Inland Revenue
Te Tari Taake

**Policy and Regulatory Stewardship**
***Kaupapa me te Tiaki i ngā Ture***
55 Featherston Street
PO Box 2198
Wellington 6140
New Zealand

T. 04-890 1500

23 May 2022

[redacted]

Dear [redacted]

Thank you for your request made under the Official Information Act 1982 (OIA) received 21 April 2022. You requested the following:

> *Whether the Commissioner of Inland Revenue or Inland Revenue has received requests from individuals for tax relief in relation to lump sum back payments of weekly compensation under the Accident Compensation Act 2022 (either under section 176 of the Tax Administration Act 1994 or other relevant legislation) and, if so:*
>
> 1. *How many such requests the Commissioner of Inland Revenue or Inland Revenue have received in the last ten years*
> 2. *The outcomes of those applications (if any) from the past ten years, including whether tax relief was granted and the reasoning for the decision to grant or not grant tax relief*
> 3. *Copies of Inland Revenue's internal policies, guidelines, etc in relation to how back paid weekly compensation under the Accident Compensation Act that is paid in a lump sum should be taxed*
> 4. *Any correspondence between Inland Revenue and the Accident Compensation Corporation on the taxation of lump sum back paid weekly compensation under the Accident Compensation Act (this can be narrowed to correspondence in relation to the policy approach of taxing such payments, and can exclude correspondence relating to particular individual's payments/taxation)*
> 5. *Any advice, briefings, etc given to Inland Revenue or the Accident Compensation Corporation's relevant Minister(s) in relation to the taxation of lump sum back paid weekly compensation under the Accident Compensation Act*

On 22 April 2022, we asked you to clarify your request regarding the type of tax relief, the tax records you are seeking, and the type of correspondence you would be happy to receive, to which you replied:

> *Question 1 - Yes, that is the tax relief I was meaning. I understand that to be under section 176 of the TAA as per my initial request, but there may be other relevant legislation I'm not aware of.*
>
> *Question 2 - I am after incidents where individuals have applied to the CIR for tax relief (ie, in the event of financial hardship) in relation to an ACC lump sum. Would the IRD have any record of such applications (even at a high level) without needing*

*to go into individuals tax records? I do not really need information about the complaints. If this information cannot be gathered, even a summary or high level overview of how many people have applied for tax relief in relation to ACC lump sum payments and have not been successful will be fine.*

*Question 3 - Yes, the internal file notes and reports you have referred to will be sufficient.*

**Questions One & Two– Taxpayers who had received ACC lump sum payments and financial hardship relief**

As previously discussed in our email dated 27 April 2022, we endervoured to locate the specific information you requested on the number and outcome of any requests for tax relief for taxpayers who had received lump sum payments from ACC. We had previously noted that it was unlikely someone who had received a lump sum payment would be given tax relief on the basis of hardship as they had just received funds to settle any tax liabilities that may be outstanding.

We also noted that it would also be unlikely that a person was granted a hardship or other relief from tax payable on a lump sum payment from ACC as the way in which the law applies to such payments is clear and settled (i.e., that the lump sum amount is taxed in the year of receipt). If there were cases that intersected with these two features any hardship relief received would more likely be for other reasons.

However, we did attempt to identify any cases that may fit within your request and, as expected, were unable to produce this information specifically. To attempt to idenity those isolated cases would require us to go through individual tax records, which would require substantial efforts. Therefore, we have refused your request under section 18(f) of the OIA, as the information requested cannot be made available without substantial collation or research.

**Question Three – Internal guidelines on the taxation of ACC lump sum payments**

The following paragraphs are from our internal knowledge base for staff:

If the taxpayer is entitled to a backdated payment, ACC will provide them with an information sheet explaining when a backdated compensation applies and how the amount is calculated.

Taxpayers who were entitled to ACC weekly compensation but did not receive it, may be entitled to a backdated payment. Any backdated payment received from ACC is considered to be taxable income in the year in which the customer receives it. This can increase the taxpayer's tax liability for the year and also impact their Working for Families entitlement, Child Support obligations, or student loan repayments.

The lump sum is is taxed by ACC as normal under PAYE rules (being a current year receipt and taxable in the year of receipt as an extra pay). This amount is reflected in the employment information provided to Inland Revenue by ACC.

***Lump sum payments***

Lump sum payments (also called extra pays) include:

- annual or special bonuses (regular bonuses aren't included and should be taxed as per normal)
- cashed up holiday pay
- retiring or redundancy payments
- payments for accepting restrictive covenants
- exit inducement payments
- gratuities
- remedial payments
- lump sum holiday pay
- employee share scheme benefits

If a customer believes they will be overtaxed on their lump sum payment (usually if they have more than one job) they can apply for a special tax code. The employee can also elect to have their lump sum/bonus/allowance taxed at a higher rate, for example if they have another job or other untaxed income. The employee needs to advise the employer if they want a higher rate to apply and this rate is used in the calculation.

***Details required for calculation***

- Tax code
- Payment frequency
- Date of calculation
- Lump sum figure (gross or net)
- Last four weeks income from this employer

More information on this can be found on Inland Revenue's website (ird.govt.nz) by searching for "Calculate PAYE for a lump sum payment."

The taxing of lump sums has been tested in the Courts. In Hollis v Commissioner of Inland Revenue (https://www.taxtechnical.ird.govt.nz/case-summaries/2021/csum-21-09), it was found that in cases involving backdated ACC payments, the taxpayer derives the income when it is received and that it cannot be spread back to earlier years to which the computation of income relates. The High Court case (Hollis v CIR (2010) 24NZTC 23,967 (HC) has become the leading authority in this area of law; a lump sum payment is taxed on a cash basis (i.e., in the year of receipt) in accordance with BD 3(2) of the Income tax Act 2007.

**Questions Four & Five – reports and correspondence relating to advice on ACC lump sum payments provided to Ministers**

The documents in scope are attached and in the table below. Some information is witheld under seciont 9(2)(a) of the OIA, to protect the privacy of natural persons.

| Item | Date | Document title | Decision |
|---|---|---|---|
| 1. | 8 February 2018 | Income tax treatment of lump sum payments of weekly accident compensation (IR2018/075) | Released with redactions under section 9(2)(a) |
| 2. | 17 July 2018 | File note - Individuals Income Tax – Meeting | Released in part. |
| 3. | 17 October 2019 | Proposed consultation approach for back-dated lump sum payments (IR2019/530) | Released with redactions under section 9(2)(a) |
| 4. | Undated | Policy Commissioning paper – taxation of lump sum payments | Released in full. |

No public interest in releasing the withheld information has been identified that would be sufficient to outweigh the reasons for withholding.

The information you have requested also included some content outside the scope of your request. Where this is the case, the relevant sections have been marked as 'not in scope'.

Should you have any queries regarding the above, please don't hesitate to don't hesitate to contact Bary Hollow (Bary.Hollow@ird.govt.nz).

**Right of review**

If you disagree with my decision on your OIA request, you can ask an Inland Revenue review officer to review my decision. To ask for an internal review, please email the Commissioner of Inland Revenue at: CommissionersCorrespondence@ird.govt.nz.

Under section 28(3) of the OIA, you have the right to ask the Ombudsman to investigate and review my decision. You can contact the office of the Ombudsman by email at: info@ombudsman.parliament.nz.

**Publishing of OIA response**

Please note that Inland Revenue regularly publishes responses to requests that may be of interest to the wider public on its website. We consider this response is of public interest so will publish this response in due course. Your personal details or any information that would identify you will be removed prior to it being published.

Thank you for your request.

Yours sincerely

Carolyn Elliott
**Policy Lead - Tax Administration**
**Policy and Regulatory Stewardship**

Inland Revenue
Te Tari Taake

# POLICY AND STRATEGY

**Tax policy report:** **Income tax treatment of lump sum payments of weekly accident compensation**

| | | | |
|---|---|---|---|
| **Date:** | 8 February 2018 | **Priority:** | **Medium** |
| **Security level:** | In Confidence | **Report no:** | IR2018/075 |

## Action sought

| | Action sought | Deadline |
|---|---|---|
| Minister of Revenue | **Note** the contents of this report.<br>**Consider** whether the tax treatment of lump sum payments should be included in the refreshed tax policy work programme.<br>**Refer** a copy of this report to the Minister of Finance. | 15 February 2018 |

## Contact for telephone discussion (if required)

| Name | Position | Telephone |
|---|---|---|
| Paul Young | Acting Policy Manager | s9(2)(a) [redacted] |
| Kieran Mecredy | Senior Policy Analyst | |

Inland Revenue
Te Tari Taake

POLICY AND STRATEGY
*Te Wāhanga o te Rautaki me te Kaupapa*

***National Office***
*Level 8*
*55 Featherston Street*
*PO Box 2198*
*Wellington 6140*
*New Zealand*
s9(2)(a) [redacted]

8 February 2018

Minister of Revenue

# Income tax treatment of lump sum payments of weekly accident compensation

## Executive summary

1. The Accident Compensation Corporation (ACC) may make a lump sum arrears payment as a result of entitlement being in dispute, or otherwise taking time to establish. This report provides information about the income tax treatment of lump sum payments of weekly compensation made by ACC, and other types of lump sum payments.

2. Taxable lump sum payments are generally taxable to the recipient in the tax year in which they receive the payment. This "cash basis" approach simplifies the tax system, but means an individual who receives a lump sum payment may end up having to pay more income tax overall than if they had instead been receiving regular payments over the years to which the payment relates. Individuals who pay more tax may consider this unfair, especially if they are not to blame for the delayed payment.

3. You recently met with tax policy officials to discuss potential tax policy issues to be included in the refreshed tax policy work programme. The income tax treatment of lump sum payments was identified as a potential matter for inclusion (IR2018/028 refers). We consider that you should discuss with the Minister of Finance whether this matter should be included in the refreshed tax policy work programme and its priority.

4. A targeted measure for addressing the ACC issue would set a precedent and would likely lead to calls for tax relief for other types of lump sum payments. Therefore, we consider the scope of any further work on the income tax treatment of lump sum payments should include consideration of the tax treatment of lump sum payments more broadly.

5. There are numerous complexities with any measure to address perceived unfairness with the income tax treatment of lump sum payments, which would need to be thought through. These include the compliance cost and administrative implications, and the potentially complex flow on impacts for social assistance programmes.

6. This report outlines some initial options we have considered, should Ministers wish to give further consideration to the provision of tax relief for lump sum payments. These include a spread-back or some form of refundable tax credit. Potential options for changing the consequences of the receipt of a lump sum payment for social assistance programmes are also canvassed, although we consider that the outcomes for social assistance programmes under the status quo are appropriate because the approach to measuring income is premised on what is available for spending on day-to-day living.

## Recommended action

We recommend that you:

(a) **Note** that, under current tax law, recipients of lump sum payments of weekly compensation made by the Accident Compensation Corporation may face a higher income tax liability than if they had been paid their entitlements during the years to which they relate.

Noted

(b) **Note** that granting tax relief for one category of lump sum payments could lead to calls for tax relief for other types of lump sum payments.

Noted

(c) **Note** that consideration of the tax treatment of lump sum payments is included in the draft tax policy work programme that was recently discussed with you.

Noted

(d) **Consider** whether this matter should be included in the refreshed tax policy work programme, and its priority, as part of your discussions with the Minister of Finance on setting that programme.

Considered

(e) **Refer** a copy of this report to the Minister of Finance, for his information.

Referred

s9(2)(a) [redacted]

**Paul Young**
Acting Policy Manager
Policy and Strategy

**Hon Stuart Nash**
Minister of Revenue
/ /2018

## Context

7. At your meeting with tax officials on 25 January, you raised concerns about the current income tax treatment of lump sum payments of weekly compensation made by the Accident Compensation Corporation (ACC). This report provides further information on this and related issues.

## Background

8. Recent media articles have questioned the income tax treatment of back-dated lump sum payments made by ACC.[1] However, the issue raised is not a new one; officials have reported to previous Ministers of Revenue about it (for example, PAD2009/182 refers), and it has probably been around since the 1970s when the ACC scheme was established.

9. ACC may make a lump sum arrears payment as a result of entitlement being in dispute, or otherwise taking time to establish. ACC may make arrears payments because:

- assessment of weekly compensation can be complex, which can result in errors occurring that require changes to be made to past payments;
- complex claims that require the collection of detailed information may take time for a decision to be reached. Decision timeframes can be extended if the claim is in dispute and is challenged through the court process; and
- clients may seek a re-calculation of their weekly compensation after presenting new earnings information.

10. When officials looked at this issue, about a decade ago, data from ACC showed that arrears payments usually related to short periods and, in most cases, were for relatively small amounts (PAD2009/182 refers). However, in some cases, it can take several years from when a claim for weekly accident compensation payments is lodged with ACC, to when entitlement to those payments is established (for example, where a claimant pursues their claim successfully through the courts, following a rejection of the claim by ACC). Therefore, in some cases, ACC ends up making a large lump sum payment covering multiple years of entitlement to weekly accident compensation payments.

[1] See, for example, https://www.msn.com/en-nz/news/other/acc-claimants-losing-millions-under-tax-system-lawyer/ar-BBH2KRd?ocid=spartandhp; and http://www.newstalkzb.co.nz/news/national/injured-kiwis-stung-by-huge-tax-bills-after-receiving-acc-back-payments/.

## Current income tax treatment of lump sum payments of weekly accident compensation

11. Payments of weekly compensation made by ACC under the Accident Compensation Act 2001 (ACA) are generally assessable income of the recipient under the Income Tax Act 2007.[2] These payments are included within the definition of "salary or wages" in the PAYE rules, making them subject to the withholding of tax at source.

12. Taxable accident compensation payments are included in the recipient's assessable income in the income year in which they are derived. Recipients of accident compensation payments are generally taxed on a "cash basis" rather than on an "accrual basis". For these individuals, income is derived in the income year it is received.

13. Taxing on a cash basis simplifies the tax system by removing the need for the vast majority of individuals to calculate income that has been earned but not yet paid at year-end. However, the cash basis approach means an individual who receives a lump sum accident compensation payment may end up having to pay more income tax overall than if they had instead been receiving regular payments of weekly accident compensation over the time since their accident occurred. This will occur if the lump sum payment pushes the individual into a higher income tax bracket (in the case of large lump sum payments, the majority of the payment may end up being taxed at the top rate of 33%). It could also occur if tax rates were higher during the year the lump sum payment was received than during the relevant back-years. Individuals who pay more tax may consider this unfair, especially if they are not to blame for the delayed payment.

## Other analogous scenarios involving lump sum payments

14. It is important to be aware that accident compensation payments are not the only type of lump sum payments that can result in the recipient having to pay more income tax overall than if the amount of the lump sum had instead been paid the same amount in instalments over multiple income years. Just last year, the previous Minister of Revenue asked officials for advice on this issue in relation to lump sum remedial payments of employment-related entitlements, following the discovery of apparently widespread miscalculation of entitlements under the Holidays Act 2003 (and, in some cases, miscalculation of entitlements under employment agreements). Following the advice officials provided (T2017/1812, IR2017/397 refers), it was noted by Cabinet that:

> [T]ax policy officials will consider how the potential fairness concerns arising from the timing of lump sum payments could be addressed as part of stage 2 of Inland Revenue's Business Transformation Programme, and will report back to the Minister of Finance and the Minister of Revenue in due course. [CAB-17-MIN-0427]

15. Similar issues may arise with other lump sum payments, such as redundancy payments, bonuses, payments made by the Ministry of Social Development (MSD), and payments of back-dated salary or wages ordered by the Employment Relations Authority or Employment

[2] The exception is payments that are recovered or recoverable under section 248 of the Accident Compensation Act 2001 (for example, overpayments).

Court (for example, upon a successful personal grievance claim for unjustified dismissal, or for a breach of the Minimum Wage Act 1983).

16. It should be noted that the receipt of a back-dated lump sum payment will not necessarily result in the recipient facing a higher overall income tax liability. The payment may relate entirely to the current tax year or, although some may relate to earlier years, it may make no difference to the individual's overall income tax liability. Moreover, in some cases, an individual may face a lower overall income tax liability from having a lump sum payment taxed in the year of receipt compared to if they had been paid their entitlements in the correct years (for example, if they had since retired).

17. You recently met with tax policy officials to discuss potential tax policy issues to be included in the refreshed tax policy work programme. The income tax treatment of lump sum payments was identified as a potential matter for inclusion (IR2018/028 refers). We consider that you should discuss with the Minister of Finance whether this matter should be included in the refreshed tax policy work programme and its priority.

### Social assistance implications arising from lump sum payments

18. Taxable lump sum payments received by individuals will also be recognised as income for social assistance purposes when the payment is received. This means a lump sum payment received this year to compensate for under-payments over a number of prior years could reduce entitlements to Working for Families tax credits, change child support obligations, and reduce payments or remove eligibility for assistance administered by MSD. These outcomes may also seem unfair to individuals who receive such payments. However, because the approach to measuring income for those programmes is premised on measuring a family's or individual's economic income – that is, income that is readily available for spending on day-to-day living needs – we consider that these outcomes are appropriate.

## Discussion of tax relief measures

19. It will be important to bear in mind other scenarios involving lump sum payments, in considering whether you wish to make any legislative change to the income tax treatment of lump sum payments of weekly compensation made by ACC. A targeted measure for addressing the ACC issue would be easier to implement (given that it involves payments from only one government agency, rather than potentially any employer), but would set a precedent and would likely lead to calls for tax relief for other types of lump sum payments. Therefore, we consider the scope of any further work on the income tax treatment of lump sum payments should include consideration of the tax treatment of lump sum payments more broadly.

20. There are also numerous complexities with any measure to address perceived unfairness about the income tax treatment of lump sum payments, which would need to be thought through. Some of these are discussed below.

21. One solution to the concern raised would be to allow back-dated lump sum payments to be spread back over the relevant income years. This would involve amending income records for previous periods to spread back the payment. This would impose additional costs on whoever is required to provide Inland Revenue with information about how much of the lump sum payment relates to each year. It would also impose additional administrative costs as it would require Inland Revenue to manually reopen and reassess income tax returns for previous periods. A further complication is that many of the lump sum payment recipients will not have filed income tax returns for all the relevant back-years, given that over 40% of employees were non-filing taxpayers in any given year. A spread-back would also have complex flow on impacts for social assistance programmes. For example, it could increase the lump sum payment recipient's social assistance obligations, and reduce their entitlements, in respect of affected back-years.

22. Due to the complexities associated with a spread-back, we consider that a simpler approach would be to separate the tax and social assistance impacts, and consider options for each discretely. Annex 1 outlines some alternative options we have considered. An overview of these is shown in the table below:

| **Tax** | **Social assistance** | |
|---|---|---|
| | **Inland Revenue administered** | **MSD administered** |
| A refundable tax credit based on:<br>• calculating the exact difference in overall income tax liability (option 1);<br>• comparing an individual's marginal tax rate in the year of the lump sum payment with their average marginal tax rate over affected back-years (option 2); or<br>• comparing an individual's marginal tax rate in the year of the lump sum payment with their marginal rate for that year excluding the lump sum payment (option 3). | Amending the definition of income used for Working for Families tax credits, child support, and/or student loans to exclude lump sum payments. | Excluding lump sum payments from the definitions of "chargeable income" and "cash assets".<br><br>Chargeable income is the definition of income used for assessing entitlement to main benefits, supplementary assistance, and hardship assistance.<br><br>Cash assets are considered in assessing entitlement to supplementary assistance (including the accommodation supplement, and temporary additional support), and hardship assistance, which are asset-tested. |

## Revenue implications

23. Changes to the income tax treatment of lump sum payments to address the fairness concerns will have a revenue cost. The size of this would depend on the types of lump sum payments within scope. Further work would be required before Inland Revenue would be able to provide fiscal cost estimates for the options presented.

## Administrative implications

24. The feasibility of the options presented is dependent on Inland Revenue being able to implement them. As noted in the discussion of potential options to address fairness concerns about the income tax treatment of lump sum payments, implementing any of these options will have administrative cost implications for Inland Revenue. The extent of the additional administrative costs would depend on the option and the number of payments. Further work would be required to assess the feasibility of implementing the options and the administrative impacts of doing so. There would also be administrative cost implications for any government agencies making affected lump sum payments (for example, ACC). The administrative implications for MSD would also have to be carefully considered.

## Compliance costs

25. Granting tax relief for back-dated lump sum payments will inevitably involve some additional compliance costs. Additional compliance costs would be imposed on the party that is responsible for providing information about the payment to Inland Revenue (including, where applicable, how much of it should be attributed to each tax year). Under a spread-back method, affected individuals would face compliance costs from having to file income tax returns for prior years for which they had not previously filed returns. It would be possible to allow taxpayers a choice about whether to seek tax relief for lump sum payments. Taxpayers for whom the compliance costs outweighed the benefit of the tax relief could choose not to apply for tax relief.

## Consultation

26. The Treasury, MSD, ACC, and the Ministry of Business, Innovation, and Employment were consulted.

## ANNEX 1 – OPTIONS FOR PROVIDING TARGETED RELIEF

### Refundable tax credit

27. A refundable tax credit to individuals disadvantaged could provide the benefit of the lower tax had the payments been made at the correct time. There are a range of options for how to calculate the amount of the tax credit. The options trade-off accuracy with simplicity:

- ***Option 1*** – The most accurate approach would be to calculate whether the individual's income tax liability if the lump sum payment is taxable in the year of receipt is greater than if the person's entitlements had been paid in the correct tax years. If so, the difference would be available to the individual as a refundable tax credit. This approach would be difficult to administer as it requires Inland Revenue to collect the relevant information from either the payer or recipient, and it would require returns to be filed for all affected back-years.
- ***Option 2*** – A simpler approach could be to compare the marginal tax rate on a lump sum payment (treating it as the last dollars earned) with the individual's average marginal tax rate for the affected back-years. If the marginal tax rate on a lump sum payment is higher than their average marginal tax rate, then a tax credit would be calculated by multiplying the difference in rates by the amount of the lump sum payment.
- ***Option 3*** – The simplest option would be to compare an employee's marginal tax rate on their income in the year of the lump sum payment with their marginal rate for that year excluding the lump sum payment. If the rate when excluding the payment is lower, a tax credit would be calculated by multiplying the portion of the lump sum payment that had been taxed at the higher marginal tax rate by the difference between the marginal tax rates.

### Adjusting income for Inland Revenue administered social assistance

28. The definition of income used for Working for Families tax credits, child support, and/or student loans could be amended to exclude such back-dated lump sum payments.[3] The income definition used for these programmes is a tax measure with adjustments to ensure the measure of income reflects an individual's actual earnings or available financial resources. In the majority of cases, the income a person has for tax purposes will be the same as that used for social assistance purposes.

29. Inland Revenue will not necessarily be able to pro-actively identify individuals who receive a lump sum payment and therefore have a reduced entitlement to Working for Families tax credits, or a change to child support obligations. Those individuals will need to notify Inland Revenue of their adjusted family scheme income at the end of the year when Inland Revenue issues a personal tax summary or requests an income tax return. Upon such a notification, Inland Revenue will need to manually re-calculate these obligations and entitlements. As the likely number of individuals in receipt of lump sum payments is unknown, we are unable to estimate the impact on Inland Revenue's service delivery area.

[3] Student loan repayment deductions from salary or wages are generally full and final, so it may not be desirable to make a year-end adjustment for student loan purposes.

**Excluding lump sum payments from "chargeable income" and "cash assets" for MSD administered social assistance**

30. When clients are underpaid over a period and are then reimbursed, MSD is required to consider this payment as income for the purposes of main benefits, supplementary assistance, and hardship assistance. A lump sum payment would be considered as income for the period in which the client received the income. Therefore, without a legislative change, MSD would need to reassess the client's income and entitlements for the affected period.

31. Any lump sum payment would also be considered a cash asset. This could affect a client's supplementary assistance entitlement. For example, Accommodation Supplement and Temporary Additional Support have asset cut-out points of $8,100 and $1,062 respectively (for a single client). Other forms of hardship assistance are also asset-tested.

32. Depending on the amount received, lump sum payments could either reduce assistance or remove eligibility for MSD clients. When back-payments of wages were paid following the enactment of the Sleepover Wages (Settlement) Act 2011, an exemption was put in place to exclude these payments from income and cash asset tests. This requires Cabinet approval and an amendment to the Social Security (Income and Cash Assets Exemptions) Regulations.

Inland Revenue
Te Tari Taake

**POLICY AND STRATEGY**

# Tax policy report: Proposed consultation approach for back-dated lump-sum payments

| | | | |
|---|---|---|---|
| **Date:** | 17 October 2019 | **Priority:** | Medium |
| **Security level:** | In Confidence | **Report number:** | IR2019/530 |

## Action sought

| | Action sought | Deadline |
|---|---|---|
| Minister of Revenue | **Agree** to recommendations.<br>**Note** the contents of this report.<br>**Refer** a copy of this report to the Minister of Finance for his information. | 4 November 2019 |

## Contact for telephone discussion (if required)

| Name | Position | Telephone |
|---|---|---|
| Mike Nutsford | Policy Lead | s9(2)(a) [redacted] |
| Susanna Berry | Senior Policy Advisor | |

17 October 2019

Minister of Revenue

## Proposed consultation approach for back-dated lump-sum payments



### Purpose

1. This report seeks your agreement to public consultation on the tax treatment of back-dated lump-sum payments. This report also outlines the main policy issues to be considered.

### Background

2. The Tax Policy Work Programme includes a project exploring an alternative tax treatment for back-dated lump-sum payments. Back-dated lump-sum payments relate to multiple tax years and are paid in a lump sum in a later tax year.

3. Current legislation provides that lump-sum payments are generally taxed on a cash basis in the year they are received. This means that a different tax outcome may apply than if the payment had been paid out over the years for which it was made. Taxing on receipt can give rise to fairness concerns, particularly for payments where the recipient is not to blame for the delayed payment and may end up with a higher overall tax liability for the payment.

4. There are a range of different forms of lump-sum payments. Back-dated lump-sum Accident Compensation Corporation (ACC) payments is a particular concern. Other types of lump-sum payments include redundancy payments, payments made by the Ministry of Social Development (MSD), and payments of back-dated salary or wages ordered by the Employment Relations Authority or Employment Court (for example, on a successful personal grievance claim for unjustified dismissal, or for a breach of the Minimum Wage Act 1983).

### Consultation process

5. We propose a two-stage consultation process to support policy development of potential solutions.

6. The first stage of consultation would focus on understanding wider implications for employers and payers, particularly identifying the scope of payments that should be covered and potential compliance costs on payers of lump-sum payments.

7. This initial consultation would help refine potential solutions and their trade-offs. Proposed options would then be consulted on in a consultation document, which would be prepared for release in the first quarter of 2020.

### Problem definition and key considerations

8. A back-dated lump sum could push the recipient into a higher tax bracket resulting in over-taxation and fairness concerns which would not apply if the payment was spread over the years to which it relates.

9. There are three broad policy decisions for consideration as part of this project.

   (a) ***Which payments should be eligible*** for any alternative tax treatment;

   (b) ***What tax treatment should apply*** – this considers:

   - how to approximate the appropriate tax outcome for the payment;
   - flow-on impacts, such as how social policy obligations and entitlements should be calculated; and
   - transitional measures, including whether there should be a distinction in treatment of payments relating to income years prior to the new tax rules for individuals.

   (c) ***How the tax treatment should apply*** – whether the payer should apply a different withholding treatment, or whether the payee should apply for an interim or end-of-year solution.

10. We expect that any solution to address the fairness issue will have a fiscal cost. The cost will depend on the design and detail of the solution, including the eligibility criterion for payments. Consultation is required to understand what other types of payments could be eligible. In addition, the tax impact on individuals will vary based on the income distribution of recipients and their marginal rates. Further detailed analysis will be required to obtain fiscal costings as this project progresses.

11. As an initial indication focusing on ACC payments, we note that in the 2018-2019 tax year, ACC paid a total of $42 million that was part of a lump-sum payment to clients of $5,000 or more and which span more than one tax year. If we assume that 50% of the amount was taxed at a higher tax rate than it would have been if paid over multiple years and that the difference between the rates that should have applied is the difference between the second lowest rate of 17.5% and the top rate of 33%, this indicates that $21 million was taxed at a tax rate 15.5 percentage points higher than it should have been. If a solution looks to apply the correct marginal rate to these ACC payments, this could cost approximately $3.3 million per year.

## Initial consultation

12. There are two areas where we consider that early consultation would be beneficial: the scope of eligible payments and compliance costs for the payers. This initial consultation will help inform trade-offs and options to be canvassed in the proposed consultation document.

### *Eligible payments*

13. There are two broad options for considering the eligibility of payments: an open-ended criterion, where any payment relating to multiple tax years could be eligible for an alternative tax treatment, or by individually listing payment types.

14. It may be desirable for some types of back-dated lump-sum payments not to be eligible for alternative tax treatment if they are intended to be made as a lump sum at the outset (for example, a bonus).

15. Consultation with other government agencies and private sector organisations is important to understand what types of back-dated payments are made assist us to consider the scope of eligible payments and how these payments are defined.

***Withholding treatment and information provision in year***

16. The administration of any type of tax relief must consider whether an alternative withholding rate should be applied for eligible back-dated payments to provide a better outcome when the payment is made, or whether it is appropriate that tax relief should be applied at the end of the tax year, and current withholding rules remain unchanged.

17. There is a clear trade-off between compliance costs for the income payer and getting the most accurate outcome for the payee within the year.

**Proposed two-stage consultation approach**

18. At the initial stage we intend to consult with both the private sector and government agencies. The government agencies we have identified and are commencing discussions with are ACC, MSD and the Ministry of Business, Innovation and Employment (MBIE). In the private sector we would like to consult with representative groups including Chartered Accountants Australia and New Zealand (CA ANZ), the Corporate Taxpayers Group and Business New Zealand.

19. We consider initial consultation with these stakeholders on the implications of the high-level decisions regarding eligibility of payments, and whether any alternative tax treatment should be applied by withholding tax or applied at the end of the year with key stakeholders. In order to refine these options, it is important to understand current business practices and the likely compliance costs.

20. This initial consultation would take place with these stakeholders on an informal basis, and would help to refine proposed criteria for consultation on the detail of the proposal in the form of a consultation document.

**Next steps**

21. Officials will consult with key stakeholders on the scope and compliance costs to help inform the trade-offs and prepare a consultation document on the issue. The proposed timeline is:

- initial consultation – November 2019;
- officials prepare consultation document – November – December 2019;
- report to Minister on themes from initial consultation and approval to release consultation document – February 2020;
- draft consultation document to Cabinet – early March 2020;
- release of consultation document – March 2020;
- report back to on the outcome of consultation and for policy decisions – May 2020; and
- inclusion in the next available tax bill.

**Consultation**

22. Treasury has been consulted on this report.

## Recommended action

23. We recommend that you:

(a) **Note** the contents of this report;

Noted

(b) **Agree** that officials should consult with key stakeholders on the high-level design decisions outlined in this report;

Agreed/Not agreed

(c) **Agree** that officials should commence drafting a consultation document;

Agreed/Not agreed

(d) **Refer** a copy of this **report** to the Minister of Finance for his information.

Referred/Not referred

s9(2)(a)

**Mike Nutsford**
Policy Lead
Policy and Strategy

**Hon Stuart Nash**
Minister of Revenue
/ /2019

Inland Revenue
Te Tari Taake

**Policy and Strategy**
***Te Wāhanga o te Rautaki me te Kaupapa***

# File note

| | |
|---|---|
| Date: | 17 July 2018 |
| Author: | Paul Young |
| Subject: | Individuals Income Tax – Meeting with Mike Shaw and Robin Oliver |

This meeting was arranged to discuss Mike's questions sent after the CAANZ session on the individuals income tax changes and the TAA changes held on Thursday 12 July 2018. As a couple of the other TAG members in Auckland had, Mike commented that it had been a very useful meeting. The list of questions is attached at the end of the file note.

Not in scope



**Robin and Mike's topics of concern**

Robin commented that given we are walking a path towards greater accuracy with the changes we are making there was a need to tidy up some areas where the law doesn't seem to work:

*ACC issues*

Robin spoke about lump sum payments of backdated weekly compensation from ACC. Where a person receives compensation to pay for care and pays the money on to carers it is not taxable to the initial recipient however where a person receives a lump sum backdated payment for care services and the person has paid carers in prior years they cannot offset the payments made in prior years against the lump sum received. This can give the recipient a tax liability and often the payments are large so will be taxed at higher rates of tax whereas if they had received the payments on a weekly basis from the outset they would have no tax liability.

Not in scope

**Mike's e-mailed list of questions:**

Not in scope

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Not in scope



10 Not in scope

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12 ACC care payments. If a taxpayer receives say $20k, but onpays say $5k, I assume adjust the IRD income from $20k to $15K? I assume the recipient of the $5k puts this in as additional income (with 10.5% PAYE deducted) even though IRD says there is no such income?

# Policy Commissioning Paper –taxation of lump sum payments

## Description of policy issue(s)

This document summarises the following potential issues for consideration on the taxation of lump sum payments:

- How fairness concerns arising from the current tax treatment of lump sum payments that span a number of tax years can be addressed; and
- The more technical issue of back-dated lump-sums and how they should be treated for PAYE purposes (e.g., whether they should be treated as an extra pay)

The tax treatment of lump sum payments is currently listed on the current tax work programme under business transformation. This paper recommends that this issues' inclusion is re-affirmed on the tax policy work programme and that the project is allocated and progressed with a medium priority. This paper also recommends that the technical issue of whether back-dated payments should be treated as extra pay be included on the tax policy work programme with a low priority.

### Fairness concerns with the taxation of lump sum payments

Under current tax law a lump sum employment income payment is subject to income tax (including PAYE) when the payment is made/received. Lump sum payments may include employment income that covers a number of income years, for example, a lump sum payment of ACC weekly compensation which covers a number of tax years due to a dispute over entitlement. This gives rise to fairness concerns due to possible over-taxation in the year received compared to if the payment had been received in the relevant years that it relates to.

One example of backdated lump sum payment which is commonly raised is ACC back-payments; these payments have been the subject of multiple ministerials over the past 2 years, and have been raised in submissions on tax bills. However, other payments with similar characteristics should also be considered, for example payments made by MSD.

### Whether back-dated payments should be treated as extra pay

A recent IR interpretation of the law about the tax treatment of payments of back-dated holiday pay potentially raises policy issues about the tax treatment of a broader range of back-dated lump payments[1], such as:

- Whether back-dated lump sum remedial payments of entitlement under other enactments (such as minimum wage legislation) should also always be taxed as an extra pay; or
- Whether all back-dated lump sum payments of salary or wages should be taxed as an extra pay.

Recent changes to tax legislation clarified that back-dated remedial payments of entitlements under the Holidays Act 2003 and/or an employment agreement should be treated as extra pay for the purpose of the PAYE rules. This technical issue would consider whether this treatment should be extended to clarify this treatment for any other types of back-dated payments.

[1] https://www.ird.govt.nz/technical-tax/op-positions/op-position-calculating-paye-holiday.html

# Policy context and purpose

## Ministerial engagement

We have discussed the fairness concerns relating to lump sum payments with Ministers on several occasions.

**July 2017** This matter was discussed with Ministers in the context of the holiday pay entitlements being miscalculated by numerous employers in both the private and public sector and the need for employers to make remediation lump sum payments.

The Cabinet paper Withholding tax treatment of backdated remedial payments of employment related entitlements (EGI-17-MIN-0228) noted that policy officials will consider the how potential fairness concerns arising from the timing of lump sum payments could be addressed as part of IR's business transformation and officials would report back to Ministers in due course.

**February 2018**: Officials reported to the Minister of Revenue in February 2018 seeking consideration for whether the matter should be included in the refreshed tax policy work programme.

**January 2019**

CA ANZ raised the issue over-taxation of lump payments in their submission on the *PAYE error correction and adjustment* issues paper and suggested in relation ACC weekly compensation that recipients should have the option of having it taxed in the year it relates to or taxed when it is paid. Officials responded to the submission as follows:

*Officials consider that the issues need to be looked at in a wider framework to ensure other payments of a similar nature are also considered as part of potential options to create an ability to spread payments over years to which they relate for the purposes of tax.*

*Officials note that this submission raises issues that would require prioritising and resourcing as part of the Government's tax policy work programme.*

# Private sector comments/views

## Fairness issue

As noted above, the issue was raised by CAANZ in their submission on the Taxation (Annual Rates Modernising Tax Administration and Remedial Matters) Bill.

OliverShaw in their submission on the BT individuals' discussion document discussed the issue of the taxation of ACC lump sum payments spanning a number of tax years. This was in the context of personal service rehabilitation payments. This point was also raised in their submission on the Taxation (Annual Rates Modernising Tax Administration and Remedial Matters) Bill.

## Back-dated payments treated as an extra pay

Business NZ, in relation to the back-payment of holiday pay issue, emphasised the need for consistency of approach and indicated that they thought all back-dated payments of the types of payments included in the tax definition of salary or wages should be treated as an extra pay.

## Public sector comments/views

Both ACC and MSD have raised concerns with the tax treatment of back-payments of weekly compensation, benefits and NZ superannuation. MSD considers that they are required to apply to the tax rates that applied during the benefit and NZ superannuation entitlement period to any adjustment to benefits and NZ superannuation and are looking at changes their systems to reflect this.

## Framework and assumptions

A well-established tax principle is that employment income is earned on a cash basis – that is when the payment is received / paid. This means that PAYE is withheld when the payment is made by an employer and is derived by the employee when the payment is received.

The officials' issues paper *PAYE error correction and adjustment* discussed the tax treatment of underpayments of PAYE income and noted the officials were not proposing to change the above principle[2].

The two issues arose in the context of the miscalculation of holiday pay. They are distinct issues and can be progressed separately. The fairness issue can be viewed a significant policy issue as it may impact on employers and employees and may require changes to a fundamental tax principle – this will depend on possible solutions.

### Fairness issue from lump sum payments which relate to multiple tax years

A key trade-off in relation to the over-taxation and fairness issue will be where the compliance costs fall in terms of possible solutions – on the employer or the employee and what role can IR play. In addition, there is revenue / fairness trade-off as allowing this income to be spread over multiple years is likely to have revenue implications. It is important to provide a consistent framework which may be applied for all relevant lump sum payments, rather than addressing one type (e.g., ACC payments) in isolation.

### Clarification of back-dated payments as extra pay

Tax rules should be simple to understand and provide certainty – treating all back-payments as an extra pay could reduce compliance costs and increase certainty. It is less likely that PAYE will be over-withheld if a lump sum payment is treated as an extra pay compared with salary or wages. If a lump sum payment is treated as salary or wages the calculation of the amount of tax to be withheld from the payment would be based on the assumption that the back-payment represented a permanent increase in salary or wages, rather than an additional one-off payment.

The back-dated payments issue is more of technical issue clarifying the law to provide certainty and reduce compliance costs.



[2] http://taxpolicy ird.govt.nz/publications/2017-ip-paye-error-correction/chapter-3 - Paragraphs 3.17 to 3 19.

# Policy impact and quality

## Materiality

Without undertaking evidential surveys of employers including ACC and MSD on the number and size of lump sum payments that span tax years we have limited information to assess the materiality of the issues.

## Scope

### *Fairness issue*

There is the question of whether this issue should just focus on income tax or should it include social policy programmes administered by Inland Revenue. The inclusion of social policy programmes such as WfFTCs would broaden the scope of the project and depending on solutions could have a negative (fiscal impact on customers) in terms of back years.

Types of lump sum payments which relate to back-years include:

- accident compensation payments (ACC)
- payments made by MSD
- back-dated salary or wages ordered by the Employment Relations Authority or Employment Court

There may also be other types of lump sum payments relating to back-years, including under pay equity legislation.

The February report to the Minister discussed several options for an alternative tax treatment for lump sum payments. Two of the key issues are whether

- Back-dated lump sum payments should be spread back over relevant income years.
- If tax and social assistance (both IR and MSD administered) impacts should be separated

If alternate treatments are warranted, an additional issue is who should have to obtain the alternative treatment: whether that is the payer, payee or if Inland Revenue is able to recognise these types of payments and intervene. If the payer (e.g., MSD or ACC) has to apply a different treatment for calculating the tax, it would incur administrative costs for these other agencies.

### *PAYE treatment of Back-dated payments*

The scope should be limited to backdated-payments of PAYE income that could be treated as salary or wages.

## Interdependencies

The BT individuals' project is focusing on ensuring that withholding tax deducted during the year is more accurate. These two issues therefore have some interrelationship with this BT project.

# Policy approach and collaboration

## Timeframes and key milestones

A decision is sought as to whether these matters should be included on the tax policy work programme. In terms of priority and the Government's focus that everyone pay their fair share, according to their means, the fairness issue should have a higher priority than the back-dated

Not in scope

payment issue.  If tax is over-withheld on back-dated payments the customer will receive a tax refund at the end of the year. Based on the above analysis, the following priority should be afforded to these issues:

- Over-taxation /fairness – medium to high
- Back-dated payments - low

## Collaboration

*Fairness* - Some early collaboration with key stakeholder to better understand the problem definition and the options to address the potential over-taxation.  This early collaboration would focus on the trade-off of where the compliance costs fall – the employer, the employee and Inland Revenue.

Key stakeholders include CA ANZ, Business NZ, NZLS, CTG, ACC and MSD.

There will be some merit in understanding the scope of START as to whether solutions that focus on the employee rather than the employer can be delivered.

We have had initial conversations with SD&I around the potential impact of this project. It is important to keep SD&I involved in order to understand the opportunities or impacts from any potential solutions. A PIA may be required.

*Back-dated payments* – Some early collaboration with key stakeholders to better understand the priority of issue would be beneficial.  We are engaging with MSD currently on adjustments to benefit and NZ superannuation entitlements.

There may be some merit in seeking some technical/legal advice on the scope of the current law in whether a back-payment of salary or wages is an extra pay or a payment of salary or wages.

## **Recommendations**

It recommended that:

(a) The fairness issue be included in the refreshed tax policy work programme with a medium priority

(b) The lump sums being treated as an extra pay issue be included on the tax policy work programme as an unallocated issue with a low priority or be considered as a remedial item.