Regulatory Impact Statement

Calculating the fringe benefit arising from employment-related loans

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

It provides an analysis of options for a remedial change to widen the group of employers who are eligible to use the market interest rate method of determining the fringe benefit arising from an employment-related loan. The issue arose out of concerns that some subsidiaries within banking groups could not use the method, even though the parent could. This leads to the subsidiaries overpaying fringe benefit tax, compared to the parent bank.

The proposed change is consistent with the key objective as per the original policy intention, which was to ensure that persons who are able to easily determine the market interest rate on comparable loans to third parties can use the market interest rate method. A second objective was to ensure that tax considerations did not impact on economic efficiency.

While our understanding is that only a limited number of organisations will be affected by the change, limitations on the available fiscal data have constrained the analysis. Estimates of the fiscal costs ($720,000 per annum) and other costs have relied on an extrapolation of industry provided figures, combined with the use of Inland Revenue's available information.

Limited targeted consultation was undertaken. The New Zealand Bankers' Association brought the issue to Inland Revenue's attention, and wider consultation was not undertaken, due to the narrow, technical nature of their issue, the fact that they represent a large number of the affected persons, and the potential to address the issue promptly through an up-coming bill.

Widening the group of entities eligible to use the market interest rate is unlikely to impose additional costs on businesses, particularly given that the use of the method is voluntary. Businesses that choose not to use the method may continue to use the prescribed rate, as set by regulation.

None of the policy options impair private property rights, restrict market competition, reduce the incentives on businesses to innovate and invest, or override fundamental common law principles.

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STATUS QUO AND PROBLEM DEFINITION

Fringe benefits

1. Remuneration received by a person in exchange for providing employment services is taxable. To prevent erosion of the tax base at the margins, certain non-monetary benefits provided by employers to their employees are also taxed, as fringe benefits. Fringe benefit tax (FBT) helps to ensure neutrality between paying employees in cash and in kind. One kind of fringe benefit that may be provided by an employer is a discounted loan.

2. Where an employer provides an employee with a loan with terms that are more favourable than the terms that the employee would be able to obtain from a third party, a fringe benefit arises. The amount of the fringe benefit is the additional amount of interest that would have been payable for a loan with similar terms, compared to the amount actually paid under the terms of the loan.

Tax treatment of employment-related loans

3. There are two methods that may be used to calculate the fringe benefit arising from an employment related loan. Most employers use the prescribed rate method to determine the amount of the fringe benefit that arises. The prescribed interest rate is set by regulation, with reference to the prevailing variable first-mortgage housing rate determined by Reserve Bank survey. This ensures that the prescribed rate is in line with market rates.

4. In some cases, the prescribed rate will exceed the rate that a third party lender would offer an individual. This is because the prescribed rate is determined based on publicly advertised interest rates for first mortgages. However, many individuals can negotiate a lower rate than the advertised rate for this type of borrowing.

5. Since 2006, persons in the business of lending money to the public (generally, financial institutions such as banks) have been able to elect to use the market interest rates to determine the fringe benefit that arises in relation to an employment-related loan, as an alternative to the prescribed rate method. The relevant market rate is the interest rate that would apply to a loan of the same kind, provided to a borrower belonging to a group of persons with comparable credit risk to the employee, dealing on an arm's length basis.

6. Employers who are not in the business of lending money to the public are not able to use the market interest rate method to value the fringe benefit from a loan, as they are not expected to have systems in place to monitor market rates without incurring undue compliance costs. In contrast, lenders will have these systems.

7. Where an employer who is in the business of lending money to the public elects to use the market interest rate method in relation to a loan, they are required to notify the Commissioner of Inland Revenue at least one year before the income year in which they will first apply the method, and must apply the method for at least two income years. This requirement is to prevent persons from switching between methods, to gain an advantage.

Problem definition

8. The banking sector has found that the focus solely on the business of the employer has created issues in practice. A company may provide fringe benefits to the employees of other companies within the same group. In the case of a financial institution, the benefit may be a loan. However, the FBT rules treat the employees' employer as providing this benefit, so they may only use the market interest rate method to value the benefit if they are a lender themselves.

9. In practice groups of companies will share information among the members, and a financial institution within a group of companies can provide the information necessary to determine the market interest rate to other companies within the group. These companies form a readily identifiable class of employers who may be able to easily apply the market interest rate method, and may be treated as an extension of the policy that persons in the business of lending money to the public can apply the method.

10. The consequence of the status quo may be a higher FBT liability for the employer, and more FBT revenue for the Government. The status quo also creates some concerns regarding economic efficiency, as it encourages employing personnel through the lender(s) within the group, over other companies in the group that do not lend money to the public.

11. This may lead to tax considerations affecting decisions around which entity to employ persons through. This is particularly so for wholly owned groups, which function as a single economic unit, and who may otherwise be indifferent between separating certain (non-lending) functions into other companies or retaining them within the company which is lending.

OBJECTIVES

12. The objectives of the proposed change are to:
    (a) ensure that persons who are able to easily determine the market interest rate of an employment-related loan can use the market interest rate method to determine their FBT liability;
    (b) maximise economic efficiency; and
    (c) minimise compliance costs.

13. One of the key features of the current rules for taxing employment-related loans is that persons do not incur undue compliance costs. Consistent with this policy choice, allowing a wider group of persons to apply the market interest rate method should not be pursued at the expense of increased compliance and administrative costs. Ensuring that persons who are able to easily determine the market interest rate of an employment-related loan may use the market interest rate method is consistent with limited compliance implications.

14. Maximising economic efficiency is a secondary consideration. The identified efficiency concern results from hiring decisions within groups which include a lender. Achieving this objective is likely to follow from widening the group of persons who may apply the market interest rate method, to include those associated with financial institutions.

REGULATORY IMPACT ANALYSIS

15. Two options have been identified to address the problem and meet the stated objectives, along with the status quo:

- ***Option one:*** Employers who are a member of a wholly owned group of companies (which includes a person in the business of lending to the public) may use the market interest rate method.
- ***Option two:*** Employers who are a member of a group of companies (which includes a person in the business of lending to the public) may use the market interest rate method.
- ***Option three:*** Only employers who are in the business of lending to the public may use the market interest rate method (status quo).

Groups of employers

16. The Income Tax Act 2007 provides rules for grouping companies which share common ownership. The test looks at the ownership of the companies and the extent to which the same owners have the same interest in each company.

17. For a company to be part of the same *group of companies* as another company, the same person or persons must generally have common voting interests of at least 66%. A person has a common voting interest where they own voting rights in both companies.

18. For a company to be part of the same *wholly owned group of companies* the common voting interest required is 100%. Therefore, a person who is in the same wholly owned group of companies as another person will always also be within the same group of companies as that person.

Option	*Meets objectives*	*Impacts*				*Net impact*
			Fiscal/economic impact	*Administrative and compliance impacts*	*Risks*	
One *Employers who are in the same wholly owned group*	a, b and c	Tax system	Fiscal cost of approximately $720,000 p.a.	Minimal additional administrative costs for Inland Revenue. Self-assessment means that costs are mostly confined to updating communications products	Minimal. Affected employers are expected to possess the necessary sophistication to correctly apply the method.	Expands eligibility to apply the market interest rate method to a wider group of persons, while minimizing compliance costs.
		Employers	Fiscal benefit of approximately $720,000 p.a. for companies within the same wholly owned group as a lender. Efficiency gain as FBT will not affect employment decisions within the wholly owned group.	The affected employers are expected to be able to apply the market interest rate method without difficulty. Employers may choose to continue to use the existing method.		
Two *Employers who are in the same group*	a, b and c	Tax system	Fiscal cost of approximately $720,000 p.a.	As for Option one.	As for Option one.	Option two more fully meets the objectives than Option one, as it expands eligibility to a wider group of persons. This may not make a material difference now given that most banking group companies are wholly owned, but provides greater flexibility for the future. The wider group is not expected to incur additional compliance costs or pose a significantly increased risk over Option one.
		Employers	Fiscal benefit of approximately $720,000 p.a. for companies within the same group as a lender. Efficiency gain as FBT will not affect employment decisions within the group.	As for Option one.		

Three *Status quo*	c	Tax system	No fiscal cost.	No change.	The status quo maintains the current approach of confining the use of the market interest rate method to a narrower group of persons, within those expected to have the technical ability to apply it correctly.	No change.
		Employers	Maintains the existing FBT preference for groups including financial institutions to employ persons through the financial institution. The taxpayers will continue to return FBT using the prescribed interest rate method, which will result in an approximately $720,000 p.a. larger FBT liability than if they could use the market interest rate method.	No change.		

Fiscal and economic impact

19. Option one is likely to have a fiscal cost of approximately $720,000 p.a. This represents a decrease in FBT of $1 million p.a. However, since FBT is deductible for the employer, there will be a corresponding increase in company tax by $280,000. The fiscal cost is based upon an extrapolation of information provided by the banking sector, for groups of companies. The reduced revenue will translate to a benefit for the affected employers, whose FBT liability has decreased by a corresponding amount.

20. The cost of Option two is expected to be largely similar to that of Option one (approx. $720,000 per annum) on the basis that most of the FBT effect is attributable to entities within the narrower wholly owned group. However, the wider coverage could be more relevant in the future, for example if a wholly owned subsidiary of a bank was to be partially sold.

21. The reduction in revenue arises because the market interest rate method and the prescribed rate method ascribe different values to the loan, with the prescribed rate method generally calculating a slightly greater benefit.

22. In both Option one and Option two there is a potential efficiency gain as the FBT outcome will no longer potentially impact on placement of employees within the group. The potential gain is greater for Option two, as it applies to a wider group; however this may be partially offset by the fact that employment through the financial institution or a company within the same wholly owned group is likely to be more substitutable than between the financial institution and the group companies which are not wholly owned.

Social, environmental or cultural impacts

23. There are no social, environmental or cultural impacts associated with any of the options.

Net impact

24. Option one achieves all three stated objectives. It expands the group of persons able to apply the market interest rate method to a slightly wider group of taxpayers who could be expected to easily apply the method, without posing significant risk.

25. Option two is similar to Option one, in that it meets all three of the stated objectives. However, Option two expands eligibility, and increases economic efficiency for to a slightly wider group of persons than Option one.

26. Option three presents no changes.

CONSULTATION

27. Limited targeted consultation was undertaken. The New Zealand Bankers' Association (NZBA) advocated for members of groups of companies (common ownership of 66% or more) which include a lender to be able to apply the market interest rate method. The NZBA strongly supported this threshold, as some entities associated with its members are not wholly owned, but have minority interests. In support of their submission, they cited the fact that group companies would have the same information available as the lender, and identified

concerns that the status quo could lead to tax-induced biases in employing staff through lenders, where normal commercial considerations may favour other entities.

28. Wider consultation was not undertaken, in the interest of responding to this identified concern in as timely a manner as possible. This was seen as a potential opportunity for an incremental change consistent with the established policy. It was also seen as taxpayer-friendly and low-risk, and could be included in the upcoming taxation omnibus Bill, to secure prompt benefit for those affected.

CONCLUSIONS AND RECOMMENDATIONS

29. Option one benefits employers within the same wholly owned group of companies as a lender. Extending eligibility to apply the market interest rate method to these employers poses little risk as they are expected to be able to easily apply the method correctly. The exact cost of this option is estimated at approximately $720,000 p.a.

30. Option two benefits a slightly wider group of employers, those within the same group of companies as a lender. This necessarily includes all the persons affected by Option One and will affect a number of additional banking group companies which have minority shareholders. This option provides greater flexibility for the future.

31. Extending eligibility to these employers likewise poses little risk. This option is expected to have a fiscal cost to the government, and a corresponding benefit to the affected employers largely similar to that of Option one (approximately $720,000 p.a).

32. Either of these options would potentially result in an efficiency gain, as FBT outcomes would not affect hiring decisions within the affected group.

33. Inland Revenue's preferred approach is Option two: allowing employers in the same group of companies as a lender to apply the market interest rate method, on the basis that it better meets the first objective, by enabling a wider group of persons who could easily apply the market interest rate method to do so. Group companies should still have access to the necessary information, and the potentially wider approach does not seem to pose any additional risk. Several other provisions in the FBT rules are based on whether companies are within the same group.

IMPLEMENTATION

34. Both Option one and Option two would require changes to the Income Tax Act 2007 to allow the groups of affected employers to use the rules. Option three (the status quo) does not require any changes to implement.

35. An amendment to the Income Tax Act 2007 could be included in the tax bill scheduled for introduction in November 2014. Legislative amendments could apply from the date the Bill receives Royal assent.

36. The current legislation imposes requirements on a person who wishes to use the market interest rate method – they must notify the Commissioner at least one year before the income year in which they wish to use the method. They must then use the method for that and the following income year, to avoid flip-flopping. This would mean that, for an amendment Act

receiving assent in 2015, taxpayers with standard balance dates could give notice before 1 April 2016, and begin applying the method from 1 April 2017.

37. To facilitate adoption of the method, affected employers could be temporarily given the opportunity to elect to apply the method from the FBT quarter following the election. To integrate this with the requirement that the person apply the method for two income years, where this does not correspond with the start of an income year, the part of an income year where the rules are applied could be treated as a full income year. Such an exception to the ordinary rule is unlikely to lead to flip-flopping.

38. Implementation is not expected to lead to compliance costs for the affected employers.

39. If the amendment is made, it would be publicised through inclusion in the commentary to the implementing bill. Inland Revenue would also include the item in a Tax Information Bulletin once the bill received Royal assent.

40. Inland Revenue would administer the changed rules through the ordinary business processes.

MONITORING, EVALUATION AND REVIEW

41. There are no plans to monitor, evaluate and review the changes after they become law. This is because the remedial change is consistent with the policy underlying the rules. If any specific concerns are raised, officials will determine whether there are substantive grounds for review under the Generic Tax Policy Process. Also, the Income Tax Act 2007 is subject to regular review by officials. As per the normal process, there will be an opportunity for submissions to be made on the proposed changes during the select committee stage of the tax bill that any legislative change is contained in.