Inland Revenue
Te Tari Taake

QUESTION WE'VE BEEN ASKED

QB 19/03

Provisional tax – impact on employees who receive one-off amounts of income without tax deducted

This Question We've Been Asked (QWBA) considers the impact of the provisional tax rules on employees who receive one-off amounts of income not taxed at source.

Key provisions

Income Tax Act 2007 (ITA), ss RC 2(2), RC 3, RC 4, RC 5, RC 7, RC 9(9), RC 12

Tax Administration Act 1994 (TAA), ss 3(1) ("new provisional taxpayer") 120KB, 120KBB, 120KE

Key terms

Provisional Tax: income tax paid as instalments

Residual income tax:

Income tax liability minus tax credits

Terminal tax date: Generally, 7 February of the following tax year

Use-of-money interest: money charged on late or underpaid tax or paid on overpaid tax

Question

What are the provisional tax implications when a person earning salary or wages subject to PAYE receives a one-off amount of income without any tax withheld and their residual income tax exceeds $2,500?

Answer

An employee who receives an amount of income without tax withheld and whose residual income tax exceeds $2,500 is a provisional taxpayer even **if their prior year's** residual income tax was $2,500 or less.

If the residual income tax is $60,000 or more, the person will be exposed to use-of-money interest if they do not pay provisional tax instalments.

If their residual income tax is less than $60,000, the person will not have exposure to use-of-money interest provided they pay the residual income tax on or before the terminal tax date.

If they file a tax return they will need to indicate in that return what provisional tax method they will use for the following year and make the instalments accordingly.

If their tax position is automatically calculated, they will be treated as required to pay provisional tax in the following year under the standard method and notified accordingly before each instalment date, unless they elect to use the estimation method.

If their residual income tax in the following year is $2,500 or less, they will not be a provisional taxpayer, but will still have an obligation to pay instalments under either the standard or estimation methods.

Explanation

1. This Question We've Been Asked has arisen because salary and wage earners can sometimes receive significant one-off lump sum amounts of income without tax deducted at source, such as:

   - an amount of recovered depreciation on the sale of a rental property;
   - the receipt of beneficiary income from a trust where s HD 4(b) of the Income Tax Act 2007 (ITA) applies;
   - the transfer of shares to an employee under an employee share scheme where the employer has chosen not to deduct PAYE; and
   - gains made on the redemption of a bond that has been acquired at a discount to face value.

2. Because such people have PAYE deducted at source on their normal income, and do not usually have residual income tax exceeding $2,500, they may not have previously been a provisional taxpayer.

3. If they continue as employees in the tax year in which they receive the one-off amount of income, they will not be classed as a "new provisional taxpayer" under the Tax Administration Act 1994 (TAA) (identified as a "person who has an initial provisional tax liability" under the ITA). However, if the one-off income amount without tax deducted results in residual income tax that is over $2,500 the person will become a provisional taxpayer (as defined in the TAA) because they are a person who is liable to pay provisional tax under s RC 3(1) of the ITA.

4. It is common for people in this situation (who have filed their return by 7 July) to have had residual income tax of $2,500 or less in the year before they receive the one-off amount of income. This means that s RC 3(3) of the ITA applies, so they have "no obligation to pay provisional tax" in the income year in which they derive the one-off amount of income.

5. This Question We've Been Asked explores what having "no obligation to pay provisional tax" means in a practical sense and what the consequences are in terms of interest exposure if provisional tax is not paid or is voluntarily paid when residual income tax is $60,000 or more. It also examines the implications for a person if their residual income tax is less than $60,000. Finally, it discusses the following tax year provisional tax consequences in both instances.

Application of provisional tax rules to one-off amounts of income where no tax has been deducted

6. A salary and wage earner with PAYE deducted at source will become subject to the provisional tax rules if they have residual income tax that exceeds $2,500 in any tax year. Section RC 3(1) of the ITA makes such a person liable to pay provisional tax for that tax year, so they are a "provisional taxpayer" as defined in s 3(1) of the TAA. A person who is liable to pay provisional tax then has a choice of methods to calculate the tax payable under s RC 5 of the ITA. For an employee receiving a one-off income amount the choice is practically limited to the standard method or the estimation method or a combination of the two methods.

7. If that person has had residual income tax of $2,500 or less in the prior tax year, s RC 3(3) of the ITA applies, and they will have "no obligation to pay provisional tax" in the relevant tax year. The intention behind this provision is to provide flexibility for taxpayers who will often have difficulty predicting receipt of income that has had no or insufficient tax deducted. It does not, however, remove them from the provisional tax

rules as they continue to retain their status as a provisional taxpayer under the TAA by being "liable to pay provisional tax" under s RC 3(1) of the ITA, despite having no obligation to pay provisional tax under s RC 3(3) of the ITA.

8. A person who chooses to pay provisional tax under s RC 4 of the ITA is also treated under s RC 3(1)(b) of the ITA as a person liable to pay provisional tax. Section RC 2(2) of the ITA re-emphasises that "the provisional tax rules apply to a person who is required or who chooses to pay provisional tax". Choosing to pay can assist with mitigating exposure to use-of-money interest when residual income tax is $60,000 or more.

Application of provisional tax rules when residual income tax on income without tax deducted is $60,000 or more

9. Because the prior year residual income tax was $2,500 or less, an employee who has residual income tax of $60,000 or more arising from receipt of income without tax deducted at source has no obligation to pay provisional tax on instalment dates. However, such a person may choose to pay provisional tax using a method prescribed by s 120KBB of the TAA to limit exposure to use-of-money interest. Voluntary payments of the expected residual income tax amount by the last instalment date will mitigate exposure to use-of-money interest.

10. To be eligible for use-of-money interest relief, the person must be an "interest concession provisional taxpayer." This expression is defined in s 120KBB(4)(a) of the TAA:

> interest concession provisional taxpayer means a person that is liable to pay provisional tax for an income year if—
>
> (i) the person uses 1 of the standard methods described in section RC 5(2) or (3) of the Income Tax Act 2007 for the tax year:
>
> (ii) the person uses the estimation method described in section RC 5(5) of that Act but their payments of provisional tax on or before the instalment dates for the tax year, other than the last 1, are not under the estimation method and are equal to the amounts given by section RC 10 of that Act, using section RC 10(3)(a)(i) or (ii) as applicable, for those relevant instalments:

11. Under s 120KBB of the TAA, if the person adopts the standard method and they top up their last instalment payment to pay any difference between the residual income tax and the three instalment payments made, they will not have any exposure to use-of-money interest. For taxpayers with a standard 31 March balance date, these provisional tax instalments are on 28 August (P1), 15 January (P2) and 7 May (P3).

12. If the person had no residual income tax assessed the previous year or their residual income tax was $2,500 or less in that year, their instalment payments using the standard method at P1–P3 will be zero on each occasion. The standard method is the default option, so if the person does not advise Inland Revenue of the option selected this is what they will be treated as having adopted. They can then top up the instalment made on P3 to ensure they pay the entire residual income tax for the current year on that date. If this course is followed, the person will be exposed to use-of-money interest from P3 if they underpay, or entitled to credit interest if they overpay, the RIT on or before P3. If they did have residual income tax exceeding $2,500 in the prior year, then they must pay the amounts identified in [11] above at each of P1–P3 plus top up to the full residual income tax amount at P3, to not be exposed to use-of-money interest.

13. A further option to obtain the interest concession is to use the standard method for the P1 and P2 instalments and on or before P3 switch to the estimation method. There is still a requirement to top up the P3 payment by the balance required to pay the residual

income tax less the value of instalments paid at P1–P3 to manage the use-of-money interest exposure. However, this option will provide more flexibility for a person who expects their residual income tax to be lower than the prior year or who does not know what their residual income tax is by P3 (usually on 7 May) even though this is some time after the standard balance date of 31 March.

Application of provisional tax rules when residual income tax on income without tax deducted is under $60,000

14. Employees whose income without a tax deduction results in residual income tax of less than $60,000 may avail themselves of the use-of-money interest safe harbour under s 120KE of the TAA by making payment of all the residual income tax in one instalment on the terminal tax date. For most taxpayers with a standard 31 March balance date this is 7 February the following year. This can be extended if their tax account is linked to a tax agent with an extension of time.

15. A person who meets this criterion will qualify for this safe harbour if they have no obligation to pay provisional tax under s RC 3(3) of the ITA because their residual income tax for the prior year was $2,500 or less.

16. They will also qualify where they did have residual income tax over $2,500 in the prior year but paid all amounts due on or before P1–P3 using the standard method set out in ss RC 5(2) and (3) of the ITA and calculated under the formula in s RC 10(2) of the ITA. Refer to Inland Revenue Department NZ, *Provisional tax, Paying your income tax in instalments* IR289 for more detail on the standard method (the standard option).

17. This terminal tax safe harbour is not available if the person has adopted the estimation method to pay their provisional tax under s RC 7 of the ITA.

Provisional tax consequences in the following tax year

18. As a result of having residual income tax that is over $2,500 in a tax year, a person has an obligation to pay provisional tax the following year. If their tax position has been automatically calculated, they will be advised in that following tax year to pay provisional tax on instalment dates based on the standard method unless they elect to use the estimation method. Such an election can be made using secure email via myIR or by phone or letter. If they file a tax return in the year when they derived the one-off income and their residual income tax exceeded $2,500, they must in that return indicate what provisional tax method they will adopt for making payments in the following tax year.

19. Often an employee in receipt of a one-off amount of income without tax deducted will not be expecting to derive any further income of this nature in the following year. If they elect to use, or by default use, the standard method this will result in payments being made in the following year of at least 105% of the prior year's residual income tax. As a result, they may choose to adopt the estimation method and estimate their provisional tax at nil and then make no payments at each instalment in that subsequent year.

20. When a person chooses the estimation method, they are exposed to use-of-money interest on any shortfall at each instalment date if their residual income tax for that year exceeds $2,500. They are also obliged to revise their estimate during the year to ensure its accuracy if their residual income tax exceeds $2,500. Consequently, if the employee adopts the estimation method for the succeeding year, they need to understand these risks when making that choice should it turn out that their residual income tax is more than $2,500.

Summary

21. A salary and wage earner who receives income without tax deducted at source resulting in residual income tax of $60,000 or more in a tax year and who did not have residual income tax over $2,500 in the prior year, will have exposure to use-of-money interest if they do not pay all the residual income tax by P3. P3 is 7 May for taxpayers with a standard 31 March balance date.

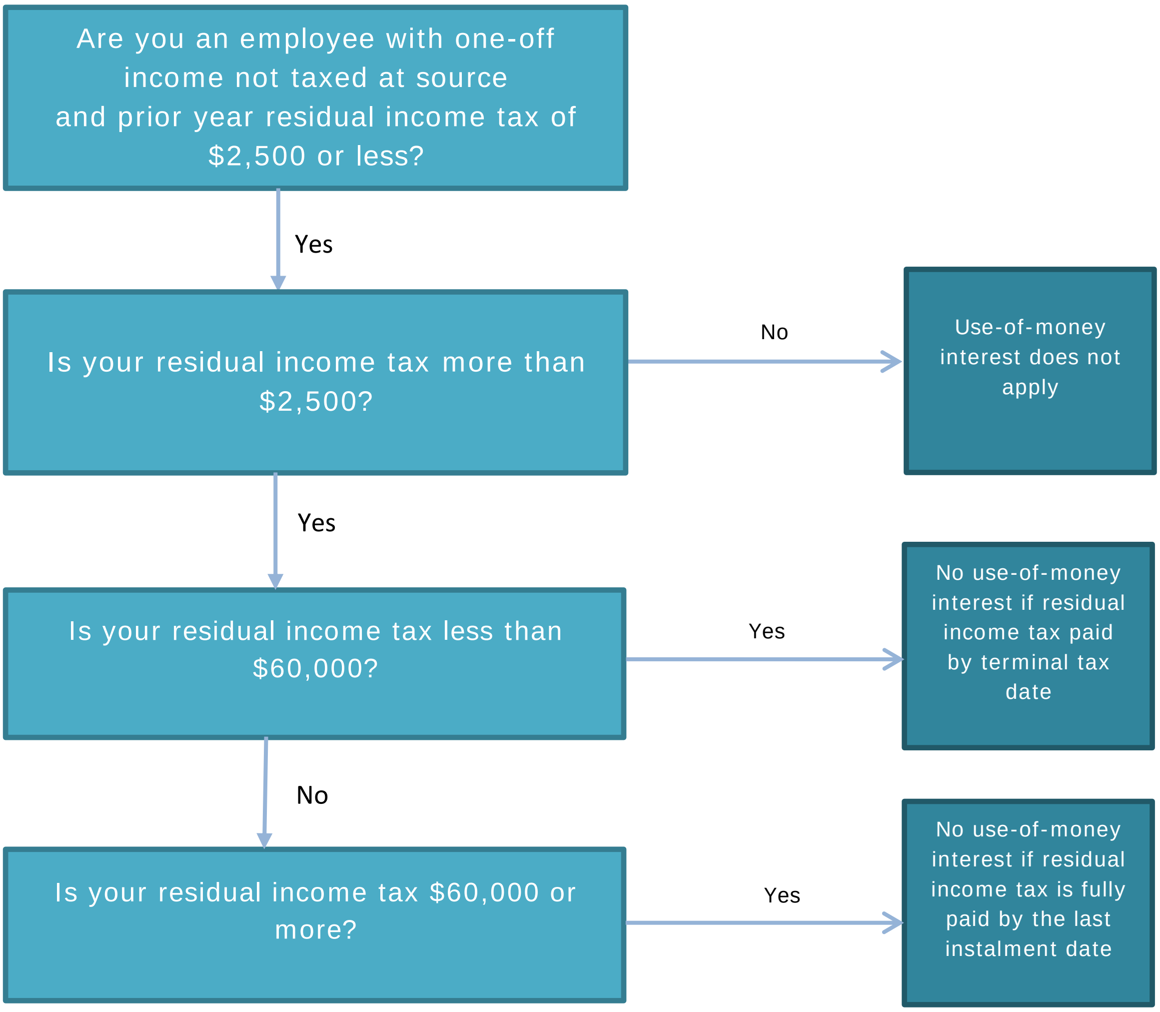
22. A salary and wage earner who receives income without tax deducted resulting in residual income tax of less than $60,000, and who did not have residual income tax over $2,500 in the prior year, will not be exposed to use-of-money interest if they pay the residual income tax on or before the terminal tax date.

23. In both situations, the person will be obliged to pay provisional tax in the income year following receipt of the amount if the residual income tax in the year of receipt exceeded $2,500. If their tax position has been automatically calculated, they will be advised to pay provisional tax on instalment dates based on the standard method, unless they elect to use the estimation method. Alternatively, if they file a tax return they must elect to pay provisional tax under the standard method or the estimation method when they file their return, and by P1 of the following year at the latest. If no election is made, the person is treated by default as adopting the standard method.

24. If they do not expect to derive any further income without tax deducted, they may choose to adopt the estimation method, but this will expose them to use-of-money interest on any shortfalls at each of P1–P3 if they do in fact have residual income tax that exceeds $2,500. Adopting the standard method is likely to result in over payment but their use-of-money interest exposure at each of P1–P3 will be limited to the lesser of one-third of the residual income tax where it exceeds $2,500 or the amount payable under the standard method. This might be more suitable if there is uncertainty about the income without tax deducted they will derive in that subsequent year.

25. The following flowchart and examples illustrate these points:

Provisional Tax / Use-Of-Money Interest Exposure



Examples

Example 1 – One-off income amount derived by salary and wage earner resulting in residual income tax of $60,000 or more

Facts: Jackie is the chief executive of Goboy Ltd with a salary of $150,000 per year and no residual income tax in the 2017 tax year. She is advised in December 2017 that she is immediately entitled under the executive share scheme to shares in Goboy with a market value of $200,000. Goboy elects not to treat this benefit as subject to PAYE but it is still reported to Inland Revenue as a benefit under the PAYE rules. Jackie derives the benefit as income not taxed at source in the 2018 tax year.

Question: What is Jackie's liability to pay provisional tax in the 2018 and 2019 tax years and her exposure to use-of-money interest due to receipt of that benefit when she continues throughout this time as a salaried chief executive?

Answer – 2018 tax year: As Jackie never ceases being an employee, she will not have an "initial provisional tax liability" under s RC 9(9) of the ITA in the 2018 tax year. She will have a residual income tax liability on the share benefit of $66,000. Since her residual income tax is more than $2,500, she is "liable to pay provisional tax" under s RC 3(1) of the ITA, so is a "provisional taxpayer" under s 3(1) of the TAA. This is despite Jackie having no residual income tax in the 2017 income year, so having "no obligation to pay provisional tax" for the 2018 income year under s RC 3(3).

Jackie can qualify as an "interest concession provisional taxpayer" under s 120KBB of the TAA if she voluntarily uses the standard or estimation methods in the prescribed manner. Because her residual income tax is $60,000 or more, the terminal tax payment concession under s 120KE does not apply.

Jackie is not exposed to use-of-money interest until P3 but can make voluntary payments at any time between P1 and P3. While Jackie could also file an estimate for P3 this is not necessary as her use-of-money interest liability will be determined by her actual residual income tax either way. Jackie would be best to make voluntary payments of the amount she expects to be her 2018 residual income tax by P3 (7 May 2018) as she will have exposure to use-of-money interest from that date on any payments (or over payments) of her actual 2018 residual income tax.

Answer – 2019 tax year: Jackie is likely to have her tax position automatically calculated in the 2019 tax year and will be advised to pay provisional tax before each instalment date under the standard method unless she elects to use the estimation method. If Jackie did file a 2018 income tax return, Jackie must make an election as to the method she wants to adopt for paying provisional tax in the 2019 tax year because her residual income tax exceeds $2,500. She is not expecting any further benefits under the Goboy executive share scheme, nor any other income receipts without tax deducted at source, so is reluctant to adopt the standard method, which would demand three payments of $23,100. So, she considers adopting the estimation method and then making payments of zero on the assumption she will not have any residual income tax exceeding $2,500 in 2019. If Jackie adopts the estimation method, it must be a fair and reasonable estimate of her residual income tax and she must inform Inland Revenue of the estimate on or before P1.

Jackie's tax agent advises that if Jackie does use the estimation method, she needs to consider the risks. If Jackie does have residual income tax over $2,500 in the 2019 tax year, including from untaxed income that unexpectedly arises, she must re-estimate her 2019 provisional tax when she becomes aware of this income. The revised estimate will apply to the remaining 2019 provisional tax payments.

Jackie will have an exposure to use-of-money interest where her 2019 residual income tax exceeds $2,500 equal to that residual income tax amount divided by three at each instalment date, less any amounts paid. Jackie can make voluntary payments at the time of revising her estimates to help mitigate use-of-money interest for instalments already paid or use tax pooling funds at backdated effective dates within the applicable time frames.

Jackie should file her nil estimate on or before P1, otherwise if she does not pay $23,100 by P1 she risks late payment penalties if her 2019 residual income tax is more than $2,500. Even if Jackie's 2019 residual income tax is not more than $2,500, by not paying P1 Jackie also risks late payment penalties if her 2019 residual income tax is later reassessed to more than $2,500.

Alternatively, Jackie could use the standard method for her 2019 tax return. The required payments will be 105% of $66,000 divided by three at each of P1–P3. If she has not filed her 2018 return because of an extension of time she can use 110% of her 2017 residual income tax of $0 divided by 3 (ie pay nothing) for P1, but must then use 105% of 2018 residual income tax x 2/3rds (ie $46,200) for her P2 payment if the 2018 return is filed by then, which would usually be the case. If she pays nothing at P1–P3, she will have an exposure to use-of-money interest on the lesser of the actual residual income tax (if it exceeds $2,500) and the amounts payable under the standard method. Jackie can make voluntary top-up payments to mitigate her use-of-money interest risk or use tax pooling funds at backdated effective dates within the applicable timeframes if her untaxed income unexpectedly arises.

Jackie faces the same late payment penalty risks as she would for estimating if she is required to make any payments under the standard option and fails to make these if her 2019 residual income tax turns out to be more than $2,500.

Given these risks, the agent advises Jackie that she should adopt the estimation method and make no payments only if she is certain about not having any residual income tax that exceeds $2,500 in 2019. If Jackie is less certain about her untaxed income position for 2019, she could choose the standard method and pay all amounts required. If this results in an overpayment Jackie will receive a refund once her 2019 residual income tax has been assessed.

Example 2 – One-off income amount derived by salary and wage earner resulting in residual income tax of less than $60,000

Facts: The facts are the same as in Example 1 except Jackie's share entitlement is worth only $100,000 so her residual income tax is $33,000.

Question: What are the provisional tax and use-of-money interest implications for the 2018 and 2019 tax years?

Answer – 2018 tax year: Jackie has residual income tax of $33,000 so she is a provisional taxpayer under s RC 3(1) of the ITA despite her having no obligation to pay provisional tax under s RC 3(3) of the ITA due to having residual income tax of $2,500 or less in the 2017 tax year. Jackie qualifies under s 120KE of the TAA for payment of the RIT on the terminal tax date for the 2018 tax year because her residual income tax in 2018 was under $60,000. Jackie's only exposure to use-of-money interest will occur if she does not pay the residual income tax amount on the terminal tax date.

Answer – 2019 tax year: Jackie is most likely to have her tax position automatically calculated in the 2019 year and will be treated as liable to pay provisional tax based on the standard method unless she elects to use the estimation method. If Jackie files her 2018 tax return she will need to identify in that return what option she is going to use for paying provisional tax in 2019. As she is not expecting another share scheme benefit or any other income untaxed at source, Jackie notifies Inland Revenue that she is adopting the estimation option of nil and then pays zero at each instalment date for the 2019 tax year.

The same risks and options when selecting the estimation method as are discussed in Example 1 above are brought to her attention by the tax agent. If Jackie has residual income tax of more than $2,500 in the 2019 tax year, she will be exposed to use-of-money interest from P1 on shortfalls over the actual residual income tax divided by three at each payment date.

References

Subject references

Credit interest
Initial provisional tax liability
Interest concession provisional taxpayer
Late payment penalties
New provisional taxpayer
No obligation to pay provisional tax
Provisional tax rules
Provisional taxpayer
Residual income tax
Tax pooling funds
Use-of-money interest

Legislative references

Income Tax Act 2007, ss RC 2(2), RC 3, RC 4, RC 5, RC 7, RC 9(9), RC 12

Tax Administration Act 1994, ss 3(1), 120KB, 120KBB, 120KE

Other references

Inland Revenue Department NZ, *Provisional tax, Paying your income tax in instalments* IR289