

Regulatory Impact Statement

Salary trade-offs

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

The problems addressed in this statement are how to:

- a) tax salary trade-offs; and
- b) account for salary trade-offs in calculating income for social assistance purposes.

Extensive consultation was undertaken during the development of the proposed approach in order to deal with the large number of potential options that stem from answering several critical design questions. An officials' issues paper was released, and following submissions, a revised suggested package was developed. Officials then met with key submitter groups to discuss and further shape this package. Given that the proposed approach changed after the issues paper, we intend to share the draft legislation with key submitter groups and expect that further submissions may be received in the Select Committee phase.

The proposed approach is crafted to minimise compliance costs but would still impose additional compliance costs on affected individuals and organisations. For problem (a), these costs are moderate since they primarily impact organisations already subject to Fringe Benefit Tax with some additional record-keeping being required to account for car parks. Also, the compliance costs would reduce over time as the new system is put into place and the rules are better understood. For problem (b), the additional compliance costs are minimal since a simple standardised approach is proposed.

The proposed approach results in:

- a) an additional tax obligation for organisations providing these benefits (estimated to be \$17 million per annum, with this cost potentially being passed on (in whole or part) to employees over time); and
- b) social assistance entitlements reducing and obligations increasing for some individuals (estimated to be a net saving of \$5 million per annum to Government).

Given that the proposed approach is limited to material (i.e. large) benefits, its impact is largely on car parks provided by organisations within the central business districts of Auckland and Wellington (although this may change over time if the value of benefits rises elsewhere). Public authorities would be within the scope of the proposed approach (examples include government departments, universities and some schools). Charitable organisations are generally not within the scope of the proposed approach.

Under the proposed approach, charitable organisations may arguably obtain an additional competitive advantage over non-charitable organisations. However, in order to remove or lessen the tax advantage more generally, charitable organisations that are not currently subject to FBT would need to be drawn into the FBT regime. A wider application of this approach would have a greater impact on charitable organisations than other organisations since, in addition to car park benefits, they provide a wider range of untaxed benefits (in particular in relation to the private use of motor vehicles). This would mean a significant increase in their compliance costs. In balancing equity and compliance, a decision was made by Ministers to exclude charitable organisations from the proposed approach for compliance reasons.

Other than as set out above, the proposed approach does not impair private property rights, reduce market competition, provide disincentives to innovate or override fundamental common law principles.

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STATUS QUO AND PROBLEM DEFINITION

1. Generally, anything that an employer provides to an employee that is salary or wages, or is a substitute for salary and wages, should be taxed. Currently, salary and wages are treated as employment income and are subject to withholding tax (PAYE), while most non-cash benefits received as a result of employment are treated as fringe benefits and are subject to fringe benefit tax (FBT). The overall effect of PAYE and FBT is intended to be the same so that cash and non-cash benefits are taxed equivalently.

2. In many instances, benefits gained in a salary trade-off, such as the availability of an employer-provided car, are taxed through the FBT rules. There are, however, instances in which neither a salary substitute, nor the salary traded off are taxed. Key examples of these are salary traded off for non-cash benefits provided on an employer's premises and salary traded off for benefits provided to employees of charitable organisations. From a policy perspective, it is difficult to justify these amounts being tax exempt, when the amounts would be taxed if provided as cash remuneration.

3. Within the overall problem there are a number of key issues that arise, such as:

Equity and efficiency issues

4. The exemptions from FBT for benefits provided on an employer's premises and to employees of charitable organisations give rise to equity and efficiency issues when the benefits are provided as substitutes for salary or wages. A key principle of tax policy is horizontal equity – ideally a tax should apply equally to people on the same effective income. By receiving a salary substitute that is not taxed, an employee receives a tax saving over other employees who are not able to structure their remuneration package to include such non-cash benefits.

5. Additionally, the FBT exemption afforded to non-cash benefits provided to employees of charitable organisations may attract employees away from other organisations, so the exemption may be economically inefficient. Where the FBT exemption is used for salary substitution, it gives the charitable organisation a relative tax advantage.

Interpretive issues

6. There is also a long-standing interpretive issue with the current boundary to determine whether the provision of a car park is a fringe benefit. That boundary has traditionally been whether the car park is on the employer's premises, with "premises" being based on the common law interpretation, under which a leased car park, like one owned by the employer, is exempt from FBT, whereas a licensed car park is not exempt. This boundary is becoming increasingly untenable because some licensed car parks, like leased car parks, also provide substantially exclusive possession. This blurring of the boundary creates uncertainty for taxpayers and administrators.

Vouchers

7. Various arrangements which aim to expand the intended scope of the FBT exemption for non-cash benefits provided to employees of charitable organisations have been marketed to charitable organisations. The arrangements, such as the provision of vouchers, aim to cover an employee's normal everyday living expenses such as groceries and petrol. Because these arrangements provide a readily substitutable alternative to salary and wages, they should arguably be taxed in the same way as salary trade-offs, even where a specific amount of cash has not been traded off.

Social assistance issue

8. Most fringe benefits provided as part of a salary trade-off (and vouchers and similar arrangements provided to employees of charitable organisations) are not currently included in the definition of “family scheme income”, and are therefore not taken into account in determining social assistance entitlements and obligations. As with the tax treatment of these benefits, this raises equity issues, given that a person’s social assistance, such as Working for Families tax credits, or child support payment obligations, can be altered by the extent to which their salary package comprises non-cash benefits.

9. One of the themes of Budget 2010 was the need to improve the integrity of the tax system and social assistance programmes so that individuals pay their fair share of tax and so that social assistance is targeted at those in genuine need. Not taxing salary substitutes of material value and not including them as income when determining social assistance entitlements and obligations distorts social assistance entitlements and obligations. This may also encourage structuring of employee remuneration packages to obtain these outcomes.

Why the status quo is not an option

10. In the absence of legislation to tax material salary trade-offs that are currently exempt from FBT, inequity is produced. It may also encourage further behavioural changes that cause a material risk to the tax base as they become increasingly common. Therefore, maintaining the status quo is not an option for the long-term.

Problems

11. The problems addressed in this statement are how to:
- a) tax salary trade-offs; and
 - b) take salary trade-offs into account in calculating income for social assistance purposes.

OBJECTIVES

12. The objectives in answering the problems are to:
- a) enhance fairness and efficiency in the tax system;
 - b) provide clarity around the boundary between when a car park is taxable and non-taxable;
 - c) be robust, and not encourage behavioural distortions;
 - d) be effective;
 - e) create simple rules which are easy to apply; and
 - f) minimise any compliance costs on employers and employees.

REGULATORY IMPACT ANALYSIS

13. Given the large number of questions to be answered (below) in addressing the problems, the number of potential options is vast. Accordingly, we chose to address each of these questions separately rather than as competing options.

Questions to be answered:

- a) Should currently untaxed salary trade-offs be taxed in the hands of the employee through PAYE?
- b) Should currently untaxed salary trade-offs be taxed as fringe benefits through the FBT rules?
- c) Should currently untaxed salary trade-offs be subject to tax only where an amount of cash is explicitly traded off?
- d) Should currently untaxed salary trade-offs be subject to tax only where there is a material benefit to the employee?
- e) Are vouchers a readily substitutable alternative to salary and wages?
- f) Is it equitable to treat charitable organisations the same as non-charitable organisations?
- g) Given that charitable organisations are generally exempt from FBT, should they be subject to FBT on salary trade-offs involving material benefits, bearing in mind the compliance costs of doing so?
- h) Should employees of charitable and non-charitable organisations be required to take the same items into account in determining income for social assistance purposes?
- i) Should salary trade-offs be taken into account in determining income for social assistance purposes only where there is a material benefit to the employee?
- j) Should salary trade-offs be taken into account in determining income for social assistance purposes only where an amount of cash is explicitly traded off?

Summary of answers to questions and impacts

Questions	Answers	Impacts
a) Should currently untaxed salary trade-offs be taxed in the hands of the employee through PAYE?	No	Taxing through PAYE would mean that the tax would be paid by the employee.
b) Should currently untaxed salary trade-offs be taxed as fringe benefits through the FBT rules?	Yes	Taxing through FBT would mean that the tax would be paid by the employer. The incidence of the FBT may (over time) fall on the employee as opposed to the employer. This would be determined through labour demand and supply and a matter of negotiation between the employer and employee.
c) Should currently untaxed salary trade-offs be subject to tax only where an amount of cash is explicitly traded off?	No	Limiting to explicit trade-offs would mean the proposal was less complex, however it would be too easy to structure contracts around this in order to avoid the tax.
d) Should currently untaxed salary trade-offs be subject to tax only where there is a material benefit to the employee?	Yes	Limiting to material (large) benefits will reduce the compliance cost of these proposals on employers.
e) Are vouchers a readily substitutable alternative to salary and wages?	Yes	Clarifying the tax treatment of vouchers by setting out that they are not generally part of the FBT exemption would mean that charitable organisations providing vouchers (over a <i>de minimis</i>) threshold would be required to pay FBT on those vouchers.

Questions	Answers	Impacts
f) Is it equitable to treat charitable organisations the same as non-charitable organisations?	Yes	This would ensure equity between employees of all types of entities.
g) Given that charitable organisations are generally exempt from FBT, should they be subject to FBT on salary trade-offs involving material benefits, bearing in mind the compliance costs of doing so?	No	Ensuring that charitable organisations were subject to FBT on these benefits would ensure equity between employees of all types of entities. It would, however, be a change from the current general exemption from FBT for charitable organisations and increase compliance costs. The application of this approach would have a greater impact on charitable organisations than other organisations since they provide a wider range of untaxed benefits.
h) Should employees of charitable and non-charitable organisations be required to take the same items into account in determining income for social assistance purposes?	Yes	This ensures equity between employees of all types of entities.
i) Should salary trade-offs be taken into account in determining income for social assistance purposes only where there is a material benefit to the employee?	Yes	Limiting to material (large) benefits will reduce the complexity of these proposals for employees.
j) Should salary trade-offs be taken into account in determining income for social assistance purposes only where an amount of cash is explicitly traded off?	Yes	Ideally implicit trade-offs should also be taken into account for social assistance calculations, although this would be more difficult for employees of organisations not required to complete FBT returns.

Reasoning for design questions relating to problem (a):

Pay as you earn (PAYE) or fringe benefit tax (FBT)?

14. Taxing amounts that are not currently taxed when they are part of a salary trade-off could be accomplished either through the PAYE system or by applying FBT to the benefits. The officials' issues paper, *Recognising salary trade-offs as income*, raised both of these options and sought submitters' views on the relative merits of each method.

15. Taxing these benefits through the PAYE system could be achieved by including the amount of salary traded off in the employee's income and applying PAYE. This would involve a general rule covering all salary trade-offs, even when the underlying benefits are already subject to FBT. To avoid double taxation, employers would be able, to the extent that the benefits are subject to FBT, to treat those salary trade-off amounts (net of PAYE) as a contribution paid by the employee when calculating their FBT liability (as a square-up).

16. Alternatively, taxing these benefits through the FBT rules could be achieved by introducing a rule that was confined to salary trade-offs involving specific types of benefits that are currently FBT exempt. FBT would be applied to the value of the benefit. The issues paper suggested that these specific benefits would be car parks and childcare, as well as cars provided to employees of charitable organisations.

17. Of the submissions that commented on the choice between administering the proposals through the PAYE system or the FBT rules, most favoured applying FBT. This was on the basis that it would be simpler given their current accounting systems, more conceptually consistent with the treatment of other non-cash benefits that are already taxed through the FBT system, and more flexible given the potential variability of size and timing of benefits. Submissions noted that the PAYE approach would impose additional compliance costs on employers as a result of having to perform the necessary square-up.

18. In light of submissions received, officials consider that these proposed changes should be advanced through the FBT regime, not through the PAYE system.

Only explicit salary trade-offs?

19. A number of submissions favoured focusing only on situations where an amount of salary is sacrificed for a specific benefit (an explicit trade-off). That is, they did not favour the alternative of taxing an implicit trade-off where a benefit is provided and no cash alternative is offered. In the case of an explicit salary trade-off, there is a clearer salary substitution and the value of the trade-off is more certain.

20. While acknowledging submitters' concerns, officials concluded that both explicit and implicit salary trade-offs ought to be included. Otherwise, it would be too easy to structure contracts to provide the same material benefits as an explicit salary trade-off by not offering a cash alternative. Also, implicit salary trade-offs can also provide material benefits that should be taxed. For example, a person receives two offers of employment from different employers. One offers a package of \$68,000 salary plus a car park on the employer's premises (with no cash alternative), while the other offers a \$70,000 salary only package. From a policy perspective, the tax and social assistance outcomes should be the same, but currently they are not because the car park is not taxed. Finally, including both provides a more certain boundary as to whether a car park is taxable or not taxable than the current lease/licence distinction.

Only material benefits?

21. Conceptually, one might want to include all non-cash benefits that are not currently taxed and are provided to employees as part of a salary trade-off. Non-charitable organisations are already subject to FBT on most non-cash benefits that they provide to employees. There is no intention to include all forms of small benefits, such as flu shots, that have been exempted under the FBT rules. This is because the compliance costs associated with such a proposal would be out of proportion with the revenue to be raised, and employers and employees would not normally consider such items to be salary substitutes. For compliance reasons, officials therefore recommend focusing primarily on the largest (material) benefits which are currently not taxed.

22. We had originally suggested that childcare benefits should also be included if provided as part of a salary trade-off. However, the submission process confirmed that there is no evidence of widespread employer provided on-premises childcare, and assessing the true value of the benefit is difficult. Accordingly, we do not consider that childcare benefits should be included as a material benefit at this stage.

23. Officials consider that these material untaxed benefits are therefore:

- a) for organisations which are already subject to FBT, car parks provided on an employer's premises; and
- b) for organisations which are not already subject to FBT, cars and car parks.

Treatment of vouchers?

24. Our proposals would also clarify the tax treatment of vouchers provided to employees of charitable organisations. It would set out that these are not generally included in the FBT exemption afforded to non-cash benefits provided to employees of charitable organisations, subject to a *de minimis* threshold. Employees receiving vouchers would be required to include the value of these vouchers in their social assistance calculations as they do with other short-term charge facilities such as credit cards.

Equitable to treat charitable and non-charitable organisations the same?

25. As noted in the issues paper, there is a strong tax equity argument for treating non-cash benefits provided to employees of charitable organisations the same as non-cash benefits provided to employees of other organisations, particularly given that cash salary is taxed in all situations.

26. This is supported by the idiosyncratic definition of 'charitable organisation' that results in benefits provided to employees of universities being taxed whilst similar benefits provided to employees of polytechnics not being taxed.

Should FBT be applied to material salary trade-offs provided by charitable organisations?

27. The design question is, given the above decisions which have been made (namely to apply FBT to explicit and implicit material non-cash benefits provided to employees) should this apply to charitable organisations, or merely non-charitable organisations?

28. Applying FBT to explicit and implicit material non-cash benefits (i.e. cars and car parks) provided to employees of charitable organisations would be a large change for charitable organisations, both in terms of compliance costs and funding. Charitable organisations are generally FBT exempt. FBT only applies to benefits provided to employees of businesses run by charitable organisations when the business is outside the charitable organisations purposes. Accordingly charitable organisations are generally unfamiliar with how FBT operates. They would need to set up new systems and train staff, who are often part-time or volunteers.

29. This obligation to understand and pay FBT would occur at a time when a range of other concurrent Government requirements (such as new accounting, auditing and contracting requirements) were being placed upon charitable organisations.

30. The additional compliance costs would be significantly higher for charitable organisations than other organisations given that their vehicles would also be brought within the FBT net under the suggested approach in the issues paper, whereas non-charitable organisations already pay FBT on cars and are therefore familiar with the relevant rules.

31. Charitable organisations were particularly concerned about the likely reduction in the funds available for charitable activities. The FBT exemption was viewed by some submitters as a low-cost means of salary substitution to reduce the salary gap with the private sector. Submitters also noted that removing tax concessions could have flow-on implications when negotiating the price of the services that charitable organisations provide to Government. In response to suggestions that the FBT exemption may provide charitable organisations with a competitive advantage, charitable organisations commented that in their view they do not face a level playing field more generally.

32. Given that GST is also payable on fringe benefits, making more non-cash benefits subject to FBT would mean that the organisations providing those benefits would automatically be required to also pay GST on those benefits. The rationale for this is that the employee is in effect the final consumer in such cases.

33. Officials considered various ways to reduce the additional compliance costs: by focusing only on the larger benefits currently untaxed (such as car parks in Auckland and Wellington where the main car park benefits arise), having rules that clearly delineate what is taxable and what is not (which included dropping the enforceable right concept (discussed below)) and providing standard values for benefits such as car parks.

34. Officials were also mindful of the impact that subjecting charitable organisations to FBT on cars would have on those charitable organisations. As a practical concession to charitable organisations, officials recommended that if charitable organisations were to be subject to FBT on material benefits a wider definition of “work-related vehicle” be applied to charitable organisations. This wider definition would waive both the requirement that the vehicle have the employer’s logo or other identifier displayed and the requirement that the vehicle not be a car. It would enable private travel between home and work in a car, but most other private use would be subject to FBT. Non-charitable organisations may, however, use this wider definition as a precedent to seek a similar exception for cars they use in their business.

35. Officials also planned for an education campaign providing for a national education programme for community organisations to assist them in dealing with FBT.

36. If this rule is not applied to charitable organisations, the equity and efficiency issues relating to providing additional assistance to charitable organisations through an FBT exemption are not addressed. Including charitable organisations in the scope of a salary trade-off rule would be more consistent with New Zealand’s general approach to taxation, that is, to apply taxes across a broad base with a minimum of exemptions.

37. This question is therefore finely balanced, largely as a result of competing objectives of equity on one hand, and minimising compliance costs on the other. Officials recommended that charitable organisations be included in the new rule for equity reasons. However, we acknowledge that there is a judgement call to be made on the compliance implications that this would have for charitable organisations. As noted earlier, those compliance costs would be relatively higher for charitable organisations given that they would need to account for FBT on any private benefits involving cars. (This compliance cost concern was recognised when the FBT exemption was reinstated in 1990 when a similar attempt was made to limit the scope of the exemption in relation to motor vehicles and it was ultimately decided that compliance was too much of an issue.)

38. Various options to reduce the compliance costs were considered and discussed with Ministers. However, these options did not overcome the compliance concerns. Consequently, the proposed approach excludes charitable organisations.

39. Public authorities, local authorities and universities are excluded from the definition of charitable organisations. They would therefore be within the scope of the proposed approach (examples include government departments, universities and some schools).

Reasoning for design questions relating to problem (b):

Same treatment for employees of charitable and non-charitable organisations?

40. Excluding non-cash benefits provided to employees of charitable organisations when calculating income for social assistance purposes, but including them for other employees, would raise issues of horizontal inequity.

Only material benefits for social assistance purposes?

41. All non-cash benefits that are provided to employees as part of a salary trade-off should theoretically be included in income for social assistance purposes. However, again, we are not proposing that such a broad approach should be taken due to compliance cost reasons.

42. As benefits which are subject to FBT rather than PAYE are not automatically included in the employee's income, employees would need to include the benefits when calculating income for social assistance purposes. The issues paper suggested including benefits which are attributable to individual employees under the FBT rules in addition to material benefits that are currently exempt from FBT. However, submissions indicated that, for compliance reasons, many employers are not attributing benefits to individual employees and instead are paying FBT at the highest rate.

43. A practical approach to this problem is to focus on the larger benefits that employees can readily identify and include in their calculations. Officials consider that the material benefits that should be taken into account in determining income for social assistance purposes are car and car park benefits, and vouchers and other short-term charge facilities.

Only explicit benefits for social assistance purposes?

44. In the proposed approach, non-charitable organisations would be subject to FBT on both their explicit and implicit trade-offs. However, charitable organisations would not be subject to FBT on either type of trade-off.

45. As a result, charitable organisations would not be in a position (without significant additional record-keeping) to provide assistance to employees around implicit trade-offs. However, both the charitable organisations and their employees will be able to readily identify explicit trade-offs.

46. Although organisations that pay FBT could provide assistance to their employees on both explicit and implicit trade-offs, in order to treat employees of all organisations in the same way, we recommend that all employees be required to take into account only explicit trade-offs for social assistance purposes.

The proposed approach

47. After addressing the questions above the proposed approach is designed to:

- a) tax salary trade-offs by:
 - i. applying FBT to both explicit and implicit material salary trade-offs (excluding those provided by charitable organisations); and
 - ii. recognising that vouchers are subject to FBT;
- b) account for salary trade-offs for social assistance purposes by:
 - i. taking explicit material salary trade-offs into account regardless of whether they are paid by charitable or non-charitable organisations; and
 - ii. recognising that vouchers should also be taken into account.

Car parks

48. Since the proposed approach does not apply to charitable organisations, the material untaxed benefits are largely limited to car parks provided on an employer's premises. For compliance reasons, officials suggest focusing predominantly on off-street car parks in the central business districts (CBDs) of Auckland and Wellington that are provided to employees as a private benefit. Car parks provided by employers outside of these defined areas would be included only when the car park was supplied by a third-party commercial car park operator at a charge of more than \$7 a day, or when an amount of salary was explicitly traded off for the car park.

49. There would be exclusions for car parks occupied by work vehicles, used by night shift workers or employees with valid disabled-parking permits, and car parks jointly available for use by both employees and customers where the customer has priority. To minimise compliance costs, officials recommend that where car parks are eligible for exclusions on some days and not others, employers should be allowed to use a test period to determine if that car park should be excluded (employers would be given the choice to use actual records).

50. Car parks provided by commercial car park operators would be valued at the amount the operator charges. A standard value determined by the Commissioner of Inland Revenue would be used to value car parks not supplied by a commercial car park operator. This standard value would be based on the average cost of long-term parking in the CBDs of Wellington and Auckland (currently around \$250 per month). Any contribution by the employee would be taken into account. Officials suggest using this standard value even when an amount of salary has been explicitly traded off for the car park. This is because the amount specifically traded off may not reflect the value of the car park. An employer may, for example, have an incentive to offer an employee a car park rather than cash because there is spare space in the basement of their building that cannot be utilised in a more effective way.

51. FBT would generally be based on the availability to the employee, which would be linked to whether the employee had a guaranteed car park. For example, the employee might have a specifically allocated space, or the employer could provide more spaces than employees with a parking option. Where there are fewer spaces than employees with a parking option, FBT would be based on the number of eligible spaces.

Social assistance

52. Employees would only be required to include car, car park, vouchers or short-term charge facility benefits that are part of an explicit salary trade-off in their calculations of income for the purposes of:

- Working for Families tax credits;
- child support;
- student loan repayments;
- student allowances (parental income test); and
- community services cards (entitlements for families with children, other than beneficiary families).

53. Neither KiwiSaver contributions nor ACC levies would be affected.

54. Employees would identify, when completing their Working for Families tax credits registration form or annual return of adjustments to income for Working for Families Tax Credits, if they had received one of these benefits and assign the appropriate valuation based on the number of days the benefit was received. It is planned that this form would become more generalised for a wide range of social assistance/obligations calculations.

Revenue impact

55. The proposed approach would raise revenue of approximately \$22 million per annum through:

- a) an additional tax obligation for relevant organisations providing these benefits (estimated to be \$17 million per annum); and
- b) social assistance entitlements reducing and obligations increasing for some individuals (estimated to be a net saving of \$5 million per annum to Government).

Employee impact

56. Employees would be required to manually include details of explicit salary trade-offs in their calculations of income if they are eligible to receive social assistance, or obliged to make social assistance payments. Officials are continuing to plan the specific manner in which explicit trade-offs would be included, to ensure the rules are easy to understand and comply with.

57. The incidence of the FBT may (over time) fall on the employee as opposed to the employer. This would be determined through labour demand and supply and a matter of negotiation between the employer and employee.

Employer impact

58. Employer FBT systems/processes would need to be updated to ensure compliance with these new rules. This would increase compliance costs, although substantial work has been done (taking submitters' concerns into account) in order to minimise the compliance costs. The proposed approach is designed to minimise complexity through primarily targeting Auckland and Wellington, by using standard values, and by using a test period.

59. Primarily focusing on car parks in the CBDs of Auckland and Wellington would mean that there is a different tax treatment for organisations within the defined areas of those CBDs, and those elsewhere. For organisations in those CBDs, car parks provided to employees as part of an explicit or implicit trade-off would automatically be included (regardless of value). In contrast, for organisations outside those CBDs, only car parks for which salary is explicitly traded off, or which are provided by commercial car park operator over the value threshold, would be included.

60. While we recognise the complexity of the exemptions, complexity is required to appropriately tax non-cash benefits and integrate the approach with the already detailed FBT system.

61. The proposals create a clearer, more equitable, outcome, which is based on practical considerations rather than the legalistic lease/licence distinction. Greater clarity reduces compliance costs.

CONSULTATION

Issues paper and submissions

62. Inland Revenue consulted on the proposals in an officials' issues paper, *Recognising salary trade-offs as income*, released in April 2012. Eighty-six submissions were received, around 70 per cent of which were from the charitable sector. Submissions generally supported the concept of equity of treatment between employees who receive all their remuneration in cash and those who receive some part of their remuneration in non-cash benefits. However, submitters had the following key concerns with the suggested reform:

Compliance costs

63. A major concern was the additional compliance costs, particularly if the new rules covered a wide range of non-cash benefits (including those exempted under the FBT rules) and required benefits, such as car parks, to be valued. Employers were also concerned about the compliance costs around providing additional information on non-cash benefits for social assistance purposes. To address these compliance concerns, the proposed approach focuses primarily on the material (largest) benefits which are provided to employees.

64. Charitable organisations were particularly concerned about compliance costs. The additional compliance costs would be significantly higher for charitable organisations given that their vehicles would be potentially within the FBT net under the suggested approach in the issues paper. They were unfamiliar with FBT so would need to set up new systems and train staff (who were often part-time or volunteers). This would be at a time when a range of other concurrent Government requirements were being placed upon them.

65. Officials considered various ways to reduce the additional compliance costs: by focusing only on the larger benefits currently untaxed (such as car parks in Auckland and Wellington where the main car park benefits arise), having rules that clearly delineate what is taxable and what is not (which included dropping the enforceable right concept (discussed below)) and providing standard values for benefits such as car parks. This approach would apply for both tax and social assistance purposes so that rather than requiring attributed fringe benefits to be included in income when determining eligibility for social assistance, the focus would be on including only the main benefits (such as cars and car parks) when part of an explicit salary trade-off.

66. For charitable organisations, the options considered to reduce compliance costs included a more generous definition of work-related vehicles in order to exclude cars used by charitable organisations for predominantly work purposes, a cap on the FBT exemption, a staged introduction and exempting charitable organisations below a certain threshold. Also, Inland Revenue's planned education campaign included providing for a national education programme for community organisations to assist them in dealing with FBT.

67. Officials recommended that charitable organisations be included in the new rule for equity reasons. Various options to reduce the compliance costs were considered and discussed with Ministers. A decision was made that these options did not sufficiently reduce the additional compliance costs for charitable organisations. The organisations would still need to understand the FBT rules and apply them, including determining whether they were under the relevant thresholds. Consequently, the proposed approach excludes charitable organisations.

Concept of an enforceable right

68. In the issues paper, officials proposed using a concept of an "enforceable right" to a benefit as a way of identifying implicit salary trade-offs. This relied on the idea that employees would want their entitlement to benefits to be legally enforceable and specifically recorded. This concept, however, was a major concern for submitters as they thought it to be unclear and compliance intensive. Submissions emphasised that employers may not have considered the enforceability of the non-cash arrangements that they entered into. Requiring them to do so would, therefore, lead to one-off material compliance costs and potential conflict between employers and employees.

69. Using instead an employee's employment contract was not considered to be a viable alternative approach because contracts could be restructured to omit references to benefits. Also, there could be issues about what constituted a contract – for example, whether a verbal agreement or material on human resources policy websites would be included.

70. In light of consultation, officials moved away from the concept of an enforceable right to instead focus directly on those circumstances when the material non-cash, untaxed benefits are provided primarily with a private benefit objective. This means, for example, that if a private benefit arises during the course of, or as a necessary part of, an employee carrying out their work, it will not be taxed.

PAYE or FBT

71. Of the submissions that commented on the choice between administering the changes through the FBT rules or through the PAYE system, most favoured applying FBT. This was on the basis that it would be simpler given their current accounting systems, more conceptually consistent with the treatment of other non-cash benefits (that are already taxed through the FBT system) and more flexible given the potential variability in size and timing of benefits. Some of the submissions from charitable organisations favoured applying the PAYE approach given their accounting staff and systems are generally not accustomed to applying FBT.

Social assistance

72. In addition to the compliance cost issues noted earlier, employers were concerned about the tension that might arise between employers and employees in relation to bringing various non-cash benefits into social assistance calculations and how they were valued. Officials refined the social assistance proposals in light of these concerns.

73. The main benefits provided to employees of charitable organisations should be included in social assistance calculations to the same extent that those benefits are included for other employees, for equity reasons. Ideally, implicit salary trade-offs should also be taken into account for social assistance calculation purposes. However, this would be more difficult for employees of charitable organisations because their employers would not be completing FBT returns and, therefore, would not be required to keep records which could help their employees in determining how to include the benefits in income when determining social assistance entitlements and obligations. Accordingly, the recommended approach takes only explicit salary trade-offs involving cars, car parks, vouchers and short-term charge facilities into account for social assistance purposes.

Vouchers

74. Some submissions argued that vouchers should not be included, as the underlying goods that the vouchers could be used to purchase would not be subject to FBT if provided directly. Other submissions acknowledged the concerns about the salary substitutability of vouchers. The proposed approach recommends a legislative clarification to confirm that vouchers are generally excluded from the FBT exemption, subject to a *de minimis* threshold.

Childcare

75. A few submissions touched on the issue of childcare. They considered taxing salary trade-offs involving childcare was inconsistent with the Government's overall childcare policy. The submission process confirmed that there is no evidence of widespread employer-provided on-premises childcare, and assessing the true value of such a benefit is difficult. Accordingly, childcare benefits are excluded from the proposals.

Advisory panel

76. An independent advisory panel was suggested to advise Inland Revenue on examples of enforceable rights and instances where no formal contract has been agreed upon, and to provide recommendations on how such situations should be handled in a salary trade-off rule. Given the proposed approach has a relatively narrow focus and no longer includes the enforceable right concept, we consider that an advisory panel is not necessary.

Further consultation with key submitter groups

77. After the above feedback was considered, officials put together a revised package of suggested changes, which was circulated to key submitter groups and several individual charitable organisations, on a confidential basis. Several of these submitters provided additional feedback which enabled further revisions.

78. The concerns and suggestions that were raised in submissions and during the subsequent consultation process were taken into account in developing revised recommendations. Overall, in deciding on the proposed approach, officials have scaled back from the suggestions in the issues paper to reflect submissions and to balance compliance concerns against the objective of improved equity.

CONCLUSIONS AND RECOMMENDATIONS

79. As noted above, the proposed approach would:

- a) tax salary trade-offs by:
 - i. applying FBT to both explicit and implicit material salary trade-offs (excluding those provided by charitable organisations); and
 - ii. recognising that vouchers are subject to FBT;
- b) account for salary trade-offs for social assistance purposes by:
 - i. taking explicit material salary trade-offs into account regardless of whether they are paid by charitable or non-charitable organisations; and
 - ii. recognising that vouchers should also be taken into account.

80. Also, as noted above in paragraph 37, officials recommended that charitable organisations be included in the new rule for equity reasons. However, we acknowledge that there is a judgement call to be made on the compliance implications that this would have for charitable organisations. Again, those compliance costs would be relatively higher for them given that they would need to account for FBT on any private benefits involving cars. (This compliance cost concern was recognised when the FBT exemption was reinstated in 1990 when a similar attempt was made to limit the scope of the exemption in relation to motor vehicles and it was ultimately decided that compliance was too much of an issue.)

81. Officials considered various options to reduce the compliance costs and discussed these with Ministers. As noted above in paragraph 37, whether to apply the proposed approach to charitable organisations is a finely balanced question, largely as a result of competing objectives of equity on one hand, and minimising compliance costs on the other. As noted directly above, a judgement call was made by Ministers that these options did not overcome the compliance concerns.

IMPLEMENTATION

82. It is proposed to seek Cabinet approval to introduce the necessary legislative changes in the next available tax bill. The systems changes are not expected to be substantial. However, in order to allow time for implementation, we recommend an effective date for the changes be 1 April 2014. If the legislative amendments are introduced in the next available tax bill, Inland Revenue considers that it will be able to deliver the necessary changes prior to the new rules becoming effective in 2014.

83. Inland Revenue customer information products would be updated (for example, guides, booklets, fact sheets and website). FBT worksheets and associated calculators would also be updated. Social assistance returns forms would need to be updated – with new fields and notes being added. Inland Revenue would also need to develop and maintain standard values to be used for the benefits in question.

84. Consistent with existing tax rules, employers providing any of these material non-cash benefits to employees would be required to complete FBT returns. Employees who receive any of these explicit material non-cash benefits will be required to include these benefits in their social assistance calculations.

MONITORING, EVALUATION AND REVIEW

85. Inland Revenue will monitor the outcomes pursuant to the Generic Tax Policy Process (“GTTP”) to confirm that they match the policy objectives.

86. The GTTP is a multi-stage policy process that has been used to design tax policy in New Zealand since 1995. The final step in the process is the implementation and review stage, which involves post-implementation review of legislation, and the identification of remedial issues. Opportunities for external consultation are also built into this stage. In practice, any changes identified as necessary following repeal would be added to the Tax Policy Work Programme, and proposals would go through the GTTP.

87. As noted above, officials considered an advisory panel to address implementation issues, similar to the GST Advisory Panel. Given the relatively narrow focus of the proposed approach, it was considered that, on balance, a panel was not needed.