Impact Summary: Fringe benefit tax on employment related loans – Market interest rate

Section 1: General information

Purpose
Inland Revenue is solely responsible for the analysis and advice set out in this Regulatory Impact Assessment, except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing final decisions to proceed with a policy change to be undertaken by Cabinet.
Key Limitations or Constraints on Analysis
Quality of data used for impact analysis Inland Revenue does not possess information on how much FBT paid by banks and other money lenders relates to employment related loans. Therefore, stakeholders were asked to self-report how much FBT they pay on employment related loans and this information was used to estimate the amount of FBT currently collected on employment related loans from banks and other money lenders. **Consultation and testing** Although there was only a short consultation period, by targeting consultation to relevant stakeholders, Inland Revenue is confident that it got the input it needed to inform the analysis.
Responsible Manager (signature and date):
Chris Gillion Policy Manager Policy and Strategy Inland Revenue 27 March 2018

Section 2: Problem definition and objectives

2.1 What is the policy problem or opportunity?

FBT rules

A fringe benefit arises when an employer provides a loan to an employee. There are two ways in which the benefit of an employment related loan can be valued. Most employers are required to use a prescribed rate of interest as defined in section RD 34 on the Income Tax Act 2007 (the Act). The prescribed interest rate is adjusted from time to time by Order in Council and is based on the floating first mortgage new customer housing rate published by the Reserve Bank. However, employers that are in the business of lending money, or are a member of a group of companies with at least one member in the business of lending money, may instead elect to use the market interest rate as defined in section RD 35 of the Act.

If they have elected to use the market rate, banks and other employers in the business of lending money are required to pay fringe benefit tax (FBT) when they provide a loan to an employee at a rate below the market interest rate. The market interest rate for a group of employees is currently defined as the rate their employer would offer to an arm's length group of persons with a comparable credit risk to the group of employees. Different money lenders will therefore have different market rates as the market rate is based on the rates a given lender offers to a group of its customers with a common risk profile.

The market interest rate rules were based on the practices banks and other lenders were using at the time the rules were developed. Money lenders would advertise rates and, in general, customers would receive these rates if they met the necessary conditions for a loan. However, some lenders would also offer discounts to certain groups of customers. For example a bank may have offered employees of a local respected employer a discount of 0.3 percentage points below the advertised rates. The market interest rate rules allow either a money lender's advertised rates or any group discount rates the money lender offers to be offered to employees as the market interest rate without banks and other similar lenders incurring FBT.

FBT should only be payable on employment related loans when a discount is genuinely provided to an employee.

Problem

The method for calculating the market rate is out-dated and no longer reflects the lending practices of banks and other money lenders. It is now common practice for banks and other similar lenders to individually negotiate loan rates with customers. Banks and other money lenders now also consider a broader range of criteria than just credit risk when determining interest rates. Individually negotiated loans cannot be used for determining the market rate as the rates received by customers through this process have not been offered to a group.

As such, the true market rate, being the interest rate an arm's length customer receives, is often lower than the market rate calculated under the current legislation. This can result in the over-taxation of employment related loans and fairness concerns. Furthermore, because of this over-taxation many employees of banks and other money lenders may be able to receive better loan rates from competitors to their employer.

The rules around the market interest rate were introduced to rectify the problem of FBT arising even when the employer is charging an employee the true market rate. As such, changing the method for calculating the market rate to more appropriately reflect the true market rate would be consistent with the original policy intent and the broader FBT policy framework.

2.2 Who is affected and how?

The affected parties are banks and other employers in the business of lending money as well as the employees of money lenders. Banks and other money lenders are affected as they are currently paying too much FBT on loans made to employees.

Employees are affected as the interest rates they receive from their employer may in some cases not be as low as if the over-taxation of employment related loans did not occur.

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

There are no constraints on the scope for decision making.

Section 3: Options identification

3.1 What options have been considered?

The following criteria have been used to assess the options:

- *Effectiveness:* the option should only result in FBT being payable when a discount is genuinely provided to an employee in order to ensure fairness.
- *Compliance*: compliance costs for banks and other employers in the business of lending money should be minimised.
- *Administration:* implementation and administration costs for Government departments should be minimised.
- *Certainty:* the option should provide certainty as to how to calculate the market rate.

Option one: Status quo

Under the status quo the market interest rate for a given employee is defined as the rate a bank (or other money lender) would offer to a group of persons when:

- The group has a comparable credit risk to the group which the employee belongs to; and
- Membership of the group arises from a factor or factors that do not include a connection between a member and the employer; and
- The group is sufficient in number to ensure a transaction on an arm's length basis.

The main issue with the status quo is its effectiveness. Under the status quo, FBT is often payable even when an employee is receiving the same interest rate they would have received as an arm's length customer and this leads to fairness concerns. Under the status quo, compliance and administration costs are relatively low and money lenders do have certainty around how to calculate the market rate.

Option two: The market rate is the lowest rate given to an arm's length customer

The option is that the market interest rate for a given employee and loan type would be defined as the lowest rate given around the same time in the ordinary course of business to an arm's length customer with a similar profile (based on the lending criteria used by the employer) to the employee.

Under this option, banks and other money lenders would have a choice about what time period they calculate the market rate from. Ideally, money lenders would calculate the market rate based on loans given to arm's length customers in the same FBT quarter as loans made to employees. However, money lenders that do not have readily available data from the current FBT quarter may instead elect to calculate the market rate using data from the FBT quarter immediately prior to the FBT quarter in which an employee received a loan.

This option has been consulted on with the New Zealand Banker's Association, Corporate Taxpayers Group, Chartered Accountants Australia and New Zealand and the Financial Services Council. All Submissions received were supportive of updating how the market rate is calculated and this option.

<u>*Effectiveness*</u>

This option would prevent the over-taxation of employment related loans that occurs under the status quo. Instead, loans made to employees would only be subject to FBT if a genuine discount compared to the rates received by arm's length customers has been provided.

Compliance

Consultation has indicated that this option would have relatively low compliance costs that are comparable to the status quo. This option would simply require them to identify the lowest rate offered over the relevant time period and apply this as the market rate.

Administration

This option would have administration costs for Inland Revenue that are comparable to the status quo.

Certainty

This option would provide certainty for money lenders on how to calculate the market rate. However, submissions did ask for further guidance on when a loan made to a customer was made in the ordinary course of business. This will be provided as part of the bill commentary and in a Tax Information Bulletin following enactment.

Option three: Employers using the market rate can make an election between using the either the status quo or option two for calculating the market rate (proposed option)

This option is that option two would be introduced alongside the status quo. Banks and other money lenders would be given the choice to use either method for calculating the market rate. The method proposed under option two for calculating the market rate will be more taxpayer favourable than the status quo, so we expect most banks and other money lenders to use this method.

However, it is possible that some money lenders may not have the data capabilities available to readily determine the lowest rate given to arm's length customers in either the current or previous FBT quarter. Allowing these employers to still use the status quo method for calculating the market interest rate would ensure they would not be disadvantaged by the introduction of the method proposed under option two.

Effectiveness

As stated above, for employers that choose to use the new method this option would prevent the over-taxation of employment related loans that occurs under the status quo.

Compliance

As above.

Administration

As above.

Certainty

As above.

Option four: Market rate is the average rate given to arm's length customers

This option is that the market interest rate for a given employee and loan type would be defined as the average rate given around the same time to arm's length customers with a similar risk profile to the employee. This option has been consulted on; however submitters were overwhelmingly opposed to this option. This is because this option would still result in some over-taxation of employment related loans.

Other options

A number of other options were considered but were not consulted on as they would not be feasible and would not provide certainty around how to calculate the market rate.

3.2 Which of these options is the proposed approach?

The proposed approach is option three which introduces an additional option for calculating the market rate along with the status quo calculation. The additional option defines the market rate for a given employee and loan type as the lowest rate given around the same time in the ordinary course of business to an arm's length customer with a similar profile to the employee.

This is the preferred approach as it would effectively address the over-taxation that occurs under the status quo without increasing compliance or administration costs. This option would also provide certainty to money lenders on how to calculate the market interest rate, while leaving them the choice of still using the status quo calculation if they wish.

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 (eg ongoing, one-off), evidence and assumption (eg 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 (Banks and other money lenders)	On-going compliance costs of proposed approach are comparable to status quo. One-off compliance costs for employers that switch to using the new method for calculating the market rate will be low.	Low
Regulators (Inland Revenue)	Administration costs of proposed approach are comparable to status quo.	Low
Wider government	Reduction in FBT revenue	$3m per annum over the forecast period
Other parties	None	None
Total Monetised Cost		$3m per annum
Non-monetised costs	Comparable to status quo	Low
Expected benefits of proposed approach, compared to taking no action		
Regulated parties (Banks and other money lenders)	Reduction in FBT payable totalling $3m per annum.	$3m per annum
Regulators (Inland Revenue)	None	None
Wider government	None	None
Other parties (employees of banks and other money lenders)	Potential decrease in interest rates for some employees of some money lenders.	Low
Total Monetised Benefit		$3m per annum
Non-monetised benefits		Low

4.2 What other impacts is this approach likely to have?
It is assumed that the entirety of the $3 million in FBT currently paid by banks and other money lenders for employment related loans will be foregone if the issue is effectively addressed. This is based on discussions with stakeholders in which they have claimed they generally treat employees no different from arm's length customers when offering loans. We do not anticipate the proposed approach would have any other impacts.

Section 5: Stakeholder views

5.1 What do stakeholders think about the problem and the proposed solution?
This problem was initially brought to Inland Revenue's attention by members of the New Zealand Bankers' Association (NZBA) and they have been consulted throughout the policy development process. A targeted consultation letter was recently sent to the NZBA as well as Chartered Accountants Australia and New Zealand (CA ANZ), the Corporate Taxpayers Group (CTG) and the Financial Services Council. The consultation letter asked for their views on options two (the lowest rate) and four (the average rate). The letter also asked for views on whether any new method for calculating the market rate should replace the status quo or be in addition to it. Submissions from CA ANZ, CTG and a number of banks were received. All submissions received were supportive of updating the market interest rate definition and the approach proposed under option two. Submissions were not supportive of option four as it would not fully address the problem and would be difficult to comply with. Most submissions were also supportive of the new option being introduced as an addition the status quo. As such, it was decided to introduce option two as an option alongside the status quo. As a result of stakeholder feedback the proposed approach has been modified. The original option two was that the market interest rate for a given employee and loan type would be defined as the lowest rate given around the same time in the ordinary course of business to an arm's length customer with a similar risk profile to the employee. Banks pointed out that risk profile is only one factor out of many they consider in offering loans and determining interest rates. Therefore, using similar profile as opposed to similar risk profile for comparing employees to arm's length customers is more likely to provide the correct result. The Treasury has also been consulted on the proposed approach and supports the proposed changes subject to consideration of how to prioritise this issue alongside other issues.

Section 6: Implementation and operation

6.1 How will the new arrangements be given effect?
The proposal will require amendment to the Income Tax Act 2007. Amendments would be included in the next available omnibus tax bill, currently scheduled for introduction in May 2018. The changes would come into effect from the start of the first FBT quarter after the bill is passed into law. It is anticipated this would be 1 April 2019. Inland Revenue will be responsible for the on-going administration of the new arrangements. Inland Revenue officials have assessed the magnitude of these administrative impacts, and consider that they would be manageable to implement in the proposed timeframe.

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. Monitoring the impact of the new arrangements will be done through consultation with the New Zealand Bankers' Association and other relevant stakeholders. Given the relationships Inland Revenue has with relevant stakeholders we would also expect stakeholders to raise any issues they experience directly with us.

7.2 When and how will the new arrangements be reviewed?
Post-implementation review is expected to occur around 12 months after implementation. If the post-implementation review identifies any need for remedial action it would be recommended for addition to the Government's tax policy work programme and could potentially be included in future taxation bills.