

# Regulatory Impact Statement: Taxation of backdated lump sum payments

## Coversheet

Purpose of Document	
Decision sought:	<i>Analysis produced for the purpose of informing final Cabinet decisions</i>
Advising agencies:	<i>Inland Revenue</i>
Proposing Ministers:	<i>Minister of Revenue</i>
Date finalised:	<i>9 November 2022</i>
Problem Definition	
<p>The project seeks to address the tax disparity that arises where the timing of a backdated lump sum payment (BLSP) paid by the Crown results in a higher tax liability than if the amount paid had been spread over the years to which it relates (i.e., an amount that should have been paid over multiple years but is paid as a lump sum in a single year).</p> <p>The project focuses on two types of BLSPs – backdated Accident Compensation Corporation (ACC) payments and backdated Ministry of Social Development (MSD) entitlements.</p>	
Executive Summary	
<p>Generally, payments of employment income are taxed on a cash basis (when they are received). This principle allows tax to be deducted by the payer when paid in the current tax year. This reduces compliance costs and is simple and easy to understand.</p> <p>While taxing payments on a cash basis tends to be the best option for employment-related payments, this can lead to fairness issues when payments are paid in a later tax year but relate to two or more previous tax years. This tax treatment can result in a large tax liability, aggravating the unfairness of the delayed payment. The taxation of BLSPs, especially ACC BLSPs, has been a longstanding issue that has been raised repeatedly over several years.</p> <p>The objective of this project is that any tax effects from receiving a BLSP in one year are mitigated using alternative tax treatment to approximate the lower amount that would have been paid, had the payment been paid over multiple years.</p> <p>We considered three options (in addition to the status quo) to address this issue for backdated ACC payments and one alternative option for backdated MSD entitlements.</p> <p><i>Preferred option for ACC payments:</i> apply the recipients' average tax rate for the 4 years prior to the year of receipt of the BLSP.</p> <p><i>Preferred option for MSD payments:</i> assume the tax deducted by MSD is correct and ignore the payments for the purpose of calculating the recipients tax liability but not their social policy entitlements.</p>	

The preferred options are both likely to address the equity issues through achieving a lower tax liability than the status quo. Both options involve one-off administrative costs because they involve changes to the employment information return, however, once the changes are implemented the compliance costs for BLSP recipients and payers of BLSP should be minimal. The preferred options were supported by stakeholders during targeted consultation.

The fiscal cost (as lost tax revenue/Crown revenue) of the option for ACC payments is estimated to be \$27.4million over the first four financial years from 1 April 2024, while the fiscal cost for MSD payments is unlikely to be a material fiscal cost due to the majority of these tax liabilities currently being written off.

The alternative tax treatment for both types of payments would apply from 1 April 2024 due to the system changes involved. The changes would not be retrospective, which will not address any past inequity for recipients who have been disadvantaged by the status quo. Officials recommend against applying this retrospectively because it does not meet the criteria for applying such a policy retrospectively and it would likely raise further inequity concerns (for example, how far back you apply the treatment). The fiscal cost would also be prohibitive.

### Limitations and Constraints on Analysis

The options were limited by the problem definition, which in itself, was limited by initial consultation. Through initial consultation it was clear that although there are many lump sums that are paid which are employment related, the main payments of concern were ACC and MSD BLSPs. Other payments which were mentioned, such as holiday pay remediation or redundancy, were considered out of scope of the problem definition. If there are further payments that warrant similar treatment, this could be addressed through the legislative process in the future.

The ability to implement a workable solution was limited by what is possible within the existing tax and MSD/ACC systems. This limitation was considered when developing suitable options. The impact of system considerations was mitigated to some extent by a later implementation date of 1 April 2024.

Officials engaged in targeted consultation both during initial consultation and when consulting on the options. Targeted consultation was thought appropriate given the subject matter and the impact on payers.

### Responsible Manager(s) (completed by relevant manager)

s 9(2)(a)

*Carolyn Elliott*  
*Policy Lead, Tax Administration*  
*Inland Revenue*  
*9/11/2022*

### Quality Assurance (completed by QA panel)

Reviewing Agency: Inland Revenue

Panel Assessment & Comment:

The Quality Assurance panel at Inland Revenue has reviewed the *Taxation of backdated lump sum payments* Regulatory Impact Statement prepared by Inland Revenue and considers that the information and analysis summarised in the Regulatory Impact Statement **meets** the quality assurance criteria.

## Section 1: Diagnosing the policy problem

### What is the context behind the policy problem and how is the status quo expected to develop?

1. Generally, payments of employment income are taxed on a cash basis (when they are received).<sup>1</sup> This principle allows tax to be deducted by the payer when paid in the current tax year. This reduces compliance costs and is simple and easy to understand.
2. While taxing payments on a cash basis tends to be the best option for employment-related payments, this can lead to fairness issues when payments are paid in a later tax year but relate to two or more previous tax years.
3. The taxation of ACC BLSPs is a longstanding issue that has been raised repeatedly over several years in complaints to the Commissioner, Ministerial correspondence, media articles, select committee submissions and letters from the Royal Commission of Inquiry on Abuse in State Care and the Ombudsman.
4. We carried out initial engagement in 2019 with key stakeholders to gauge perception of the problem definition, understand the types of BLSPs currently being made and identify compliance costs associated with payer involvement in implementing a solution. Overall, consultation supported the intent to improve the tax outcome for BLSPs. Within this consultation, a spectrum of BLSPs were identified from ACC payments to lump sum payments made under employment contracts. Throughout consultation it was clear that ACC BLSPs were considered a significant and continuing source of inequity.
5. In June 2022, we engaged in targeted consultation on options for the alternative tax treatment of ACC and MSD BLSPs where we refined the final proposal. The consulted groups supported the proposal and gave valuable feedback when refining the options.

### What is the policy problem or opportunity?

6. The project seeks to address the tax disparity that arises where the timing of a BLSP results in a higher tax liability than if the amount paid had been spread over periods to which it relates (i.e., an amount that should have been paid over multiple years but is paid as a lump sum in a single year).
7. The problem arises where:
  - a. between the period the person should have received their payments and the year they receive the payment the recipients tax rate has increased over time; and/or
  - b. due to the size of the payment the BLSP pushes the recipient into a higher tax bracket.

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<sup>1</sup> This is due to the main charging provision BD 3 for income tax in the Income Tax Act 2007 and case law.

**Problem definition**

8. We consider that a fairness issue arises when all the following occur:
  - a. A backdated (or remedial) payment relating to two or more tax years is made in a lump sum,
  - b. The amount is significant enough to move the taxpayer into a higher tax bracket,
  - c. If spread over the relevant tax years, the taxpayer would have had a lower tax liability in relation to that amount, and
  - d. The delay or error has been caused by an action or inaction by the Crown.
9. Example one demonstrates how this can occur in practice:

**Example one**

Montgomery Scott (Scotty) was a forklift operator for one of the major ports in New Zealand. In 2018, he was involved in a workplace accident that saw him suffer long-term damage to his leg.

For a time, Scotty received weekly compensation under the Accident Compensation Act 2001 for loss of earnings. However, ACC stopped paying him weekly compensation in 2018 when it considered he was able to return to paid employment. Scotty disputed this decision, but it took some years to resolve as there were several investigations that needed to be completed before final eligibility was established. In 2022, Scotty was awarded a payment of \$50,000 per year. This was paid in a lump sum of \$200,000 in March 2022.

If Scotty had received this amount in the relevant years, his tax liability for the payments would have been as follows:

	2019	2020	2021	2022	Total
Income	\$50,000	\$50,000	\$50,000	\$50,000	\$200,000
Tax liability	\$8,020	\$8,020	\$8,020	\$8,020	<b>\$32,080</b>

However, for tax purposes the payment is only taxed on receipt of the full amount in 2022. This will result in income in the 2022 year of \$200,000, and a tax liability for Scotty of **\$58,120**.

The difference between the two treatments is an additional tax liability for Scotty of **\$26,040**.

10. Receipt of a BLSP can ‘artificially’ push a recipient into a higher tax bracket for a single year. This compounds the disadvantage suffered by the affected person, who in addition to the delay in receiving their entitlement, also receives a smaller net amount than if the amount was paid over multiple years.
11. A contributing issue is that over time the recipient could move tax brackets as their income increases. This will also mean that the BLSP is taxed at a higher rate that it would have if it was paid over the period that it should have been.

**Payments within the problem definition**

12. During the initial scoping of the project, we drew a distinction between lump sum payments in general, and BLSPs which relate to prior years. A lump sum payment of income may lead to a higher tax bill in one tax year than if it were spread over multiple

years. However, this does not create a policy issue unless the entitlement to the payment arose, and should have been paid, in earlier years.

13. After initial consultation, we considered that there were two types of payments that fell within the problem definition and were of most concern, ACC lump sum payments and backdated MSD entitlements. Around 1,200 backdated lump sum payments are made annually by ACC with an average payment of around \$48,000. MSD make more payments annually, but the amounts are much smaller, with many being under \$1,000. In the majority of MSD cases, any resulting tax payable is written off, so the issue for MSD payments is much smaller.

#### *ACC lump sum payments*

14. ACC makes different types of compensation or reimbursement payments depending on the situation. In some cases, whether a person is entitled to ACC compensation may be the subject of dispute or delay in awarding compensation and making payment to the person. These payments can relate to several years, meaning these payments can be large, running into tens or hundreds of thousands of dollars.
15. Payments of weekly compensation are akin to employment income and PAYE must be withheld when such payments are made. If these payments are made belatedly in a lump sum in one tax year, the individual may be overtaxed when compared with the tax that would have applied if the payments were made over multiple years.

#### *Backdated MSD entitlements*

16. Backdated payments of MSD entitlements may also give rise to an increased tax liability if they are paid in a subsequent tax year, although these payments tend to be smaller amounts than ACC payments. This may occur for multiple reasons, including a system error, or incorrect or incomplete information being provided at the time of an assessment.
17. There are some existing legislative provisions that can help mitigate these issues:
  - a. **Withholding:** the Income Tax Act 2007 and the Social Security Act 2018 provides that the Commissioner of Inland Revenue can agree a withholding rate and tax payable with the Chief Executive for the Ministry of Social Development. However, this is not particularly useful for BLSP, as each individual BLSP may require a different rate of withholding and it does not alter the tax liability assessed on the payment, just any shortfall in withholding.
  - b. **Write off:** the *Tax Administration Act 1994* allows the Commissioner to write off tax for an individual when their income is solely comprised of income-tested benefits, education grants, New Zealand superannuation or a veteran's pension. However, this write-off is not available if the recipient is receiving Working for Families or where an individual moved to employment for all or part of a year and is awarded a backdated amount of an income-tested benefit by MSD, they will not qualify for this write-off.
18. While these existing mechanisms may mitigate consequences for some BLSP recipients, a tailored solution will ensure all BLSP recipients are treated the same.

#### *Payments that were out of scope*

19. As mentioned, we have drawn a distinction between lump sum payments in general and BLSPs which relate to prior years.
20. Further distinctions may be drawn when a lump sum payment arises from an employment agreement, in other words, when it is contemplated the payment will be paid out in a lump sum as opposed to spread over multiple tax years.

21. Where a provision in an employment agreement triggers an entitlement and this entitlement is paid out pursuant to the provisions in the employment agreement (e.g., bonuses), we consider no alternative tax treatment is required.
22. This was affirmed through consultation that although arguments can be made for other types of payments to be included,<sup>2</sup> other lump sum payments are generally either:
  - a. calculated with reference to prior years but incurred because of an action during the current year (e.g., redundancy and pay equity payments); or
  - b. are not material enough to shift a person into a higher tax bracket (e.g., holiday pay reparation).

### **What objectives are sought in relation to the policy problem?**

23. The main objective is that any tax effects from receiving a multi-year payment in one year are mitigated using an alternative tax treatment to approximate the lower amount that would have been paid had the payment been made over multiple years.
24. We note that implementing an alternative tax treatment would not compensate customers for delayed payments. This project seeks to address the tax impacts only. We acknowledge that the delayed nature of these payments adds to the perception of a lack of fairness. However, to the extent that further compensation for delayed payment is desirable,<sup>3</sup> this is outside the scope of this project and should ultimately be dealt with in the specific Act that authorises the payments.

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<sup>2</sup> Feedback from initial consultation was that the most common lump sums paid were holiday pay remediation payments, redundancy payments and payments ordered by the Employment Court/Employment Relations Authority.

<sup>3</sup> ACC BLSPs generally include a portion intended to compensate for the time value of money.

## Section 2: Deciding upon an option to address the policy problem

### What criteria will be used to compare options to the status quo?

The criteria that have been used to assess the options are:

- **Equity:** do the options address the fairness issue?
- **Compliance costs:** do the options impose disproportionate compliance costs on payers or BLSP recipients?
- **Fiscal cost:** the fiscal costs to the government should be minimised.
- **Administrative cost:** are the options possible for Inland Revenue, ACC, and MSD to implement and administer without substantial administration costs?
- **Stakeholder support:** are the options supported by interested parties?

### What scope will options be considered within?

26. Several employment-related payments relate to prior year entitlements (e.g., holiday pay recalculations). One of the complexities in considering the BLSP issue is fairness and where to draw the line as to which payments should be eligible for an alternative tax treatment.
27. The scope of the project was refined through initial targeted consultation and agreement by the Minister of Revenue.<sup>4</sup> The payments that warranted alternative tax treatment were:
  - a. backdated payments of ACC weekly compensation, and
  - b. backdated MSD entitlements.
28. The scope was further refined by the problem definition because we are most concerned with payments which artificially push a recipient into a higher tax bracket for a single year.
29. Both of the identified payments are paid by the Crown and involve people who have often suffered a disadvantage. The disadvantage suffered by the affected person is compounded as, in addition to the delay in receiving their entitlement, they also receive a smaller net amount than if the amount was paid over multiple years.
30. These payments also result due to some failure of the Crown whether this be an action or inaction by the Crown that prevented the person being paid at the time they should have been paid.

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<sup>4</sup> IR2022/310 refers.

## What options are being considered?

The options that have been considered are

- **Option one:** status quo;
- **Option two:** apply an average tax rate from the previous four income years to the BLSP;
- **Option three:** apply the average marginal tax rate from the current year, ignoring the BLSP;
- **Option four:** allow reassessment of earlier tax years when the payment should have been received; and
- **Option five** (for MSD payments only): ignore the BLSP and assume the tax deducted is correct.

### *Background*

31. The options for dealing with payments made by ACC and MSD differ due to the way in which tax is calculated by each of the payers.
32. For BLSPs made by ACC, tax is deducted from the payment at the extra pay rate (or potentially the modified withholding tax rate as advised by Inland Revenue). In this case, depending on whether they use the correct rate of withholding, a tax debt may still arise.
33. MSD BLSPs are paid “net of tax” (with tax already deducted). MSD determine how much the recipient is entitled to in their hand and then gross up that amount for the tax payable. MSD calculate the tax to withhold as if the payments had been made on time (by reference to previous years). Since Inland Revenue tax the BLSP in the year of receipt, this may result in a higher amount of tax payable for the recipient.
34. Whilst we could use the same options for both types of payments, using the ACC solution for MSD payments could still result in tax debts unless MSD changed the way they withhold tax from the payments. We considered that the way MSD calculates the tax should result in a more accurate calculation for MSD BLSPs, than under the approximated ACC model.
35. Options 2 and 3 below would only apply to ACC payments and option 5 would apply to MSD payments. Option 4 would apply to both.

### **Option One – Status Quo**

36. Option one is the status quo. Maintaining the status quo would continue to tax BLSPs on a cash basis. While taxing these payments on a cash basis is often the best option for employment-related payments, applying this to BLSPs can give rise to fairness issues if they are paid in a later tax year but relate to two or more previous tax years.
37. Maintaining the status quo would continue to lead to unfair outcomes for recipients of BLSPs.

### **Option Two – Apply an average tax rate from the previous four income years**

38. Inland Revenue would calculate an average tax rate<sup>5</sup> of the person based on the previous 4 years’ income information Inland Revenue holds. This rate would then be applied to the BLSP separately from the person’s annual income tax calculation. This

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<sup>5</sup> Average tax rate refers to the total amount of tax paid divided by total income.



option is based on the way a person who invests in a portfolio investment entity is squared up for the year.

39. Under this option, the payer could request the person's average tax rate before the BLSP is made and then apply that as the withholding rate. This would mean no additional amount of tax should be payable for the BLSP (assuming the recipient's circumstances do not change).
40. Initially, consultation posed the option of either 2 or 4 years. Overwhelmingly submitters preferred the four-year option as averaging the tax rate over more time should smooth the rate for any changes within that time.
41. This option would apply to payments made on or after 1 April 2024 due to the lead in time required to make system changes both at Inland Revenue and the paying agencies.
42. A retrospective application date was considered as an option during consultation and in reporting to Ministers. However, officials considered there was no clear basis to make such a change retrospective. It did not meet any of the usual requirements to make a change retrospective such as confirming a long-standing policy intent or correcting a clear error in the legislation. This would also have increased the fiscal cost significantly.

### *Equity*

43. This option would address the issue of the BLSP pushing the person into a higher tax bracket by removing the BLSP from the person's tax calculation. This would mean their overall tax liability should be lower than the status quo.
44. Using the average tax rate rather than an average marginal tax rate should also result in a more accurate taxation of the payment as it represents a true average tax rate for the recipient.
45. It would also partially smooth any changes in a person's tax rate between the time they should have received the income and the time they receive the BLSP. The "lower of" test<sup>6</sup> would allow the status quo to be applied if that resulted in a lower tax impost. This should address any issues of fairness if the option would disadvantage the recipient.
46. It would also enable ACC to request the withholding rate before making the payment, to enable the correct amount of tax to be deducted (provided their income situation did not change for the current year) which would avoid the recipient having additional tax to pay.

### *Compliance costs*

47. This option would require ACC to contact Inland Revenue to obtain their average tax rate before making the payment. ACC would then have to apply that withholding rate and indicate that they are paying a lump sum on the employment information supplied to Inland Revenue.
48. This option will have minimal compliance costs for recipients. For ACC payments, ACC will be able to request a withholding rate from Inland Revenue and apply this without requiring further information from the recipient. Provided the recipients position does not change in the current year, they will not be required to pay any additional tax.

### *Fiscal cost*

49. The fiscal cost of this option applying to payments made on or after 1 April 2024 is outlined below:

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<sup>6</sup> See paras 60-62

Table 1: Four-year average tax rate

	\$m – increase/(decrease)			
<b>Vote Revenue Minister of Revenue</b>	<b>2023/24</b>	<b>2024/25</b>	<b>2025/26</b>	<b>2026/27 &amp; outyears</b>
Crown Revenue and Receipts: Tax Revenue	(1.900)	(8.100)	(8.500)	(8.900)

*Administrative cost*

50. Implementing this option will require moderate systems changes from ACC. This is because it will require an update to the employer information return to identify the BLSPs. This will impact ACC because they will be required to identify when the payment is a BLSP, which will flow through to Inland Revenue where the alternative tax treatment needs to be applied. There will also be costs involved in requesting the new proposed tax rate from Inland Revenue to enable them to withhold correctly from the BLSPs.
51. ACC has indicated the changes required are possible within the timeframe, and system changes may cost between \$200,000 - \$400,000 to implement.
52. This option will also involve complex system changes by Inland Revenue to alter the annual tax calculation to account for the differing treatment of those payments. The differing treatments may also be more difficult for recipients to understand over the status quo (notwithstanding that the status quo results in higher taxation). Inland Revenue has indicated that the changes required are possible within the timeframe, and while they will be included within wider changes, Inland Revenue estimates the cost will be in the range of \$200,000 - \$400,000.

*Stakeholder support*

53. This option was the preferred option during targeted consultation given its simplicity and ability to address the current inequities.

**Option Three – Apply the average marginal tax rate from the current year, ignoring the BLSP**

54. This option is similar to option two, but instead of using the recipient’s average tax rate over the previous four years, it would use their average marginal tax rate<sup>7</sup> for the year the BLSP is received (excluding the BLSP). Like option two, this rate would then be applied to the BLSP in a separate calculation.

*Equity*

55. This option would address the issue of the BLSP pushing the person into a higher tax bracket by ignoring the BLSP for the person’s tax calculation. However, it would not

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<sup>7</sup> Average marginal tax rate refers to the incremental tax paid on incremental income. For example, the current marginal tax rate for each dollar of income up to \$14,000 has a tax rate of 10.5%.

address the issue of any changes in a person’s tax rate between the time they should have received the income and the time they receive the BLSP.

- 56. Using the average marginal tax rate would effectively be a snapshot of the person’s current tax position, rather than achieving a more even average tax rate (using multiple years) as in option two.

*Compliance costs*

- 57. These would be the same as option two.

*Fiscal cost*

- 58. The fiscal cost for this option is as follows:

*Table 2: Current year marginal tax rate*

	\$m – increase/(decrease)			
<b>Vote Revenue</b>	<b>2023/24</b>	<b>2024/25</b>	<b>2025/26</b>	<b>2026/27 &amp; outyears</b>
<b>Minister of Revenue</b>				
Crown Revenue and Receipts:	(1.600)	(6.600)	(6.900)	(7.200)
Tax Revenue				

*Administrative cost*

- 59. This option would require similar system changes for Inland Revenue and ACC as option two.

*Stakeholder support*

This option was not preferred during targeted consultation. Stakeholders thought this may lead to unfair outcomes where their current tax rate does not reflect their previous position when they should have received the payments.

**Additional rules for options two and three**

- 60. In addition to each of option two and three, the lowest tax rate to be applied would be 10.5%,<sup>8</sup> and there would be a “lower of” test.
- 61. Changing the status quo could result in some recipients being worse off than under the current treatment. This could occur where a person has had a higher tax rate in the four years prior to the lump sum payment but has a lower tax rate in the year the lump sum is paid. In this case, the recipient may end up with a higher tax bill than under the status quo. To counter this, a “lower of” test would ensure recipients are not worse off under this proposal compared to the status quo.
- 62. If there was no “lower of” test, from the information we have obtained from ACC, we estimate that the number of people worse off than under the current treatment, would be between 39-84 per year. Due to the small number of affected taxpayers, this may be

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<sup>8</sup> For example, a person with an average tax rate of less than 10.5% would be capped at 10.5% to account for the payment itself. However, the cases where a person would have an average tax rate at less than 10.5% would be rare, given the lowest rate applied to any income over \$0 is 10.5%.

delivered in a slightly different way than the main proposal (i.e., it may require some manual intervention by the recipient). These issues will be worked through in the ultimate design of any proposed solution.

#### **Option Four – Allow reassessment of earlier tax years when the payment should have been received**

63. This option would essentially remove the cash receipt “basis” for these BLSPs by allowing the taxpayer to re-open assessments for earlier tax years and spread the income back over the periods to which it relates. After the income is spread, the lump sum would be taxed as if it was received in those years.
64. For some claimants, their BLSP could relate to over 10+ years which would result in multiple reassessments over a large number of years.
65. Re-opening assessments would also trigger the reassessment of related obligations and entitlements, for example Working for Families tax credits and student loan obligations.
66. Essentially this is the treatment that MSD follow in calculating the withholding tax from the BLSPs that it pays.

#### *Equity*

67. This option would produce the fairest, and most accurate result in terms of tax liability. This would tax the BLSP as if it was received in those years. However, because this would re-open earlier years’ assessments it would also trigger the re-assessment of related obligations and entitlements, for example Working for Families tax credits and student loan obligations. This could claw back previous years entitlements and lead to other inequitable outcomes.

#### *Compliance costs*

68. This would place a high compliance burden on Inland Revenue to identify every past income return and verify the tax code. For some, this would require 10 or more years of returns and may include a mix of paper and electronic records. This would come with a significant manual intervention.
69. As this would reopen previous assessments, it would reassess all social policy entitlements which could lead to the creation of debt and owing entitlements. The multiple reassessments could be complex to understand and may require recipients to dispute or apply for reassessment again. This would be administratively burdensome and have significant compliance costs for the recipient.

#### *Fiscal cost*

70. Due to the workability and complexity of this option, particularly in relation to the need to reassess social policy entitlements, it was not formally costed. Inland Revenue considers it would likely have at least as large of a fiscal cost as option two (see table 1 above). This would be due to the amount of manual intervention required, in addition to the effect of reassessing many years of entitlements.

#### *Administrative cost*

71. This option would require significant system changes for Inland Revenue and ACC.
72. As mentioned above, this would result in a large administrative cost, given the large amount of work involved in reopening and reassessing previous tax assessments, especially where there may be limited information (for example, in the transition from

paper to electronic returns). It would also require a significant manual effort by Inland Revenue to ensure the reassessment can be processed.

#### *Stakeholder support*

73. This option was not preferred during targeted consultation. While Stakeholders acknowledged this would be the most accurate option, we received some feedback that the prospect of the reassessment of all social policy entitlements outweighed the benefits of spreading the income.

#### **Option Five – Ignore the BLSP and assume the tax deducted is correct**

74. This option would apply only to MSD BLSPs. This option would assume the tax deducted by MSD is correct and ignore the BLSP for the purpose of the recipient's income tax liability (but not social policy entitlements).
75. We would accept the tax withheld as correct because of the way MSD calculates the tax on the BLSPs.
76. MSD calculates entitlements from the ground up. They first decide how much a person is entitled to in their hand and then grosses that amount up for the tax payable. This also occurs for BLSPs, MSD calculates the net amount of the underpayment and calculates the tax to withhold with reference to the period the client was underpaid. In essence, MSD calculates the correct tax liability as if the payments had been correctly made on time. This is similar to option four, however, this would not trigger a reassessment of social policy obligations for previous years because the reassessment is being calculated by MSD.

#### *Equity*

77. This option would produce a fairest, and accurate result in terms of tax liability for most BLSP recipients. This is because the result would tax the BLSP as if it was received in the years it related to. It would also remove the additional tax liability that occurs because of Inland Revenue's application of tax in the current year, which can result in additional tax being payable.
78. This would also resolve the inconsistency of the current tax write-off that is available for some MSD BLSP recipients where there is additional tax payable.
79. This write off is available for auto-calculation customers who do not receive Working for Families and for whom their only income is from MSD (with a de minimis that allows a small amount of other income).<sup>9</sup> However, for those who receive Working for Families or those who are no longer on a benefit, the differences in tax are payable.
80. As MSD would calculate the reassessment, this removes the additional square-ups than would occur in option four.

#### *Compliance costs*

81. This option will have minimal compliance costs for MSD recipients, and they will be unlikely to have any additional income tax owing.

#### *Fiscal cost*

82. We have not accounted for any fiscal cost for the change to the treatment for MSD BLSPs. This is on the basis that because in the majority of cases, any tax liabilities arising from those payments is subject to a write off. It will only be where a recipient

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<sup>9</sup> Section 22J of the Tax Administration Act 1994.

has ceased to receive a benefit or where they have WFF debt that the amount will be payable.

83. The fiscal cost is likely to be immaterial. Given this, we consider the fiscal cost of these BLSPs to be within the margin of error of the fiscal cost of the ACC BLSPs, and therefore no additional amount needs to be accounted for.

*Administrative cost*

84. Implementing this option would require moderate systems changes from MSD. This is because it will require an update to the employer information return to identify the BLSPs. This will impact MSD because they will be required to identify when the payment is a BLSP, which will flow through to Inland Revenue where the alternative tax treatment needs to be applied.
85. The proposals will also involve complex system changes by Inland Revenue to alter the annual tax calculation to account for the differing treatment of the BLSP payments.
86. MSD has indicated this work is doable in the timeframe, and they estimate the cost of the changes to be \$525,000.

*Stakeholder support*

87. This option was supported during external (stakeholders and MSD) and internal consultation. MSD agreed that this option is likely solve the current equity issues for their customers.

How do the options compare to the status quo/counterfactual?

	Option One – Status Quo	Option Two – Applying an average tax rate from the previous four income years	Option Three – Applying the average marginal tax rate from the current year, ignoring the BLSP	Option Four – Allow reassessment of earlier tax years when the BLSP should have been received	Option Five – Ignore BLSP and assume tax deducted is correct (MSD BLSP only)
<b>Equity</b>	0	<p>++</p> <p>This option would address the fairness issue, resulting in a lower tax liability than the status quo</p>	<p>+</p> <p>This option would address the fairness issue to some extent but would not address the issue of changes in the recipient's tax rate</p>	<p>-</p> <p>This option would produce the most accurate result in terms of tax liability, but as it could trigger the reassessment of social policy entitlements and obligations, this could lead to other inequitable outcomes</p>	<p>++</p> <p>This option would address the fairness issue, resulting in a lower tax liability than the status quo</p>
<b>Compliance costs</b>	0	<p>0</p> <p>This option would have minimal compliance costs for recipients and for payers</p>	<p>0</p> <p>This option would have minimal compliance costs for recipients and for payers</p>	<p>--</p> <p>This option would have significant compliance costs for recipients and for payers</p>	<p>0</p> <p>This option would have minimal compliance costs for recipients and for payers</p>
<b>Fiscal cost</b>	0	<p>-</p> <p>This would have a fiscal cost of \$27.4m (2023/24 – 2026-27 &amp; outyears)</p>	<p>-</p> <p>This would have a fiscal cost of \$22.3m (2023/24 – 2026-27 &amp; outyears)</p>	<p>-</p> <p>This option was not formally costed but would likely have at least as large of a fiscal cost as option two</p>	<p>-</p> <p>This option would have a small fiscal cost</p>

<b>Administrative cost</b>	0	- <i>This option would involve system change from IR and ACC</i>	- <i>This option would involve system change from IR and ACC</i>	-- <i>This option would involve significant system change and manual intervention</i>	- <i>This option would involve system change from IR and MSD</i>
<b>Stakeholder support</b>	0	++ <i>Stakeholders favoured this option</i>	0 <i>Stakeholders did not prefer this option to the status quo</i>	- <i>Stakeholders considered this was not desirable as it would increase the complexity for recipients given the reassessments and claw-back of social policy entitlements that would flow from it</i>	++ <i>Stakeholders agreed that this was the best way to solve the fairness issue for MSD BLSP recipients</i>
<b>Overall assessment</b>	0	++	-	--	++

**Example key for qualitative judgements:**

- ++ much better than doing nothing/the status quo/counterfactual
- + better than doing nothing/the status quo/counterfactual
- 0 about the same as doing nothing/the status quo/counterfactual
- worse than doing nothing/the status quo/counterfactual
- much worse than doing nothing/the status quo/counterfactual



**What option is likely to best address the problem, meet the policy objectives, and deliver the highest net benefits?**

88. For ACC BLSPs, option two is likely to best address the problem and deliver benefits to BLSP recipients, compared to the status quo. The option is likely to achieve the objective, by mitigating the tax disparities that currently arise for BLSP recipients.
89. For MSD BLSPs, option five is likely to best address the problem and deliver benefits to BLSP recipients, compared to the status quo. This option is the best way to address the tax disparity that arises with the current treatment and would impose almost no compliance costs on recipients. This option essentially calculates the correct amount of tax that would have been payable if the BLSP was paid in the years it should have been received, without the additional reassessments, that would be generated in the tax system, that would occur under option four.
90. Option two and option five are the preferred options which best meet the policy objectives and are able to be implemented within the existing ACC, MSD, and Inland Revenue systems. Both options involve one-off moderate systems changes for ACC, MSD, and complex changes for Inland Revenue. However, once the treatment is implemented, the compliance costs for BLSP recipients and payers of BLSPs should be minimal. As the changes involve modifying the employment information tax return, the policy would apply to payments made from 1 April 2024 to allow sufficient time to implement the changes required.

## What are the marginal costs and benefits of the option?

<b>Affected groups</b> <i>(identify)</i>	<b>Comment</b> <i>nature of cost or benefit (eg, ongoing, one-off), evidence and assumption (eg, compliance rates), risks.</i>	<b>Impact</b> <i>\$m present value where appropriate, for monetised impacts; high, medium or low for non-monetised impacts.</i>	<b>Evidence Certainty</b> <i>High, medium, or low, and explain reasoning in comment column.</i>
<b>Additional costs of the preferred option compared to taking no action</b>			
Regulated groups (taxpayers who receive BLSPs)	Taxpayer friendly	No cost	Medium
Regulators (Inland Revenue)	One-off. System changes are required to implement the proposal.	Medium	Medium
Payers (ACC/MSD)	One-off. System changes are required to implement the proposal	Medium ACC: \$200,000 – 400,000 MSD: \$525,000 IR: \$200,000 - \$400,000	Medium
Others (Government)	Ongoing. Fiscal cost	Fiscal cost of \$27.4m (2023/24 – 26/27 & outyears)	Medium
<b>Total monetised costs</b>	Fiscal and administrative cost	Fiscal cost: \$27.4m (2023/24 – 26/27 & outyears) Administrative cost: \$925,000-\$1,125,000	Medium
<b>Non-monetised costs</b>	One-off	Medium	Medium
<b>Additional benefits of the preferred option compared to taking no action</b>			
Regulated groups	Ongoing. This will likely lower the BLSP recipients' tax liability to a fairer rate.	Reduced tax liabilities totalling \$27.4m (2023/24 – 26/27 & outyears)	Medium
Regulators	Ongoing. Fairer tax system and less customer contacts	Medium	Medium
Payers	Ongoing. Fairer treatment of BLSP and less customer contacts	Medium	Medium
<b>Total monetised benefits</b>	Fiscal cost	\$27.4m (2023/24 – 26/27 & outyears)	Medium
<b>Non-monetised benefits</b>	Ongoing	Medium	Medium

## Section 3: Delivering an option

### How will the new arrangements be implemented?

91. To implement the proposal, it will require legislative, and system change from ACC, MSD, and Inland Revenue.
92. The proposals, if agreed, would be included in the 2023 omnibus taxation bill. The alternative tax treatment for ACC and MSD BLSPs will apply to payments made on or after 1 April 2024. The purpose of a later application date is to allow ACC, MSD, and Inland Revenue time to implement the required system changes.
93. Under the new proposals for ACC payments, ACC BLSP recipients will still be provided the option to choose their desired withholding rate for their BLSP, with this new rate (provided by Inland Revenue to ACC) as an option. Appropriate guidance will be issued to those involved.

### Application date

94. Due to the prospective application date of 1 April 2024, this would not address any past inequity for recipients who have been disadvantaged by the status quo. While applying the proposed solution retrospectively may be seen to be “undoing a wrong”, we do not consider this change would meet the usual criteria for a retrospective change.
95. Changes are normally made retrospective where a change fills in a gap in existing legislation - in particular, a relatively newly enacted regime. Usually, retrospective application either “fills gaps” in such a regime, fixes an obvious error or confirms well-documented policy intent. The tax treatment of BLSPs would fill no such gap and it is a well-established policy decision that employment “type” payments are taxed on receipt.
96. A second reason legislative changes may be applied retrospectively is where the change is taxpayer friendly, and the fiscal cost is acceptable. On a prospective basis, this change is taxpayer friendly because it reduces the tax impact on BLSPs. However, extending the change retrospectively will favour some taxpayers in this situation but not all, unless the change was made back to when these types of payments were first made (which could in theory go back to 1974 when ACC was created). To extend the benefit for some taxpayers for a shorter period will continue to result in some taxpayers not getting the benefit of the change. Additionally, determining where that line should be set would be arbitrary. The fiscal cost of such a change would also be prohibitive.

### How will the new arrangements be monitored, evaluated, and reviewed?

97. Inland Revenue will monitor the effectiveness of the proposed reforms on an ongoing basis, through the normal use of data analytics. The data obtained will assist with analysing whether the new rules are effective and whether they have lessened the tax BLSP recipients have to pay.
98. Once the rules are implemented, Inland Revenue will monitor any feedback from external stakeholders on how the rules are functioning.