters on the officials' issues paper supported the rules applying on a portfolio basis, as it would be easier from a compliance point of view. However, some submitted that a portfolio approach penalises smaller "mum and dad" investors and favours investors with large portfolios.

5.1.27 Some submitters also suggested that taxpayers should be able to make an upfront election to apply the rules on a property-by-property basis if they wish. If a property is taxed on sale any remaining losses for that property could then be released. Officials do not see any issue with taxpayers electing to apply the rules on a property-by-property basis if they are willing to bear any associated compliance costs in order to be able to close out the net profit on that property. It is noted that some submitters advised they (or their advisors) already do this, so they did not see this as adding compliance costs for them. This option is desirable for taxpayers if it means any remaining losses after the taxable sale of a property can be released to be used against other income. We are recommending that be the case – this is discussed further in 5.1.41.

5.1.28 For the above reasons, we suggest that the ring-fencing rules generally apply on a portfolio basis, so a person with multiple properties would calculate their overall profit or loss across their whole residential portfolio. However, we also recommend that taxpayers who wish to elect to apply the rules on a property-by-property basis should be allowed to do so.

Using ring-fenced losses

Grouping losses

5.1.29 In addition to the design features in Option 2, it has been submitted that losses should be able to be transferred between companies under the grouping rules. Often a corporate group will hold rental properties in a different entity to trading business properties.

5.1.30 We agree that ring-fenced losses should be able to be transferred between companies, but that this should be limited to companies in the same wholly-owned group, as the economic ownership is the same in that situation. It is acknowledged that this would be a higher threshold than is applied for the grouping of other losses.

5.1.31 Transferred losses should remain ring-fenced, so they are only able to be used in the relevant income year to the extent the transferee company has residential rental income or residential land sale income, with any remaining losses being carried forward and remaining ring-fenced.

Carrying back ring-fenced losses

5.1.32 Some submitters suggested that losses should be able to be carried back as a typically profit-making property may make a loss in one year due, for example, to large repairs and maintenance expenses or a period of vacancy.

5.1.33 We do not recommend that losses be able to be carried back. This would add complexity, and if a property is typically profit-making the carried forward losses would be available to offset against income in future years. Allowing losses to be carried back would also be inconsistent with general policy settings.

Shareholder continuity

5.1.34 It has been submitted that companies could have losses ring-fenced when their overall position is tax paying, and that this would be unfair. It has been suggested either that the 49% shareholder continuity requirement should not apply to ring-fenced rental losses, or failing that, that if shareholder continuity is breached, losses should be made available to offset against other income.

5.1.35 The shareholder continuity rules reflect that it should be the shareholders at the time company losses arise who are able to benefit from them in the future.

5.1.36 We consider that it would undermine the credibility and fairness of the loss ring-fencing rules if ring-fenced rental losses were not subject to the shareholder continuity requirement, or if losses were released when continuity is breached.

Release of losses on sale

5.1.37 In the case of a property with ring-fenced rental losses that is taxed under one of the land sale rules on disposal, there is an argument that the losses should be able to be fully utilised (ie, un-fenced) at that point, and be used to offset any other income of the taxpayer. This would reflect that all of the economic income from the investment has been taxed (the rental stream and the capital gain), and that the investor should not be penalised for making an overall loss on the investment. For this reason, not releasing losses that relate to a particular property on a taxable sale of that property would undermine neutrality and fairness.

5.1.38 However, if the rules are applied on a portfolio basis (which is the preferred option – see 5.1.21 to 5.1.27), allowing accumulated rental losses to give rise to a tax loss on a disposal subject to one of the land sale rules would create risks. For example, it would enable a portfolio investor to sell a property that has made a small capital gain within the bright-line period, offset that gain with ring-fenced losses from across their portfolio, and apply any remaining losses from the portfolio against other income. While there are ring-fencing rules in relation to the bright-line test, they only apply to deductions for the cost of the property, not other costs.

5.1.39 Enabling taxpayers to sell their lowest capital gain makers within the bright-line period and access what might be substantial portfolio-wide accumulated ring-fenced losses would significantly undermine the credibility of the rules.

5.1.40 Release on taxable sale, recognising that the full economic income had been taxed, would be the preferred option if the ring-fencing rules were to apply on a property-by-property basis. This is because it would only be losses that relate to the particular property that would be released. As noted at 5.1.21, a portfolio approach is preferred to a property-by-property approach because it would be significantly simpler from a compliance and administrative point of view. However, as also noted at 5.1.27, we are recommending that taxpayers who wish to elect to apply the rules on a property-by-property basis be able to do so. For those properties, we think that the preferred option of fully releasing the ring-fenced losses should be adopted. This design feature would be in addition to the features identified in Option A. The new design feature of allowing an election to apply the rules on a property-by-property approach enables all the losses associated with a given property to be used against that property upon a taxable sale.

5.1.41 We therefore do not consider that ring-fenced losses should generally be fully released on a taxable sale of residential property, meaning the losses (if not exhausted from offsetting the income derived on sale) would be able to be used to offset other income. However, for those properties which have had the rules applied to them on a property-by-property basis on the taxpayer's election, we recommend that the losses become fully unfenced if they are taxed upon sale. This would also be the case where the rules applied on a portfolio basis and all of the properties in a portfolio were sold and taxed. This would most commonly be the case for land that was taxable under the bright-line test because it was sold within five years of acquisition.

5.1.42 We do not recommend that losses become released on any sale of residential land if there was no tax on the sale of that property. Releasing losses on a non-taxable disposal would reduce the impact of ring-fencing to one of timing alone, which would reduce the effectiveness of the measure.

Anti-structuring rules

5.1.43 There are two main structuring opportunities that have been considered in terms of whether specific rules are required. These concern interest allocation and the interposing of entities.

Specific interest allocation rules

5.1.44 Without specific interest allocation rules, investors (particularly larger and more sophisticated investors) may be able to structure around the loss ring-fencing rules. For example, by reorganising funding so that business assets other than rental properties are debt-funded, and rental properties are equity-funded, to the greatest extent possible. This could undermine the credibility of the rules, neutrality, and fairness.

5.1.45 However, interest allocation rules would add substantial complexity, and increase compliance and administrative costs. Because money is fungible, it is very difficult to attempt to match borrowings to particular investments (tracing). Stacking rules (eg, allocating debt firstly to ring-fenced investments) may be seen as unfair. And pro rata interest allocation between assets that are subject to the ring-fencing rules and those that are not would require regular valuation of assets.

5.1.46 If interest on any loan that was secured by a residential property was included in the rules, this would create issues for many taxpayers who use their rental properties to secure loans for their businesses. This would impact on small and medium business' access to capital. In addition, many arrangements could be even more difficult to apply interest allocation rules to, as revolving credit facilities are often used to fund both a rental property and a business.

5.1.47 The private sector advisors who officials consulted were strongly of the view that the substantial complexity that interest allocation rules would add should be avoided. It was observed that such complex rules would be particularly onerous for smaller taxpayers to comply with.

5.1.48 Given the substantial complexity that interest allocation rules would introduce, we recommend against such rules. The ring-fencing rules will affect many taxpayers, with varying levels of sophistication and tax knowledge, and we consider it important that they remain as easy to apply as possible, and minimise compliance costs for taxpayers.

Specific rules for interposed entities

5.1.49 We have considered whether there should be specific rules to mitigate the risk of taxpayers interposing entities to get around the loss ring-fencing rules.

5.1.50 Without rules to deal with interposed entities, a simple way taxpayers (particularly larger and more sophisticated taxpayers) could get around ring-fencing rules would be by interposing an entity (eg, a company) to separate a loan (and interest deduction) from the residential rental property, so the interest is not subject to ring-fencing. This could undermine the credibility of the rules, neutrality, and fairness.

5.1.51 In the 1980s, New Zealand had a loss restriction provision that capped the extent to which losses from rental, agricultural and horticultural activities could be offset against other income (the maximum was $10,000 per annum). There was also a provision that clawed back interest and development expenditure where land was sold within ten years of acquisition and the profit derived on sale was not otherwise assessable. A major failing of the interest claw back provision was the absence of specific rules to deal with simple structuring such as that noted above. As a result, a common strategy was to hold the land in a company and incur interest on funds borrowed to buy shares in the company. This meant that no interest was incurred with respect to the land, so there could be no clawback of interest deductions on sale.[7]

5.1.52 While there is a general anti-avoidance rule in the Income Tax Act, it may not be adequate to prevent the simple interposing of an entity to get around loss ring-fencing, as there are legitimate non-tax reasons for holding property in an entity. In addition, it is preferable from a certainty perspective to have specific rules to counter avoidance concerns rather than rely on the uncertain boundary inherent in the general anti-avoidance rule. There would be some administrative costs associated with a specific rule to deal with interposed entities, as compliance would need to be monitored. However, compared to relying on the general anti-avoidance rule, this approach should reduce taxpayer compliance costs, uncertainty, and administrative costs.

[7] *Consultative Document on the Taxation of Income from Capital* (December 1989).

5.1.53 We therefore recommend a specific rule to deal with the interposing of entities, as this would otherwise be a simple mechanism to get around the loss ring-fencing rules, and would undermine their credibility.

5.1.54 The private sector advisors who officials consulted were in agreement that rules to deal with the above mechanism of interposing an entity should be developed, to maintain the integrity of the ring-fencing rules.

5.1.55 The officials' issues paper consulted on a suggested approach to dealing with interposed entities. Submitters have proposed a number of technical refinements to the treatment of interposed entities proposed in Option 2, which we agree with. These are:

- The 50% "residential property land-rich" threshold should take into account all residential properties, not just those within the scope of the ring-fencing rules. This is to ensure that the interposed entity rule applies even if the main home was held in the same entity as a rental property (which would often be worth less than the main home). We recommend that the rule therefore apply where over 50% of the entity's assets are residential properties, not just residential properties within the scope of the ring-fencing rules.

- Interest deductions for the owner of a "residential property land-rich" entity should not be ring-fenced to the extent the profit from the residential property or properties is sufficient to cover the interest, but is not distributed. This is appropriate as the properties are profitable overall, so there is no mischief in allowing the interest covered by the profits to be deducted in that year.

- Where part of an entity's capital is used to acquire a rental property, and part is applied to something else, the interest incurred by the shareholder to fund the entity's capital should be allocated on a pro-rata basis between the uses to which the capital is applied.

- Where the entity's capital is used to acquire a rental property, and the entity also has another profitable activity that does not require any (or much) capital, the shareholder's interest expenses should only be allocated to the extent of the entity's profit from the rental activity.

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			
Investors	Residential property investors who negatively gear will face higher tax liabilities for as long	$570m total over 5-year forecast period (not	High

	as they are making losses on their investment. Inland Revenue estimates that approximately 40% of taxpayers with rental properties record rental losses, with an average estimated tax benefit of $2,000 per annum.	discounted), assuming full application from 2019-20 income year.[8] And then $190m/yr ongoing.	
Owner-occupiers	Current home owners will be negatively impacted insofar as the policy puts downwards pressure on house prices.	Low	Low
Renters	Loss ring-fencing will reduce after tax rental returns for some landlords. This could encourage the transfer of housing stock from investment housing (ie, rental housing) to owner-occupier housing, putting pressure on the remaining rental stock. Reduced supply of rental housing could put upwards pressure on rental prices.	Medium	Low
Inland Revenue	Initial Inland Revenue estimates suggest implementation costs will be up to $1.5 million, mostly through changes to START (Inland Revenue's new tax processing computer system).	Up to $1.5m (not discounted)	High
Wider government	Pressures in the rental market could increase fiscal costs to the Government, most directly from higher income-related rent subsidy costs.	Medium	Low
Total Monetised Cost		$570m over 5 year forecasting period (not discounted). And then $190m/yr ongoing.	High
Non-monetised costs		Medium	Low

Expected benefits of proposed approach, compared to taking no action			
Owner-occupiers	Negative gearing restrictions could help improve first home buyers' ability to compete with investors, improving housing affordability for home buyers, and increasing the share of New Zealanders who own their own homes. Residential property investors who negatively gear properties will face higher tax liabilities under the proposal. This will weaken the business case for their residential property investments, and constrain investor cash flows, both of which will lead to reduced demand for residential property by those investors. All else being equal, this should improve affordability (ie, reduced house prices) for first home buyers.	Medium	Low
Renters	Lower house prices could put downwards pressure on rents, potentially offsetting the pressures on the rental market noted in "Additional costs" section above.	Low	Low
Wider government	Ring-fencing rental losses will prevent investors from offsetting their non-property earnings with rental losses, thereby increasing tax revenues.	$570m total over 5-year forecast period (not discounted), assuming full application from 2019-20 income year. And then $190m/yr ongoing.	High
Total Monetised		$570m over 5 year	High

[8] Discussed further from paragraph 6.1,3,

Benefit		forecasting period (not discounted)	
Non-monetised benefits		Medium	Low

5.3 What other impacts is this approach likely to have?

Uncertainty about housing market impacts

5.3.1 There is significant uncertainty about the net impact of the policy on the housing market, especially on the rental market. Overseas experience underlines the uncertainty in the direction and magnitude of housing market impacts. For example, negative gearing was banned in Australia between 1985 and 1987, and while rents spiked in Sydney during this period, they were flat or falling across much of the rest of the country. The exact relationship between the tax changes and observed changes in rent is unclear.

5.4 Is the preferred option compatible with the Government's 'Expectations for the design of regulatory systems'?

5.4.1 Yes.

Section 6: Implementation and operation

6.1 How will the new arrangements work in practice?

Legislative process

6.1.1 Following consultation and final decisions on the design of the proposed rules, primary legislation will be prepared to give effect to loss ring-fencing.

6.1.2 It is currently anticipated that loss ring-fencing rules will take effect from the 2019-20 income year. It is planned that legislation will be introduced before the start[9] of the income year the rules will apply from (the 2019-20 income year) – giving most taxpayers a degree of certainty about how the rules will operate.

Implementation options

6.1.3 The rules could either apply in full from the outset, or alternatively they could be phased in over three years (ie, a third of a taxpayer's losses are ring-fenced in year one, then two-thirds of their losses in year two). Tax law changes are not usually phased in, but this possible approach has been suggested to allow affected investors more time to adjust to the new rules, or to rearrange their affairs before the rules apply in full. However, we note that phased introduction of the rules would result in some additional complexity.

6.1.4 The officials' issues paper sought feedback on whether the rules should apply in full from the 2019-20 income year, or be phased in over two or three years. Submitters were strongly in favour of phasing the rules in over three years.

6.1.5 A number of submitters considered that existing rental properties should be grandparented, on the basis that such a fundamental change to the rules after investments have been made would be unfair. Other submitters suggested that the rules should apply in full for properties acquired after an announced date, but phased in for existing properties (or existing properties grandparented). Officials consider that these suggestions would produce overly complex rules, and recommend that the rules either apply in full from the outset, or be phased in for all properties over three years.

6.1.6 On balance however, Inland Revenue considers that phasing in the changes could potentially create a precedent-setting risk and there is a stronger argument to apply the rules in full from the 2019-20 income year for all properties.

6.1.7 The Treasury prefers a split approach, with no phasing for new investments, and a three-year phase in for existing investments. This is on the basis that investments made after the ring-fencing rules have been introduced do not need time to adjust to the new rules, while acknowledging that some time may be necessary for existing investments.

6.1.8 The Ministry of Business, Innovation and Employment have expressed a

[9] For standard balance date taxpayers.

preference for a phased introduction for both existing and new investments. This is because if there are sales of some low quality rental properties in anticipation of the Healthy Homes Guarantee Act standards, as expected, a phased introduction of the loss ring-fencing rules could strengthen incentives for new owners to upgrade these rental properties quickly.

Responsibility for ongoing operation and enforcement

6.1.1 Once implemented, Inland Revenue will be responsible for ongoing operation and enforcement of the new rules.

Communications

6.1.2 When introduced to Parliament, commentary would be released explaining the new rules, and further explanation of the effect would be contained in a *Tax Information Bulletin*, which would be released shortly after the bill receives Royal assent. The information on Inland Revenue's website, booklets, etc, would be updated to explain the new rules to property investors.

6.2 What are the implementation risks?

6.2.1 Inland Revenue is currently delivering on its Business Transformation programme. It is anticipated that implementation of ring-fencing of rental losses will occur in START, as the proposed commencement date of 2019-20 occurs after the go-live of START major release 3 scheduled for April 2019. Implementation of the proposed rules will mean changes to START will be required. Officials expect these changes to be relatively minor. However, they are not yet fully scoped, costed and integrated into Inland Revenue's 2019-20 annual returns plan, creating an implementation risk.

6.2.2 Successful implementation is based on taxpayers understanding the changes and how they apply to their situation. For those electing to apply the rules on a property-by-property basis, this explaining the changes in a simple way for them to understand may present an implementation risk.

Section 7: Monitoring, evaluation and review

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

7.1.1 Inland Revenue's monitoring, evaluation and review of new legislation takes place under the Generic Tax Policy Process (GTPP). The GTPP is a multi-stage tax policy process that has been used to design tax policy in New Zealand since 1995.

7.1.2 The Ministry of Business, Innovation and Employment currently investigates trends in house prices and housing affordability, using a variety of measures to get a complete picture of affordability. For home buyers, this includes the level of house prices, how house prices compare to incomes, and the experimental Housing Affordability Measure for first home buyers. For renters, the data monitored includes rent levels and the Housing Affordability Measure for renters. The impact of loss ring-fencing may be seen in an improvement in measures of housing affordability for home purchasers, and may also be seen in the proportion of houses in each area that are purchased by first home buyers and investors – with the percentage of property purchased by first home buyers expected to increase over time as a result of the ring-fencing rules. The impact on rental affordability will be monitored to identify if there appear to be any significant negative impacts on renters from the policy. There is significant uncertainty about the scale of the potential impact of the policy on the housing market. Furthermore, because of the substantial number of factors that affect the housing market, including other policy interventions under development, it is likely to be difficult from a practical perspective to identify the causal impact of the proposed loss ring-fencing rules on affordability for first-home buyers, though housing affordability data may give some indication of the impact of the policy.

7.1.3 We will also monitor data on the amount of ring-fenced rental losses, which will provide an indication of the impact of the policy, and whether the proposed anti-structuring rules are effective.

7.2 When and how will the new arrangements be reviewed?

7.2.1 We will monitor the first year of operation of new legislation, and if we identify anything that suggests a formal review is warranted we will undertake that – for example data that suggests significant negative impacts on the rental housing market. Stakeholders will have the ability to raise concerns with us, and if there is a need to make remedial amendments to the new rules these will be prioritised for inclusion on the Tax Policy Work Programme, and proposed amendments would go through the GTPP.

7.2.2 It is noted that if a comprehensive capital gains tax were to be implemented, loss ring-fencing would be reviewed at that time.

Impact Summary: Securitization of pre-1990 forestry emissions units

Section 1: General information

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

Key Limitations or Constraints on Analysis
Quality of data used for impact analysis Inland Revenue used public information available on holders of pre-1990 emission units to inform our analysis of the proposed approach discussed in this Impact Summary. This information, however, did not provide any insights about taxpayers' use of the emission units, including decision-making behaviours over holding or trading these units. Targeted consultation with interested stakeholders was carried out to bridge this gap in our knowledge; however, for the reasons set out below, there were time constraints on the period of consultation. **Consultation and testing** A private sector stakeholder who raised the initial concerns about the tax treatment of arrangements to securitise emission units was influential in shaping the problem definition. While the ideal response to the concern was to include the issue in a wider context as part of an examination of the use of the financial arrangement rules, the scheduling of this review meant it could not address this issue in a sufficiently timely manner. Analysis of the problem definition and possible options for change led officials to conclude that there was a case for developing an interim solution, focusing on pre-1990 forestry emissions units only, which would address the stakeholder's concern. The recommended interim solution is consistent with current tax policy settings and the framework underpinning the interim solution is sustainable and robust. A consequence of developing the interim solution in a sufficiently timely manner was that it truncated the timeframe that would otherwise be available for consultation to just over one week. Engagement with relevant stakeholders in the public and private sector was high, with most responding either via telephone or letter. Subject to decisions by Cabinet, further consultation on the detailed design of the proposal will be carried out before final decisions, as delegated by Cabinet, are made by Ministers. The wider review of the financial arrangement rules is on the Government's tax policy work programme and will consider if the scope of the interim solution should be extended.

Responsible Manager (signature and date):
Peter Frawley Policy Manager Policy and Strategy Inland Revenue Department May 2018

Section 2: Problem definition and objectives

2.1 What is the policy problem or opportunity?

This Regulatory Impact Analysis addresses the question of whether current taxation laws, particularly the Income Tax Act 2007 (the Income Tax Act), impedes financial decision-making by holders of pre-1990 forestry emissions units that are held for intergenerational purposes.

Pre-1990 forestry emissions units

New Zealand's emissions trading scheme (ETS) distinguishes between pre-1990 forest land and post-1989 forest land, 1990 being the base year of measurement under the Paris agreement, The scheme places mandatory deforestation obligations on exotic forests that were first established before 1990, referred to as 'pre-1990 forests'. This means if pre-1990 landowners choose to deforest, for example when converting forest land to a different use, they face 'deforestation liabilities' under the ETS, have to report on emissions and surrender an equivalent amount of New Zealand emission units to the Government. When the ETS was introduced, owners of 'pre-1990 forests', were able to apply for a one-off free allocation of New Zealand emissions units. This allocation was intended to recognise the possible impact on land values due to the cost New Zealand's ETS places on deforesting, and the resulting reduction in land-use flexibility.

A wide variety of owners applied for the free units, including farmers with small forest holdings, regional councils, owners of large commercial forests, and Māori entities who received forest land as part of treaty settlements. In total, nearly 48 million pre-1990 units were issued, 38 million of which are still held today, some of which have been either sold or surrendered.

The tax treatment also distinguishes between pre-1990 forestry emissions units and post-1989 forestry emissions units. As a transitional measure, the first disposal of emissions units by taxpayers who received the initial allocation of pre-1990 emission units is not treated as income under the Income Tax Act. Subsequent transactions are subject to normal tax treatment on disposal. The special tax treatment for pre-1990 emission units reflects the transitional nature of those units under the ETS, as outlined above.
Public information on the use of pre-1990 forestry emissions units suggests that a large proportion are held long-term. As the units themselves do not produce income, the cash value of these assets can only be realised on disposal. For holders that want to take a long-term inter-generational approach, the units can represent an unproductive asset. The Inland Revenue Department (Inland Revenue) was approached by a private sector stakeholder about changing the Income Tax Act so that unit holders could extract value from the emission units using sale and compulsory buy-back arrangements without triggering a sale for tax purposes.

Sale and compulsory buy-back arrangements

It is a well-established principle of interpretation that the tax treatment of a transaction follows its legal form. When a taxpayer sells property, such as pre-1990 forestry emission units, with a compulsory obligation to buy the same or equivalent property back, the tax rules treat the transaction as a disposal – that is, the taxpayer alienates all rights in the property.

By treating the sale and compulsory buy-back arrangement as a disposal for tax purposes, taxpayers extinguish the benefit of the tax transitional treatment for pre-1990 forestry emissions units. Economically, however, the transaction is a loan or lease of property. As the tax treatment follows the legal form of the transaction rather than its economic substance, tax law can act as an impediment to unit holders seeking to extract value from emissions units that are held for inter-generational purposes.

Agreements involving the sale and compulsory buy back of property are typically referred to as “securitization”. Securitization usually involves using a long-term asset as security in return for a payment for up to the asset’s worth that is repayable at a specified later date. The borrower can use the asset for the period but the expectation is that the asset or an asset of an equivalent nature will be returned to the lender when the monies are paid back. As the set of transactions is in-substance a loan or lease, the tax consequences should follow the difference in the net cash flows as a measure of income, expenditure or loss arising from the arrangement. A netting approach is more consistent with existing tax policy frameworks when economic ownership of the asset is not surrendered.

Case for change

The approach to Inland Revenue for legislative reform was motivated by a unit holder wanting to enter into a significant transaction that would allow them to lend the emissions units to a third party who will likely use the units to offset liabilities connected with their emissions. Because the agreement requires the unit holder to reacquire the units at a specified future date, the property rights in the units cannot be said to have been extinguished or disposed of. In return for the emissions units, the unit holders would receive monies that could be used to produce income, such as interest. Tax law, however, inhibits such arrangements as they would result in the pre-1990 forestry emissions units losing their one-off tax-free status, and limits options for unit holders to seek opportunities to maximise the value from otherwise unproductive assets on their balance sheet.

Work on the issue was initially planned for late 2018. However, an impetus for dealing with this issue more quickly is the fact that the stakeholder who approached Inland Revenue is planning to enter into a sale and buyback transaction of pre-1990 forestry emissions units by the end of May 2018. In the absence of the proposed change, the transaction is unlikely to take place.

There is high confidence in the evidence and assumptions underpinning the case for change.

2.2 Who is affected and how?

The key group of taxpayers affected by the change are holders of pre-1990 forestry emissions units. Preliminary indications from this group, via targeted consultation with a selected group of unit holders with an interest in inter-generational asset retention and growth, were supportive of any reform that would allow them to maximise value from these units without losing any tax transitional benefits.

2.3 Are there any constraints on the scope for decision making?
Tax issues with securitization of assets are not isolated to pre-1990 forestry emissions units. Other assets that could be securitised can be similarly affected, but reforming tax law generally for all assets at this stage has a risk of unintended consequences. Inland Revenue does not have sufficient evidence at this time to advance regulatory reform, even at an in- principle level, for the treatment of long term assets that are not pre-1990 forestry emissions units. Developing a response for pre-1990 forestry emission units only at this time is a reflection of the constraints on our analysis. The wider issues concerning the securitization of assets are scheduled to be considered as part of the review of the financial arrangement rules as announced as part of the Government's tax policy work programme.

Section 3: Options identification

3.1 What options have been considered?

The **main** objective is to ensure that the tax system recognises the economic substance of arrangements that securitise pre-1990 forestry emissions units and ensures that tax law does not inhibit opportunities to maximise the value of those units. The following criteria have been used to assess the options:

- Effectiveness: the options should not act as a disincentive for holders of pre-1990 forestry emissions units to maximise value from those units.
- Sustainability: the options should maintain the integrity of the income tax, and operate coherently with the frameworks used by the Income Tax Act.
- Fairness: the options should apply equally to all taxpayers. Like-transactions should have similar or equivalent tax outcomes.
- Administration efficiency and compliance efficiency: the option should not introduce new processes or procedures that would not otherwise arise under the Income Tax Act.

As the obligations, rights and entitlements of taxpayers are prescribed by legislation, non-legislative responses, apart from the status quo (which does not meet the main objective), are not viable.

Effectiveness was the most important criterion at it aligned closest with the main objective. There was little difference between the options in terms of impact on compliance and administration efficiencies.

Option one: Status quo

Under the status quo, the sale and compulsory buy-back arrangement is treated as a disposal for tax purposes and taxpayers lose the benefit of the tax transitional treatment for pre-1990 forestry emissions units. Current tax policy settings inhibit unit holders from maximising the value of pre-1990 forestry emissions units unless they are sold. As such, the option is not effective and does not meet the main objective.

The status quo is consistent with interpretation principles insofar as the Income Tax Act applies to transactions involving the transfer of property. As such, the status quo is arguably fair. Officials are aware, however, that broader concerns have been expressed that the current position is not sustainable and for this reason the tax treatment of sale and compulsory buy-back arrangements is part of a proposed review of the financial arrangement rules on the Government's tax policy work programme.

Option two: Apply the principles of the financial arrangement rules to securitised pre-1990 forestry emissions unit transactions

Under option two the securitization of pre-1990 forestry emissions units would be treated as a financial arrangement under the Income Tax Act. The financial arrangement rules tax all returns on financial arrangements on an accrual basis over the term of the arrangement, including the returns on instruments that can alter the incidence of those returns. Tax outcomes under the financial arrangement rules would align with the economic substance of the securitization arrangement. This outcome means that option two is effective for the purpose of meeting unit holder expectations regarding their tax obligations and preserves the special tax transitional treatment of pre-1990 forestry emission units until such time as the unit holder choses to alienate their rights to the units.

Option two uses existing tax frameworks in the Income Tax Act and is sustainable because it maintains the integrity of the tax base by ensuring that interest cash flows created by the arrangement are appropriately taxed.

Option two does not rely on the creation of new frameworks and does not create any new or additional compliance or administration costs and meets the administration and compliance cost efficiency criterion.

This option could result in market changes regarding the supply and demand of pre-1990 forestry emissions. Commoditizing such emissions units improves market liquidity but also introduces market risk (such as price and counter party default). We expect that holders of pre-1990 forestry emissions units would carry out appropriate due diligence before entering into any sale and compulsory buy-back arrangements to mitigate these risks.

The option does not fully meet the fairness criterion as it applies to pre-1990 forestry emissions units only. The fairness criterion would be fully met if the proposed approach applied to emissions units generally. Widening the scope of option two is not preferred at this time although officials will be considering in the coming months whether it would be desirable to also include post-1989 forestry emissions units in the proposed amendment prior to the legislation being introduced late this year. Originally, Inland Revenue had intended to discuss the securitization of emissions units in an officials' issues paper for later in 2018. However, the impetus for dealing with pre-1990 forestry emissions units more quickly is the fact that a key stakeholder is planning to enter into a sale and buy-back transaction at the end of May 2018 and has sought an assurance from Ministers that there is support for legislative change to the Income Tax Act to ensure that tax law reflects the economic substance of the transaction.

Preliminary feedback from stakeholders has been supportive of option two.

Other options: Apply the principles of the share lending rules to pre-1990 forestry emissions units

Other options were briefly considered. For example, the share lending rules which are based on a similar securitization concept. Share lending involves the lending of shares to another party for a fee. The share lending rules in the Income Tax Act tax transactions on the basis of economic substance rather than legal form. The share lending rules met some of the evaluation criteria (effectiveness, and administration and compliance efficiency) but did not adequately reflect the underlying cash flows under this particular type of securitization arrangement as the share lending rules are specifically targeted to shares. Therefore, it was dismissed as an option as it was not sustainable, notwithstanding its effectiveness.

3.2 Which of these options is the proposed approach?
The proposed approach is option two, which relies on the principles and framework of the financial arrangement rules in the Income Tax Act to appropriately tax securitization arrangements involving pre-1990 forestry emissions units. This option is preferred as it meets the main objective and is effective and sustainable. By using existing frameworks in the Income Tax Act, it does not create new compliance or administrative processes. The proposed approach has no areas of incompatibility with the Government's expectations for the design of regulatory systems.

Section 4: Impact Analysis (Proposed approach)

4.1 Summary table of costs and benefits

Affected parties *(identify)*	**Comment**: nature of cost or benefit (e.g. on-going, one-off), evidence and assumption (e.g. compliance rates), risks	**Impact** *$m present value, for monetised impacts; high, medium or low for non-monetised impacts*
Additional costs of proposed approach, compared to taking no action		
Regulated parties	On-going compliance costs of the proposed approach are comparable to the status quo.	Low
Regulators	Administration costs of the proposed approach are comparable to the status quo.	Low
Wider government	Revenue effect is negligible for several reasons: in the absence of legislative change it is unlikely securitization transactions involving pre-1990 emissions units would go ahead.	Low
Other parties	None	Low
Total Monetised Cost		Low
Non-monetised costs		Low
Expected benefits of proposed approach, compared to taking no action		
Regulated parties	Tax environment supports securitization of pre-1990 emissions units allowing holders to maximise the value of those assets.	Low
Regulators	None	Low
Wider government	None	Low
Other parties	Users of emissions units to offset emissions may find suppliers of pre-1990 units more willing to lease or loan those units due to the neutral tax environment created by the proposed approach.	Low
Total Monetised Benefit		Low
Non-monetised benefits		Low

4.2 What other impacts is this approach likely to have?
Inland Revenue officials are aware that a review of the emissions trading scheme is currently underway. The proposed approach is not anticipated to have any impacts on the outcome of this review. To provide certainty for stakeholders, the proposed approach would apply from the start of the 2018-19 income year for transactions entered into from that year. Applying the change from this time gives assurance and certainty to the stakeholder (and others) who initially raised concerns that the Income Tax Act was limiting opportunities for holders of pre-1990 forestry emissions units to maximise the value of those assets.

Section 5: Stakeholder views

5.1 What do stakeholders think about the problem and the proposed solution?
The problem with the current tax rules as they apply to securitization of pre-1990 forestry emissions units was brought to Inland Revenue's attention by a specific taxpayer. Taxpayer secrecy prevents Inland Revenue from naming this taxpayer. The taxpayer has been consulted throughout the policy development process. Inland Revenue also undertook targeted in-confidence consultation, via letter, with a selection of the larger holders of pre-1990 forestry emissions units to test initial reactions to the proposed approach. The letter sought stakeholder views about the proposed change. Feedback supported a change from the status quo. Inland Revenue also carried out follow up contact via telephone with stakeholders. Their feedback was very positive. One submitter suggested the amendment should extend to the securitization of any forestry emissions units, not just pre-1990 forestry emissions units. The submitter's point is that owners of post-1989 forestry emissions units tend to retain them to cover the future surrender obligations that arise under the emissions trading scheme when the forests are harvested. Being able to securitize those units in the meantime would be useful for the owners of post-1989 forestry emissions units. Over the coming months Inland Revenue will consider and report back to Ministers on whether the proposed amendment should be extended to all emissions units, or alternatively, whether any extension should be left to be considered as part of the financial arrangements issues paper. This consideration should not, however, hold up obtaining Cabinet agreement to a legislative tax amendment for pre-1990 forest land emissions units. More generally, Inland Revenue considers any wider securitisation issues should be considered as part of the proposed review of the taxation of financial arrangements, which is planned for later in 2018. The outcome of this review is not expected to result in changes that would be inconsistent with the proposed approach discussed in this Impact Summary. Separate from the review of the taxation of financial arrangements, an additional round of consultation is proposed about the detailed design of the proposed approach before final policy decisions are made by Ministers. Cabinet is being asked to delegate authority to the Minister of Revenue to finalise the detailed design of the proposed approach. Another round of consultation will also be available as part of Parliament's consideration of any legislative amendment through the Parliamentary select committee process. The Treasury was consulted as part of the policy development process and supports the measure being taken to Cabinet for approval. The Ministry for Primary Industries, the Ministry for the Environment and the Office of Treaty Settlements were also consulted and did not identify any concerns with the proposed approach.

Section 6: Implementation and operation

6.1 How will the new arrangements be given effect?
Legislative change to the Income Tax Act 2007 is necessary to implement option two. These amendments would be included in an omnibus taxation bill planned for later in 2018. The changes would apply to securitization transactions entered into by taxpayers from the 2018-19 and later income years. Stakeholder feedback has not highlighted any concerns regarding compliance with the proposed approach and it has been positively received. When the bill is introduced into Parliament, a Commentary on the bill will be concurrently released explaining the amendments. Further explanation about their effect will be contained in Inland Revenue's *Tax Information Bulletin* series, which would be released shortly after the bill receives Royal assent. Inland Revenue would administer the proposed legislative changes. Enforcement of the changes would be managed by Inland Revenue as business as usual. Inland Revenue has assessed the magnitude of the administrative impacts and considers that the proposed approach can be implemented and made effective for transactions entered into anytime from the start of the 2018-19 income year.

Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?
Inland Revenue would monitor the outcomes as per the objectives of the Generic Tax Policy Process (GTPP) to confirm that the proposed approach meets its objectives. The GTPP is a multi-stage policy process that has been used to design tax policy in New Zealand since 1995. Monitoring of the proposed approach will be done through existing relationships Inland Revenue has with relevant stakeholders and their advisors.

7.2 When and how will the new arrangements be reviewed?
A proposed review of the financial arrangement rules is on the Government's tax policy work programme for later 2018. It will consider a variety of financial arrangement taxation issues ranging from remedial to policy enhancements to ensure the rules work as intended. This review will ultimately involve the preparation of a public consultation document and the opportunity for stakeholders to comment. Any concerns identified by stakeholders about the proposed approach discussed in this Impact Summary, including its possible extension to other assets, would be considered as part of this review.