

Cabinet Committee on State Sector Reform and Expenditure Control

STAGE 2 OF TRANSFORMING NEW ZEALAND'S REVENUE SYSTEM

Proposal

1. This paper provides an update regarding preparations for Stage 2 of the transformation of New Zealand's revenue system. I am asking Cabinet to:

- note that Stage 2 will implement all tax products, the Accounting Income Method for calculating provisional tax and the Automatic Exchange of Information with tax treaty partners in START, and implement enabling technologies, capabilities and a new organisational model for Inland Revenue;
- note the benefits and costs until 30 June 2018 of Stage 2 which are within the multi-year funding approved by Cabinet (CAB-15-MIN-0249 refers) for implementation; and
- note that approval has been provided through the March Baseline Update for a multi-year appropriation of funding for transformation.

Executive Summary

2. Stage 1 of transformation went live on 7 February 2017, three months ahead of schedule. New services are making it quicker and easier for customers to manage their GST online, representing a very significant and public step forward in the journey to modernise New Zealand's revenue system.

3. Preparations for implementation of Stage 2, which will build on and extend these new services, are underway. In comparison to Stage 1 which focused on a single tax product and involved little legislative change, Stage 2 will see more than 20 products migrated to new systems and processes and legislative changes introduced. Accordingly, the requirements for co-existence, integration, testing, stakeholder engagement and change management are exponentially greater and more complex.

4. Given the scale of changes that will be made, Stage 2 is likely to be implemented in a series of releases throughout 2018 and 2019. Once Stage 2 has been implemented, the effort required by businesses to keep on top of their tax obligations will be significantly reduced. The changes being introduced in this stage will also allow existing social policy processes to be more effectively supported and assistance better matched to the needs of individuals.

5. Inland Revenue has estimated capital costs of \$224.6 million and operating costs of \$330.4 million for implementing transformation from 1 March 2017 to 30 June 2018. These costs are within the funding approved for transformation (CAB-15-MIN-0249 refers). Based on Inland Revenue's performance to date and the transparent, regular reporting of progress, approval was provided through the March Baseline Update for the multi-year funding

approved by Cabinet to be managed through a multi-year appropriation (from 1 July 2017 to 30 June 2021).

Business transformation is a once-in-a-generation opportunity to modernise New Zealand's revenue system

6. A modern, digital, revenue system will serve the needs of all New Zealanders. It will help customers to get their tax and social policy payments right first time, avoid errors and give them a clearer view of what they've paid and what they owe during the year. The revenue system will be simple to comply with and responsive to customers' changing circumstances. It will be easy for customers to get things right and difficult to get wrong. They will spend far less time and effort ensuring they meet their obligations and receive their correct social policy entitlements, as tax will be correctly withheld and assistance provided at the time it is needed.

7. Customers' interactions with government and Inland Revenue will fundamentally change. In the future, most customers will not need to interact with Inland Revenue as their information will be provided to Inland Revenue on their behalf. Those with less complex needs will only need to confirm their details using automated, straight-through digital services. Customers who do have to provide information will use their own systems and processes to do so as part of their everyday business activities. Information will be checked when it is received and errors fixed wherever possible.

8. Although Inland Revenue will design digital channels with customers in mind - easy to use, intuitive and interactive - and will strongly encourage their use, there will be some customers who are unable or unwilling to use digital services. Exceptions will need to be made for customers without access to internet services or computers, and for groups who would incur disproportionate compliance costs, e.g. the smallest employers.

9. Earlier, more complete information will be available to Inland Revenue which will lead to greater accuracy and mean fewer under or over payments for customers. Government will be able to make policy changes more quickly and cost effectively and there will be more opportunities to provide broader access to the information Inland Revenue holds.

10. Modernising the revenue system will significantly contribute to improving digital interactions with government, the Business Growth Agenda and a growing, healthy economy, and achieving Better Public Services Results 9 and 10.

Inland Revenue successfully implemented Stage 1 on 7 February 2017, just under three months ahead of schedule

11. New systems and processes were available for GST customers to use from 7 February 2017, nearly three months ahead of schedule, representing a very significant and public step forward in the journey to bring New Zealand's revenue system into the modern world. It's now quicker and easier for customers to manage their GST online. Customers can now:

- file and pay their GST at the same time;

- make GST payments by direct debit, or credit or debit card;
- set up email and text message reminders of when GST returns and payments are due to avoid penalties;
- set up GST instalment payment plans and, in most cases, receive immediate confirmation and approval; and
- request a change to an already filed GST return.

12. These are the first of many changes Inland Revenue will make over the next few years to make tax and social policy payments simpler for New Zealanders. As at 31 March 2017:

- there had been more than 670,000 logins to myGST;
- more than 280,000 GST returns had been filed using the new web service;
- more than 43,000 customers had set up direct debits, enabling them to file and pay their GST at the same time;
- more than 6,500 GST returns had been amended online by customers, saving them from having to contact Inland Revenue to arrange this;
- more than 2,400 instalment arrangements had been set up online to pay off debt; and
- more than 4,300 new migrants, visa holders and organisations had registered for IRD numbers through the new digital registration service.

13. The majority of customers are working well with new systems and processes. However some, including tax agents, have experienced challenges with initial set-up tasks, navigating the new system and working in a digital environment for the first time. Inland Revenue has initiatives and processes in place to manage and resolve issues, including an active programme of communications consisting of emails, newsletters, and site visits including 1:1 sessions with customers where needed.

14. Inland Revenue is on track to realise the benefits committed from the implementation of Stage 1. These are improved experiences for customers, compliance cost reductions for small–medium sized businesses and administrative savings for Inland Revenue:

- Customers using their accounting software to manage their GST obligations are providing positive feedback on their experience and on other enhancements to Inland Revenue’s services.
- Customers perceive that the level of effort in meeting their GST obligations has reduced by approximately 10 hours since 2013.¹
- Administrative savings are being achieved as customers increasingly self-manage and use digital channels.

¹ Inland Revenue’s 2016 survey of compliance costs for small and medium enterprises

The scope of Stage 2 is all tax products and once completed will significantly reduce customer effort

Customer experiences will improve

15. Planning for Stage 2 is well advanced. Stage 2 will build on and extend the new services delivered to customers in Stage 1. Once Stage 2 has been implemented the effort required by businesses to keep on top of their tax obligations will be significantly reduced, enabling them to spend more time running their businesses.

16. The likelihood of errors will be much reduced, resulting in greater certainty, fewer interactions, less debt, and less need for compliance checks. Businesses will have a clearer view of their tax position during the year and will be able to meet their tax obligations at minimum cost and minimum disruption.

17. Once Stage 2 has been completed customers will have:

- More on-line services for all tax products;
- Integrated tax and business processes;
- Faster, more accurate tax information, providing near real-time visibility of tax;
- Faster tax refunds; and
- Less likelihood of tax debt and more payment options.

18. Initiatives that continue to improve customers' experiences when they do have to interact with Inland Revenue will be piloted as part of Stage 2. Customers will be able to request immediate assistance when they need it with their digital interactions through pilots of click-to-chat and virtual assistant services. More efficient handling of investigations and litigation will improve customer experiences as all case management will be undertaken in START following implementation of Stage 2.

All taxes will be administered using new systems and processes

19. In line with the roadmap attached as an annex and noted by Cabinet (CAB-15-MIN-0249 refers), Stage 2 will include all tax products.² Following subsequent decisions made by Cabinet, this stage will also include the Accounting Income Method (AIM) option for calculating provisional tax (CAB-16-MIN-0089 refers) and the Automatic Exchange of Information (AEOI) with international tax treaty partners (CAB-16-MIN-0189.25 refers).

² PAYE information collection is part of Stage 2, whereas PAYE processing will remain in FIRST until Stage 3 to minimise the amount of technical integration required.

20. As part of Budget 2016, Cabinet noted that the preferred implementation option for AEOI was to be determined (CAB-16-MIN-0189.25 refers). Inland Revenue has determined that implementing AEOI in START³ during Stages 2 and 3 is the best option as:

- START has the functionality required already built in and will be configured to support AEOI without the need for any customisation.
- Technology delivery and change management for AEOI will be aligned with the wider changes Inland Revenue is making, minimising change impacts for both customers and staff.
- Information about customers' incomes, whether earned in New Zealand or overseas, will be held in one place and there will be a single interface for all Inland Revenue services.
- Inland Revenue will be able to more effectively match data received through AEOI with information already held about customers, providing greater options for use of data.
- START is scalable for Foreign Account Tax Compliance Act (FATCA).

21. Stage 2 will also include gaming machine duty. This is a stand-alone duty not linked to other taxes. Implementing gaming machine duty in Stage 2 should allow Inland Revenue's heritage FIRST mainframe to be decommissioned at the end of Stage 3 rather than at the end of Stage 4 as originally envisaged.

Improvements to Inland Revenue's foundational infrastructure will continue

22. To enable Inland Revenue to provide customer-centred, intelligence-led services, improvements to internal processes and systems are required. To ensure that customer information is secure and accessible by those with appropriate authorisation, Inland Revenue will further develop its security capabilities.

23. To reduce the cost of providing the department's services, improvements will be made to workplace and network technology by continuing the migration to the all-of-government telecommunications-as-a-service common capability. Inland Revenue will also continue to consolidate its existing applications, and to de-commission those superseded or no longer required in its new systems environment.

Stage 2 is likely to be implemented in a series of releases

24. Given the scale of changes that will be made to systems and processes by Inland Revenue, business partners and customers, Stage 2 is likely to be implemented in a series of releases throughout 2018 and 2019. These will reflect the annual tax cycle, i.e. processes required at the beginning of the tax year will be released first, with end-of-year processes released later.

³ START stands for simplified tax and revenue technology, and is the name chosen by Inland Revenue for the GenTax software provided by FAST Enterprises LLC.

25. While Inland Revenue has every expectation that Stage 2 releases will go-live successfully, the requirements for co-existence, integration, testing, stakeholder engagement and change management are exponentially greater and more complex. Given this, Inland Revenue will continue to place considerable emphasis on maintaining its strong management and governance of transformation. Notwithstanding, there may be unforeseen issues which arise and this is not unexpected in a transformation of this nature.

Change management will be critical during Stage 2

26. In comparison to Stage 1 which focused on a single tax product and involved little legislative change, Stage 2 will see more than 20 products migrated to new systems and processes and legislative changes introduced. Together, these changes will simplify customers' tax affairs and make it easier for them to meet their obligations.

27. Inland Revenue has begun planning for the work needed to ready customers for change. In particular, the department intends to work closely with key government agencies and other stakeholders, such as banks, who are both customers and business partners. The need for a well integrated approach is recognised.

28. Customers will be supported to adapt to using new systems and processes and Inland Revenue intends to minimise any disruption resulting from the changes being made. As customers will be interacting with a revenue system administered via two systems that will need to co-exist until the heritage FIRST system is decommissioned, considerable emphasis will be placed on communications and engagement.

29. Business customers will be the principal beneficiaries of Stage 2. Employers, government agencies, software developers, business partners and service providers will benefit from modernised information sharing processes and greater integration with Inland Revenue's systems.

30. To be able to fully leverage these benefits, and meet requirements to provide investment income and PAYE information more regularly, they will need to make changes to their own systems and processes. Those with customised payroll software will need to upgrade it; typically this will be larger corporates and government agencies, as will providers of accounting and payroll software. As previously noted by Cabinet (CAB-15-MIN-0249 refers) Inland Revenue has not included any costs and benefits to other Crown organisations and stakeholders in making any changes to their systems and processes.

31. In addition, during the same period, changes that will help smaller businesses tailor their tax payments to their circumstances (the accounting income method option for calculating provisional tax) and help to detect and prevent tax evasion (AEOI reporting requirements for financial institutions) come into effect.

32. The changes being introduced in Stage 2 will allow Inland Revenue to more effectively support existing social policy processes and ensure better matching of assistance to the needs of individuals. More accurate and timely income information will improve access to entitlements and delivery of services to individuals. Engagement with key

stakeholders about possible improvements to social policy has already begun and will continue throughout 2017.

Transformation will have a significant impact on Inland Revenue’s work.

33. At the end the department expects to be a leaner and more agile organisation, approximately 25%-30% smaller than today. Estimated cumulative administrative savings of between \$495 million and \$580 million until 2023/24 are part of Inland Revenue’s funding contribution to transformation.

34. A new organisational model for Inland Revenue has been agreed in principle by its senior leadership team. Three new organisational groups are proposed to be established early in 2018 to support customer-centred delivery of services and new ways of working, and enable the realisation of administrative savings. Planning for the changes that will be made has been completed and preparations are well underway, including on-going engagement with unions. Consultation on the proposed changes begins on 9 May 2017. The proposed changes mean that some people transition costs will be required earlier than originally planned. This change in timing means Inland Revenue will need to bring forward funding from 2019/20 to 2017/18.

The costs and benefits of Stage 2 are consistent with the estimates made in the detailed business case

Costs and funding

35. Inland Revenue has estimated the costs of implementing transformation from 1 March 2017 to 30 June 2018, as shown in the table below.

\$ million	2016/17	2017/18	Total
Capex	41.0	183.6	224.6
Opex	67.9	262.5	330.4
Total	108.9	446.1	555.0

36. These estimates include costs for bedding down Stage 1, implementation costs for Stage 2 during this period, costs for preparation for future stages, and contingencies held by Inland Revenue to allow the department to manage financial risks.

37. These costs, along with the associated depreciation and capital charge, are within the funding approved for transformation (CAB-15-MIN-0249 refers) and AEOI (CAB-16-MIN-0189.25 refers). Subsequently, a swap between capital and operating funding for AEOI was approved by the Ministers of Finance and Revenue⁴ in September 2016 to enable Inland Revenue to minimise the impacts on its legacy system.

38. Major cost drivers include the implementation of business taxes in START, co-existence with the heritage environment, implementation of foundational technologies and

⁴ IR2016/374

intelligence-led ways of working. As Stage 2 is likely to be implemented in a series of releases, some costs for this stage will be incurred after 30 June 2018. These will be reflected in future transformation updates.

39. Since multi-year funding for the implementation of the future revenue system was approved by Cabinet (CAB-15-MIN-0249 refers), Inland Revenue has achieved an A Investor Confidence Rating and successfully delivered Stage 1. The Treasury is encouraging agencies to use the new flexibility afforded by changes to the Public Finance Act to support the delivery of major transformations.

40. Based on Inland Revenue’s performance to date and the transparent, regular reporting of progress, approval has been provided through the March Baseline Update for the multi-year funding approved by Cabinet to be managed through a multi-year appropriation (from 1 July 2017 to 30 June 2021).

41. This will provide greater flexibility for managing changes in the timing of expenditure that are expected in a programme of this nature. A multi-year appropriation will minimise unnecessary technical processes while maintaining transparency. Performance will continue to be measured through milestone measures linked to each stage, which will be included in Inland Revenue’s Estimates of Appropriations each year.

42. Inland Revenue requested expense and in-principle transfers as part of the March 2017 baseline update. These transfers were requested to:

- better align investment with the implementation of START; and
- reflect the rapid ramp up of resources required for Stage 2 and the potential for market constraints and other circumstances outside of Inland Revenue’s control to hinder this.

Benefits

43. Stage 2 will deliver both non-financial and financial benefits in line with the estimates noted by Cabinet (CAB-15-MIN-0249 refers) as shown in the table below.

Stage 2 financial benefits for the period 2015/16 to 2023/24	
Compliance effort savings	\$635m - \$1,060m (8 – 14 hours per annum)
Administrative savings from IR	\$260m - \$300m
Additional assessed Crown revenue	\$2,880m
Stage 2 non-financial benefits	
Easier for customers	✓
Revenue system resilience	Improved resilience of technology infrastructure
Agility to implement policy	Improved agility for tax products

44. Following stage 2, government will have much greater agility for tax products. The complex inter-relationship between income and social policy may however place some limits on this until Stage 3 is completed. Full policy agility will be provided once transformation is complete. Similarly, resilience will be enhanced however Inland Revenue's technology risk profile will remain high until completion of transformation due to the need for old and new systems to co-exist.

45. Financial benefits for Stage 2 include the realisation of administrative savings resulting from a more efficient, smaller Inland Revenue of between \$260 million to \$300 million over the period until 2023/24. Inland Revenue will apply these savings to transformation as part of its funding contribution (CAB-15-MIN-0249 refers). Additional, cumulative Crown revenue of approximately \$2,900 million⁵ is expected over the same period. Inland Revenue will have improved analytical capabilities which will enable better and earlier detection of non-compliance, and opportunities for non-compliance will reduce as core transactions will be provided through accounting software.

46. The effort required by customers to meet their obligations will further reduce, building on the gains already made in Stage 1. Inland Revenue estimates that small and medium businesses will spend between 8 and 14 fewer hours a year on compliance by 2023/24 as a result of the changes being introduced in Stage 2. This will further contribute to Better Public Services Result 9.

Policy changes

47. Stage 2 will give effect to the decisions Cabinet has already made to introduce AIM, a provisional tax option (CAB-16-MIN-0089 refers), and require more regular reporting of PAYE (CAB-16-MIN-0283 refers) and investment income information (CAB-16-MIN-0307 refers). The costs and benefits of these policy changes have been accounted for.

48. For policy which has not yet been consulted on, full fiscal implications will be included in final policy advice provided to Cabinet following consultation.

Transformation is consuming the majority of Inland Revenue's change capacity given its size and high risk profile

49. Transformation remains inherently high risk. Although implementation risk for Stage 1 was successfully mitigated, Stage 2 is higher risk given the breadth and complexity of products to be migrated and the consequent impacts on customers, staff, other stakeholders and Inland Revenue itself.

50. In November 2016, the Government announced its updated tax policy work programme for the next 12 months. This, combined with the implementation of Stage 2 of transformation, means Inland Revenue has very limited capacity to implement additional policy changes. These would need to be assessed on a case by case basis.

⁵ Includes inflation

51. Officials have advised me that if additional initiatives are added, the work programme may need to be reconsidered to ensure that the change capacity Inland Revenue does have is used on our highest priorities. Factors that will need to be taken into consideration when considering new opportunities are:

- Inland Revenue's capacity to deliver further reforms over the next three income years in FIRST will likely be exhausted;
- A number of items on the current tax policy work programme have administrative implications and are also drawing on Inland Revenue's change capacity; and
- Transformation costs and timelines assume that implementation of policy changes are aligned with the roadmap.

52. Progress and risks will be constantly re-assessed. Any material changes or trade-offs will be highlighted for Ministers to consider.

The next transformation update will be provided to Cabinet by December 2017

53. Inland Revenue has been directed (CAB-15-MIN-0249 refers) to provide transformation progress updates to Cabinet by July and December each year.

54. When Cabinet considered the most recent update in November 2016, Inland Revenue indicated that these updates could be supplemented with a report back in March to confirm any inputs required for the Budget process. Cabinet noted (CAB-16-MIN-0621 refers) that the costs and benefits of Stage 2 would be confirmed by March 2017 and that the July 2017 transformation update would provide an overview of the results of the go-live of Stage 1.

55. As both these topics have been covered in this paper and as no significantly new information about Stage 1 go-live will be available by July, the most opportune time for Cabinet to consider the next progress update will be December 2017. Comprehensive monthly reporting of progress will continue to be provided to the Ministers of Finance and Revenue.

Next steps

56. The next steps are to:

- complete bedding down of Stage 1 by May 2017;
- support the passage of the Taxation (Annual Rates for 2017-18, Employment and Investment Income, and Remedial Matters) Bill which contains key transformation proposals;
- finalise the discussion document and communications strategy regarding social policy for consideration by Cabinet in May 2017;
- release the Individuals' and social policy discussion documents in June 2017;
- complete detailed design for Stage 2 for the first release by June 2017;
- provide a summary of submissions and then final proposals for modernising the Tax Administration Act for Ministers; and

- prepare a transformation update for consideration by Cabinet by December 2017.

Financial implications

57. Inland Revenue is tracking to the multi-year funding agreed by Cabinet in November 2015. The management of Inland Revenue's multi-year, multi-stage transformation has been simplified through the adoption of a multi-year appropriation. Agreement has been provided through the March Baseline Update to establish a multi-year appropriation to run from 1 July 2017 to 30 June 2021.

Human rights implications

58. The proposals in this paper have no human rights implications.

Legislative implications

59. The proposals in this paper do not require any changes to legislation.

Regulatory impact analysis

60. The proposals in this paper do not require a Regulatory Impact Statement.

Publicity

61. I intend to ask Inland Revenue to publish this paper on its website once it has been considered by Cabinet.

Consultation

62. A copy of this paper has been provided to the Accident Compensation Corporation, the Department of Internal Affairs, the Department of Prime Minister and Cabinet, the Ministry of Business, Innovation and Employment, the Ministry of Education, the Ministry of Social Development, the New Zealand Customs Service and Statistics New Zealand.

Central agencies' comment (The Treasury, State Services Commission and Government Chief Information Officer)

63. Corporate Centre agencies were consulted on this update.

64. Since the November update, Inland Revenue has successfully migrated GST to the new platform, three months ahead of schedule. This will build confidence for the successful delivery of Stage 2. We understand Inland Revenue is increasingly sharing lessons and good practice with other agencies for the benefit of wider government and anticipate this will continue.

65. Preparation for Stage 2 implementation is underway. Inland Revenue is preparing lessons learned to support implementation and expects to share these more widely. As noted

by Inland Revenue, Stage 2 is a much more complex operation. Adding further change may add risk to an already risky programme.

66. Stage 2 is likely to impact other government agencies through changes to the administration of income taxes. Inland Revenue has committed to working with agencies to minimise impacts where possible, though Ministers should note that Stage 2 changes could result in additional cost to the wider government system. We will work with Inland Revenue to bring matters to Ministers attention.

Recommendations

I recommend that the Committee:

1. **Note** that Stage 1 of Inland Revenue’s transformation was successfully implemented on 7 February 2017;
2. **Note** that Stage 2 will focus on:
 - i. the end-to-end implementation of tax products, the Accounting Income Method for calculating provisional tax, and the Automatic Exchange of Information with international tax treaty partners in START, including enhanced customer interaction and case management capabilities;
 - ii. implementation of enabling technology and capabilities;
 - iii. implementation of a new organisational model for Inland Revenue;
 - iv. preparation for future stages, including social policy;
3. **Note** that expected benefits of Stage 2 are in line with the estimates previously noted by Cabinet;
4. **Note** that the expected costs of Stage 2 until 30 June 2018 have been updated and are within the funding approved by Cabinet for transformation and the Automatic Exchange of Information;
5. **Note** that the next transformation update will be provided to Cabinet to consider by December 2017;

Multi-year appropriation

6. **Note** that approval has been provided through the March Baseline Update to establish a multi-year appropriation for the departmental other expense Transformation to run from 1 July 2017 to 30 June 2021;

Vote	Appropriation Minister	Title	Type	Scope
Revenue	Minister of Revenue	Transformation MYA	Departmental Other Expense	This appropriation is limited to the design and implementation of a modern system for tax revenue and social policy administered by Inland Revenue

7. **Note** that changes to appropriations have been approved through the March Baseline Update to give effect to the establishment of a new multi-year appropriation.

	\$ million – increase / (decrease)				
Vote Revenue Minister of Revenue	2016/17	2017/18	2018/19	2019/20	2020/21
Departmental Other Expense: Transformation (funded by revenue Crown)	-	1,112.607			
Departmental Other Expense: Transformation (funded by revenue Crown)	159.730	(363.372)	(251.500)	(286.060)	(211.675)

Hon Judith Collins
Minister of Revenue

/ /2017

Annex – Transformation Roadmap

