Inland Revenue
Te Tari Taake

POLICY AND STRATEGY

Document 1

THE TREASURY
Kaitohutohu Kaupapa Rawa

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Tax policy report: Fringe benefit tax on employment related loans - Market interest rate

Date:	6 March 2018	**Priority:**	Medium
Security level:	In Confidence	**Report no:**	T2018/537 IR2018/124

Action sought

	Action sought	**Deadline**
Minister of Finance	**Note** the contents of this report **Agree** to the recommendations	29 March 2018
Minister of Revenue	**Note** the contents of this report **Agree** to the recommendations	29 March 2018

Contact for telephone discussion (if required)

Name	**Position**	**Telephone**
Hannah Overton	Graduate Analyst, The Treasury	s 9(2)(a)
Chris Gillion	Policy Manager, Inland Revenue	

6 March 2018

Minister of Finance
Minister of Revenue

Fringe benefit tax on employment related loans - Market interest rate

Executive summary

1. Banks and other employers in the business of lending money are required to pay fringe benefit tax (FBT) if they provide a loan to an employee at a rate below the market interest rate. However, the legislative definition of the market interest rate is out-dated and no longer reflects the lending practices of banks and other money lenders. As such the legislated market interest rate may often be higher than the true market interest rate. This can result in loans to employees of banks and other money lending institutions being taxed even if the same loan rates are received by ordinary customers and there is no private benefit to the employees.

2. This is a longstanding issue that has been raised with officials regularly by stakeholders over a number of years.

3. To address these concerns the market interest rate definition should be updated to more accurately reflect the true market rate. The proposal 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 to the employee.

4. The estimated revenue cost of this proposal is $3 million per year over the forecast period. This can be accounted for on the tax policy scorecard.

5. If Ministers agree with the proposed change and wish to include it in the first omnibus taxation bill of 2018 then a Cabinet paper should be lodged with the Cabinet Office by 29 March for discussion at the 4 April Cabinet Economic Development Committee meeting. The attached Cabinet paper is a draft and the finalised paper will be provided to you shortly once the Regulatory Impact Statement quality assurance has been completed.

6. Alternatively, Ministers may instead wish to consider this issue as part of a wider discussion on the tax policy work programme – on which you will receive further advice next week. This would mean the proposed option could not be included in the first omnibus taxation bill of 2018 – although it could potentially be considered for inclusion in a later omnibus taxation bill.

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Recommended Action

We recommend that you:

(a) **Note** that the legislative definition of the market interest rate for calculating fringe benefit tax on employment related loans provided by banks and other money lenders is outdated and does not reflect the true market rate.

Noted Noted

(b) **Agree** that the market interest rate for a given employee and loan type should 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 to the employee.

Agreed/Not Agreed Agreed/Not Agreed

(c) **Note** that the proposed option in (b) has an estimated revenue cost of $3 million per year, which can be accounted for on the tax policy scorecard.

Noted Noted

EITHER

(d) If Ministers wish to include the proposed option in the first omnibus taxation bill of 2018 they should **authorise for lodgement** the finalised Cabinet paper with the Cabinet Office by 29 March for discussion at the 4 April Cabinet Economic Development Committee.

Authorised for lodgement/Not authorised Authorised for lodgement/Not authorised

OR

(e) **Agree** to consider this issue as part of a wider discussion on the tax policy work programme.

Agreed/Not Agreed Agreed/Not Agreed

Matt Cowan
Team Leader
Tax Strategy
The Treasury

Chris Gillion
Policy Manager
Policy and Strategy
Inland Revenue

Hon Grant Robertson
Minister of Finance
/ /2018

Hon Stuart Nash
Minister of Revenue
/ /2018

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Background

7. 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 the prescribed interest rate. However, banks and other money lenders may instead elect to use the market rate as they often offer loans to customers below the prescribed rate, and have the data to accurately calculate the market rate readily available.

8. 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 its customers.

9. 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 would allow either the advertised rates or the group discount rates to be offered to employees as the market interest rate without banks and other similar lenders incurring FBT.

10. However, it is now common practice for banks and other similar lenders to individually negotiate loan rates with customers. 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.

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

12. The rules around the market interest rate were introduced to rectify the problem of the prescribed rate becoming out of date and fringe benefits arising even when the employer is charging an employee the true market rate. As such, changing the definition of the legal market rate to more appropriately reflect the true market rate would be consistent with the original policy intent.

13. The issue of the legislated market interest rate being higher than the true market rate is longstanding and has been raised with Inland Revenue regularly by stakeholders over a number of years.

Proposed solution

14. The proposed option is that the market rate for a given employee and loan type is defined as the lowest rate received around the same time by an arm's length customer with a similar profile to

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the employee. However, employers would not be permitted to create an artificially low market rate by providing a single customer with an exceptionally discounted loan rate. Instead, the market rate would need to be based on loans offered in the ordinary course of business.

15. For example, Carlos, an employee of XYZ Bank, wants to receive a fixed rate home loan from his employer. The lowest rate XYZ bank has offered on this type of loan to arm's length customers who meet similar lending criteria as Carlos is 4%. Only one customer has received this rate, however, a number of other low risk customers have all received loans close to this (4.01-4.05%). As such, the market rate for Carlos will be 4% and FBT will only be payable if Carlos receives a rate below this.

16. However, if XYZ bank had offered a single arm's length low-risk customer a rate of 3.5% as part of a promotion, and the next lowest rate received by an arm's length customer was still 4%, then the market interest rate for Carlos would still be 4% as this is the lowest rate offered by XYZ bank in the ordinary course of business. The question of whether any given loan rate has been offered in the ordinary course of business will always be a matter of fact and degree.

17. This proposed solution will prevent the over-taxation of employment related loans that occurs under the status quo. Instead, loans made to employees will only be subject to FBT if a genuine discount compared to the rates received by arm's length customers has been provided. This is consistent with the broader FBT framework which only seeks to tax benefits obtained due to a person's employment status.

Revenue

18. Currently $3 million of FBT is paid per year on employment related loans by banks and other money lenders using the market rate. It is assumed that the proposed solution will result in most of this revenue being foregone.

19. The revenue cost of the proposed option can be accounted for on the tax policy scorecard. The scorecard is an accounting mechanism designed to ensure that the cumulative net revenue impacts of non-significant tax policy changes are considered in aggregate. It acts as a memorandum account attached to the Between-Budget contingency. The current balance of the scorecard is s 18(c)(i) over the forecast period.

Consultation

20. Officials have consulted with members of the New Zealand Bankers' Association, Corporate Taxpayers Group, Charted Accountants Australia and New Zealand, and the Financial Services Council on this issue. Submissions were strongly supportive of updating the market interest rate definition and the proposed solution.

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Next Steps

21. If Ministers wish to include the proposed changes in the first omnibus taxation bill of 2018 they should lodge the finalised Cabinet paper by 29 March for consideration at the 4 April Cabinet Economic Development Committee meeting. Subject to Cabinet approval, the proposed option could then be included in the omnibus taxation bill.

22. The attached Cabinet paper is a draft and the finalised paper will be provided to you once the Regulatory Impact Statement quality assurance has been completed.

23. Alternatively, Ministers may wish to consider this issue as part of a wider discussion on the tax policy work programme – on which you will receive further advice next week. This would enable the costs of this proposal to be considered alongside the costs of other potential items on the work programme.

24. If this issue is considered as part of the wider discussion on the tax policy work programme the proposed change could not be included in the first omnibus taxation bill of 2018 – although it could potentially be considered for inclusion in a later omnibus taxation bill.

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Document 2

In Confidence

Office of the Minister of Finance
Office of the Minister of Revenue

Cabinet Economic Development Committee

Fringe benefit tax on employment related loans - Market interest rate

Proposal

1. This paper seeks the Cabinet Economic Development Committee's (the Committee) agreement to change the legislative definition of the market interest rate for calculating fringe benefit tax (FBT) on employment related loans provided by banks and other money lenders.

2. The proposed change 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 to the employee.

Executive summary

3. Banks and other employers in the business of lending money are required to pay fringe benefit tax (FBT) if they provide a loan to an employee at a rate below the market interest rate. However, the legislative definition of the market interest rate is out-dated and no longer reflects the lending practices of banks and other money lenders. As such the legislated market interest rate may often be higher than the true market interest rate. This can result in loans to employees of banks and other money lending institutions being taxed even if the same loan rates are received by ordinary customers and there is no private benefit to the employees.

4. To address these concerns the market interest rate definition should be updated to more accurately reflect the true market rate. The proposal 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 to the employee.

5. The estimated revenue cost of this proposal is $3 million per year over the forecast period. This can be accounted for on the tax policy scorecard.

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Background

6. 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 its customers.

7. The market interest rate definition was based on the practices banks and other lenders used 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 would allow either the advertised rates or the group discount rates to be offered to employees as the market interest rate without banks and other similar lenders incurring FBT.

8. However, it is now common practice for banks and other similar lenders to individually negotiate loan rates with customers. 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.

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

10. 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 definition of the legal market rate to more appropriately reflect the true market rate would be consistent with the original policy intent.

Comment

11. The proposed option is that the market rate for a given employee and loan type is defined as the lowest rate received around the same time by an arm's length customer with a similar profile to the employee. However, employers would not be permitted to create an artificially low market rate by providing a single customer with an exceptionally discounted loan rate. Instead, the market rate would need to be based on loans offered in the ordinary course of business.

12. For example, Carlos, an employee of XYZ Bank, wants to receive a fixed rate home loan from his employer. The lowest rate XYZ bank has offered on this type of loan to arm's length customers who meet similar lending criteria as Carlos is 4%. As such, the market rate for Carlos will be 4% and FBT will only be payable if Carlos receives a rate below this.

13. This proposed solution will prevent the over-taxation of employment related loans that occurs under the status quo. Instead, loans made to employees will only be subject to FBT if a genuine discount compared to the rates received by arm's length customers has been provided. This is consistent with the broader FBT framework which only seeks to tax benefits obtained due to a person's employment status.

Consultation

14. Officials have consulted with members of the New Zealand Bankers' Association, Corporate Taxpayers Group, Charted Accountants Australia and New Zealand, and the Financial Services Council on this issue. Submissions were strongly supportive of updating the market interest rate definition and the proposed solution.

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Financial implications

15. The proposal will impact how much FBT is collected from banks and other money lending institutions. Currently $3 million of FBT is paid per year on employment related loans by banks and other money lenders using the market rate. It is assumed that the proposed solution will result in most of this revenue being foregone.

16. The revenue cost of the proposed option can be accounted for on the tax policy scorecard. The scorecard is an accounting mechanism designed to ensure that the cumulative net revenue impacts of non-significant tax policy changes are considered in aggregate. It acts as a memorandum account attached to the Between-Budget contingency.

Human rights

17. We consider that the proposals contained in the discussion document are not inconsistent with the New Zealand Bill of Rights Act 1990 and the Human Rights Act 1993.

Legislative implications

18. Legislative changes will be necessary if Cabinet decides to implement the proposal. These changes can be included in the first omnibus taxation bill of 2018.

Regulatory impact analysis

Note the Regulatory Impact Statement quality assurance has not yet been completed. The finalised Cabinet paper will be provided once the quality assurance has been completed.

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Recommendations

We recommend the Committee:

1. **Agree** that the market interest rate for a given employee and loan type 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 to the employee.

2. **Note** that the proposal has an estimated revenue cost of $3 million per year which can be accounted for on the tax policy scorecard.

3. **Agree** to include the proposed option in the first omnibus taxation bill of 2018.

Hon Grant Robertson
Minister of Finance

____ / ____ / ____
Date

Hon Stuart Nash
Minister of Revenue

____ / ____ / ____
Date

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Document 3

In Confidence

Office of the Minister Revenue
Chair, Cabinet Economic Development Committee

Miscellaneous Tax Policy Changes for Inclusion in the Next Omnibus Taxation Bill for 2018

Proposal

1. This paper seeks the Cabinet Economic Development Committee's agreement to a number of miscellaneous measures that require changes to the Income Tax Act 2007 Outside scope

2. If approved, I propose including the necessary legislative amendments in the next omnibus taxation bill for introduction in 2018.

Executive Summary

3. This paper has been prepared to obtain the Cabinet Economic Development Committee's agreement to a number of miscellaneous tax policy matters for inclusion in the next omnibus taxation bill for introduction in 2018. I am recommending changes to:

   3.1 Outside scope

   3.2 the legislative definition of the market interest rate for calculating fringe benefit tax (FBT) on employment related loans provided by banks and other money lenders, and

   3.3 Outside scope

Outside scope

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Outside scope

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Fringe Benefit Tax on Employment Related Loans - Market Interest Rate

41. Banks and other employers in the business of lending money are required to pay fringe benefit tax (FBT) if they provide a loan to an employee at a rate below the market interest rate. However, the legislative definition of the market interest rate is out-dated and no longer reflects the lending practices of banks and other money lenders. As such the market interest rate calculated under the Income Tax Act 2007 may often be higher than the true market interest rate. This can result in loans to employees of banks and other money lending institutions being taxed even if the same loan rates are received by ordinary customers and there is no private benefit to the employees.

Background

42. 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 its customers.

43. The market interest rate definition was based on the practices banks and other lenders used 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 would allow either the advertised rates or the group discount rates to be offered to employees as the market interest rate without banks and other similar lenders incurring FBT.

44. However, it is now common practice for banks and other similar lenders to individually negotiate loan rates with customers. 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.

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

46. 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 definition of the legal market rate to more appropriately reflect the true market rate would be consistent with the original policy intent.

Comment

47. I recommend the market rate for a given employee and loan type should be defined as the lowest rate received around the same time by an arm's length customer with a similar profile to the employee. Employers would not, however, be permitted to create an artificially low market rate by providing a single customer with an exceptionally discounted loan rate. Instead, the market rate would need to be based on loans offered in the ordinary course of business.

48. For example, Carlos, an employee of XYZ Bank, wants to receive a fixed rate home loan from his employer. The lowest rate XYZ bank has offered on this type of loan to arm's length customers who meet similar lending criteria as Carlos is 4%. As such, the market rate for Carlos will be 4% and FBT will only be payable if Carlos receives a rate below this.

49. This proposed solution will prevent the over-taxation of employment related loans that occurs under the status quo. Instead, loans made to employees will only be subject to FBT if a genuine discount compared to the rates received by arm's length customers has been provided. This is consistent with the broader FBT framework

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which only seeks to tax benefits obtained due to a person's employment status. I recommend the change applies to interest paid on employment related loans from the start of the tax year quarter following the enactment of the proposed omnibus taxation bill.

Consultation

50. Officials have consulted with members of the New Zealand Bankers' Association, Corporate Taxpayers Group, Charted Accountants Australia and New Zealand, and the Financial Services Council on this issue. Submissions were strongly supportive of updating the market interest rate definition and the proposed solution. The Treasury was also consulted.

Financial implications

51. The proposal will impact how much FBT is collected from banks and other money lending institutions. Currently $3 million of FBT is paid per year on employment related loans by banks and other money lenders using the market rate. It is assumed that the proposed solution will result in most of this revenue being foregone.

Table 3: Impact of reducing FBT on employee related loans

	$million – increase/(decrease)				
Vote Revenue **Minister of Revenue**	**2017–18**	**2018–19**	**2019–20**	**2020–21**	**2021–22 & outyears**
Crown Revenue and Receipts: Tax Revenue	(0.000)	(0.750)	(3.00)	(3.00)	(3.00)

52. The revenue cost of the proposed option can be accounted for on the tax policy scorecard. The scorecard is an accounting mechanism designed to ensure that the cumulative net revenue impacts of non-significant tax policy changes are considered in aggregate. It acts as a memorandum account attached to the Between-Budget contingency. The current balance of the scorecard is s 18(c)(i) over the forecast period.

Outside scope

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Outside scope

Compliance and Administrative Cost Implications

70. Outside scope The other measures recommended in this paper do not materially affect Inland Revenue's administration costs or create new taxpayer obligations. The measures do not impact on Inland Revenue's Business Transformation programme.

Economic Impacts

71. The measures recommended in this paper are intended to improve the efficiency of tax legislation by reducing compliance costs. No other economic impacts, apart from those already mentioned in this paper, have been identified.

Human Rights

72. The changes I am recommending in this paper are not inconsistent with the New Zealand Bill of Rights Act 1990 or the Human Rights Act 1993.

Legislative Implications

73. Implementing the recommendations in this paper requires changes to the Income Tax Act 2007 Outside scope . I recommend that the necessary amendments be included in the next omnibus taxation bill, scheduled for introduction in early 2018.

Regulatory Impact Analysis

74. The Quality Assurance Reviewers at Inland Revenue have reviewed the following Impact Summaries prepared by Inland Revenue:

 74.1 Outside scope

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

75. The Quality Assurance Reviewers consider that the information and analysis summarised in the Regulatory Impact Summaries meets the quality assurance criteria.

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Outside scope

76.

77.

Publicity

78. I will make an announcement on the contents of the proposed omnibus taxation bill for early 2018 when it is introduced in the House. A Commentary on the bill explaining the changes recommended in this paper will be released at the same time. Inland Revenue will publish details of the new legislation in *its Tax Information Bulletin* series once the bill is enacted. Outside scope

Recommendations

79. The Minister of Revenue recommends the Cabinet Economic Development Committee:

Outside scope

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Outside scope

Fringe benefit tax on employment related loans

10 Agree that the market interest rate for a given employee and loan type 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 to the employee.

11 Agree that the change in recommendation 10 applies to interest paid on employment related loans from the start of the tax year quarter following the enactment of the bill.

12 Note that agreeing to recommendations 10 and 11 has the following estimated fiscal cost:

	$million – increase/(decrease)				
Vote Revenue **Minister of Revenue**	**2017–18**	**2018–19**	**2019–20**	**2020–21**	**2021–22 & outyears**
Crown Revenue and Receipts: Tax Revenue	(0.000)	(0.750)	(3.000)	(3.000)	(3.000)

Outside scope

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Outside scope

Legislative vehicle

16 Agree that legislation to give effect to changes recommended in this paper be included in the next omnibus taxation bill for 2018.

17 Invite the Minister of Revenue to instruct Inland Revenue to draft the necessary amendments to give effect to the changes recommended in this paper.

Authorised for lodgement

Hon Stuart Nash
Minister of Revenue

____/________/ 2018

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