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Report of the Tax Working Group released

The report of the Victoria University Tax Working Group ("TWG") – *A Tax System for New Zealand's Future* – was released today. The report, which followed a series of meetings in 2009 by the TWG, a group of leading tax professionals, business people, academics and policy officials, and a conference in December last year, highlights a number of deficiencies in the current system and directions for reform. The report can be downloaded from <http://www.victoria.ac.nz/sacl/cagtr/twg/Report.aspx>.

The report does not contain a "silver bullet". What is clear is that the current system is broken. The solutions are complex and will be subject to a number of real world constraints, including fiscal and political sustainability. Given the size and make up of the TWG, it is impressive that consensus on the critical issue: the need and broad direction for reform has emerged.

Issues

The critical issues are:

The structure of the tax system. New Zealand relies heavily on the taxes most harmful to growth (corporate and personal taxes on capital income), while there is a major hole in the tax base concerning the taxation of capital, which is manifest in high investment and low returns in the property market. People also face a disincentive to work because the abatement of social assistance creates very high effective marginal tax rates.

Coherence, integrity and fairness. Differences in tax rates and the treatment of entities provide opportunities to divert income and reduce tax. Investment decisions can be about minimising tax rather than the best business investment. The tax burden on individuals is disproportionately borne by wage and salary earners, while those earning capital income can restructure their affairs through trusts and companies to reduce their tax.

The Government response (to the TWG report) needs to be politically and economically sustainable in the medium term. This means implementing a system that will be stable, that is not changed and tweaked often. It also means looking past some of the easier fixes, to the more fundamental reforms required.

The sustainability of the tax revenue base. Compliance is likely to be affected by perceptions that the system is unfair. International competition for capital and labour, especially from Australia, will impact on the sustainability of corporate and personal tax rates. An ageing population will place higher demands on the tax revenue base while simultaneously placing greater tax pressure on a smaller proportion of the population.

Frameworks

A coherent tax policy framework is needed. The TWG has identified six principles of a good tax system: (1) the overall coherence of the system; (2) efficiency and growth; (3) equity and fairness; (4) revenue integrity; (5) fiscal cost; and (6) compliance and administration costs.

In addition, the TWG considered that economic and political sustainability of reform was vital. Economic sustainability means less reliance on internationally mobile tax bases, such as capital and skilled labour. Political sustainability requires a tax system that is resistant to political temptation to change the critical elements.

Overall, the current "broad base low rate" model is generally seen as a sound framework and not inconsistent with the above axioms.

Reform options

The TWG's recommendations are very much a "pick and mix" approach – in other words there are a range of choices available. The different options are broadly complementary. As noted at the December conference, the TWG's approach has been to identify a range of reform scenarios for Government to consider:

- There is broad support for alignment of company, trust and top personal tax rates to improve the system's integrity to improve the integrity of the tax system.
- At the same time, New Zealand's company tax rate needs to be internationally competitive (this needs to be balanced against the alignment objective above).
- Imputation should be retained but needs to be reconsidered if Australia decides to abandon its imputation regime.
- The 38% and 33% personal rates should be reduced as part of the alignment strategy, and an overall reduction in personal tax rates across the board is preferred. There should be an accompanying review of the social welfare system, to address the current high effective marginal tax rates facing individuals.
- GST should continue to apply without any exemptions. Increasing the GST rate to 15% has merit, on efficiency grounds, but would need to be accompanied by compensation to those on lower incomes.
- Base broadening is required to deal with existing biases, improve efficiency and economic sustainability, and maintain revenue levels (i.e. fund corporate and personal tax rate reductions).
- Of the base broadening options, a capital gains tax, while prima facie the most comprehensive option, was considered to have a range of practical challenges by most TWG members.
- An alternative approach of addressing specific problem areas (where income is systematically under-taxed) had greater support, with most of the TWG supporting taxing returns from residential rental properties using a RFRM or a low-rate land tax (both would tax a notional rate of return on the relevant asset base).
- Other recommendations include removing the current 20% "loading" on tax depreciation rates, removing tax depreciation on buildings (if there is empirical evidence that buildings do not depreciate) and lowering the thresholds for full interest deductibility to 60% gearing (from 75% at present), under the thin capitalisation rules.
- Ensuring a more coherent approach when considering future tax reform, via the use of an independent body to monitor compliance with the six principles of tax reform, outlined earlier.

KPMG Comment

The TWG report, which has been highly anticipated, does not contain any surprises. The issues and direction for reform have largely been previously signalled. The Group's background papers, their minuted discussions, and the feedback from the December forum have been built into the report.

It is also encouraging that the "hot button" issues have, largely, been able to be debated rationally. This owes much to the open approach adopted by the TWG, which has allowed a mature debate on the future of New Zealand's tax system to take place.

We outline some observations on the TWG process and conclusions below:

Scope of the TWG's considerations

Tax reform, particularly for an overhaul of the system itself, is inherently difficult due to the many competing interests (including self-interest) and trade-offs required. The TWG is to be commended for considering as much as it did and in the public spotlight. Even then, certain aspects, such as the benefit system, and consideration of the expenditure side were outside its scope.

It is disappointing that the TWG did not have scope to consider the administration of the NZ tax system. We consider this to be a key aspect of designing a world class tax system (along with implementing world class tax policies). There is important work to be done in this space.

Overall, while the TWG endorsed the broad base low rate framework, its finding that the status quo is untenable cannot be ignored. In particular, the strain on the company and personal tax bases which are both internationally mobile means the present tax mix is unsustainable. This leads to the question of what the "appropriate" tax rate on capital and labour should be.

Alignment of tax rates

The Government has a medium term tax rate alignment objective of 30/30/30 (for the company, trust and top personal tax rates). The TWG broadly supports alignment and reduction of rates (with base broadening to fill in the gaps and improve integrity).

In particular, the impact of high effective marginal rates (when the cost of benefit abatements is added to the tax impost) is seen as a significant obstacle when New Zealand is competing globally for labour. Also of concern is that while New Zealand's top personal rate of 38% is not high by OECD standards, it applies at a much lower level of income than in other countries, including Australia. In the OECD, New Zealand has the highest proportion of highly skilled workers working overseas and is dependent on this group for its tax revenue.

Alignment would also ensure that different entity structures are tax neutral. This is important as corporate tax is not the same as "business" tax, due to the mix of business operating structures.

Non-aligned options

However, there is recognition that alignment may not be feasible if the international trend of lower corporate tax rates continues. A non-aligned system (with the top personal rate different to the company rate) must therefore also be considered.

In addition, there is the risk of New Zealand's imputation regime being stranded if the Australian tax review, led by Treasury Secretary Ken Henry recommends that Australia abandon imputation. While we understand this is unlikely, the possible options if this were to happen are intriguing.

They include a “classical” system - i.e. company profits and dividends taxed independently with no recognition of tax paid on the former, and a potentially lower rate on dividends to compensate.

A dual income tax system to tax capital income at a flat low rate, with a capital gains tax as a back stop, and where labour income is taxed progressively has also been considered. (There are variations to a dual income system, depending on the desired policy outcomes.) The TWG considered that a dual income approach, while innovative, remains untested and has a number of implementation challenges that would need to be resolved. Such a system, as an alternative to imputation, has received some coverage in Australia and depending on the results of the Henry Review may require additional attention.

What is clear, with a non-aligned system, is the need for “belts and braces” to reinforce tax system integrity. Targeted measures, such as excess profit retention taxes are one option. Base broadening options, such as a capital gains tax, are another.

(By way of illustration the TWG report comments on both aligned and non-aligned scenarios and possible accompanying base broadening options.)

Base broadening

One of the main areas of critique, of the current system, is the various gaps which allow certain types of capital income to be derived tax free. The proliferation of these gaps can be attributed to the ad hoc nature of tax reform. (Reform of a part of the system may appear justified, but could have a negative impact on the coherence of the tax system as a whole.)

The PIE regime is considered by the TWG to be such a distortion (as the tax rate on income earned through a PIE is capped at 30%, versus the top marginal tax rate of 38%). However, the PIE rules need to be viewed through the lens of KiwiSaver (a non-tax policy driver), which was designed if not to encourage then not to discourage saving for retirement through investment funds. Further, if capital income should be taxed at a lower rate, the PIE regime achieves this for some capital income. The question then is whether this treatment should be extended to other savings. Alignment would remove these disparities.

Investment in residential property has also received significant attention in the report (and the media) mainly due to Inland Revenue data which suggests that the stock of rental property investment (valued at around \$200 billion) is generating tax losses of approximately \$500 million per annum.

While prima facie an anomalous outcome, the causes (and the potential “cures”) need to be carefully investigated. Depreciation of buildings has been identified as a potential culprit. The current fiscal cost is estimated at up to \$1.3 billion, which also makes it a useful revenue source for funding change elsewhere.

To the extent buildings do not economically depreciate, it seems reasonable to deny tax deductions for depreciation. However, what is the relevant asset base? For example, it is arguable that commercial and industrial buildings do depreciate. Would these be carved out of any such measure? These matters of detail need to be carefully considered.

Support for reducing the thin capitalisation safe harbour from 75% to 60% appears to be based on comparable safeguards in other countries.

Options – Capital gains tax, RFRM and land tax

More wide ranging options include a capital gains tax, or an RFRM type mechanism, which may or may not be limited to certain asset classes (i.e. real property).

A capital gains tax seems appealing but there are likely to be compromises:

- the inability to tax gains (and losses) as they accrue; and
- the need to exempt owner occupied housing.

The result, a realised capital gains tax excluding owner occupied housing, runs into other practical issues – such as “locking-in” gains (while bringing forward capital losses). For these reasons we do not support a general capital gains tax. This appears to be broadly consistent with both the views of the (majority of the) TWG, and the Tax Review in 2001 which preceded it.

An RFRM on the value of equity held in an asset is one way of getting around some of the practical issues with a realised capital gains tax, such as “lock-in”. However, a number of issues such as valuation and the applicable asset class (e.g. should it apply to real property only?), still remain. Again, particularly if limited to residential rental property, the benefits of an RFRM need to be carefully considered.

Land taxes, a selective form of base broadening, are another option discussed in the report. A land tax is considered efficient as it would tax an immobile capital base. Estimates of the impact of a land tax on land values range from a 16% to 26% drop depending on the rate and accompanying assumptions. Whether such an option would be politically acceptable (or sustainable) is one of the many considerations here.

We also note that although land is not mobile, its value to some extent is. The New Zealand experience has been that immigration has supported land value. If a land tax increases the burden for those most likely to own land, skilled New Zealanders, increased emigration of this internationally mobile group may ultimately impact land values and therefore the effectiveness of a land tax as a revenue source.

A variation to the land tax is a charge on all capital employed in the economy. Due to the size of the New Zealand capital base, this option was mooted by Dr Gareth Morgan in the December conference as allowing significant reductions in company and personal tax rates (to around 25%). The report notes that the detail design of such an option, including fiscal implications, would need to be more fully developed. We think that such work is worth doing to confirm the costs and benefits and also to be able to contrast it with the other options covered in more detail in the report.

GST

In summary, none of the base broadening options, specific or general, is costless. Similarly, changes to the GST regime. We welcome the TWG’s recommendations that the current coverage of GST be retained. The lack of exemptions is a key driver of the relative efficiency and simplicity of this tax type (while the additional revenue raised by increasing GST would be severely compromised by the introduction of various exemptions).

In our opinion, it will be difficult to ensure that those consumers who are intended to benefit from any GST exemptions fully capture them. When GST was introduced in Australia, businesses were required to only pass on the real cost of GST on introduction (so it is possible to some extent). However, when prices are set by the market, it becomes very difficult to judge when the GST benefit is not being passed on.

The key concern with increasing GST to 15% is the impact on lower income households. We support the TWG’s view that any adverse implications for this group should be dealt with through targeted mechanisms.

Other

KPMG also supports the TWG recommendation for a review of the social welfare system in light of the penal effective marginal tax rates imposed under the Working for Families system. As an aside, alignment of income tax

rates does not fully remove the high effective marginal tax rates faced at quite low income levels. This suggests a degree of universality should be considered.

Similarly, the framework for ongoing tax reform needs to be more coherent to leverage the economic benefits from such reform. While we strongly support the Generic Tax Policy Process, recent reforms have been ad hoc, adding to the incoherence of the system overall. An independent body to monitor the integrity, efficiency and coherence of the New Zealand tax system has merit.

Where to from here?

The report of the TWG provides a comprehensive account of the deficiencies of, and opportunities for, the New Zealand tax system. The challenge for Government will be finding the appropriate mix of policies which meet its reform criteria.

We believe the Government response needs to be politically and economically sustainable in the medium term. This means implementing a system that will be stable, that is not changed and tweaked often. It also means looking past some of the easier fixes, to the more fundamental reforms required.

This will be no easy task. The TWG should be commended for setting out, in reasonably stark terms, the trade-offs involved. It is now up to Government to follow their lead. Government has indicated that it will signal its intentions in Budget 2010 (expected to be around May). Developments across the Tasman will also have a bearing on how New Zealand reacts.

The recommendations of the TWG will have different impacts – proposals to align and reduce company and personal tax rates will reduce costs for business. On the other hand, changes to tax depreciation could have adverse implications for our property and business clients, while any thin capitalisation changes will impact on how inbound investment is funded. What is clear is that all our clients will be affected, in one way or another.

Further information

To discuss the implications of the TWG report for your business, please contact your regular KPMG advisor or:

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