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Coversheet: **Effective company tax rates in New Zealand**

Supplementary Background Paper for Session 12 of the Tax Working Group
June 2018

Purpose of discussion

At its meeting on 20 April, the Group requested further information on the effective tax rates of certain industries in New Zealand. Within the constraints of taxpayer secrecy, this paper attempts to provide information on how certain industries have low effective tax rates.

The paper also responds to a request from the 1 June meeting for more information on the agriculture sector, including specific tax concessions.

Key points for discussion

- Is there any further information or advice that the Group would like on industry-specific effective tax rates.
- Does the Group wish to make any comments on effective tax rates of industries as part of its interim report.

Recommended actions

We recommend that you:

a **note** that there are several factors that can contribute to lower effective tax rates, including specific tax concessions and the lack of a comprehensive tax on capital gains.
b **indicate** whether the Group wants any further information on effective tax rates
c **indicate** whether the Group's interim report should include material on effective tax rates of specific industries.

Effective company tax rates in New Zealand

***Supplementary** Background Paper for Session 12*
of the Tax Working Group

June 2018

Prepared by the Inland Revenue Department and the New Zealand Treasury

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Background

1. The paper "Effective company tax rates in New Zealand" was provided to the Tax Working Group ("the Group") in April 2018 to help inform the Group about the industries in which some companies may be paying low levels of tax relative to their accounting profit.

2. From that meeting, the Group requested, while recognising the constraints of taxpayer secrecy, further information on the profile of industries with low effective tax rates.

3. For the purposes of this and the April 2018 report, the effective tax rate (ETR) has been calculated as follows using a four-year average (2013-2016):

$$Effective\ tax\ rate = \frac{28\%\ x\ Total\ group\ taxable\ income\ (before\ losses\ brought\ forward)}{Accounting\ profit\ before\ tax}$$

4. As was noted at the Group meeting in April, this methodology captures all book-tax differences, that is, both permanent and temporary differences. This is often referred to as a CASH ETR, as opposed to a GAAP ETR which only captures the effect of permanent differences. Whilst permanent differences are of primary interest to officials, we recognise that temporary differences can have a significant ongoing impact on tax revenue. In general, the noise from small and short-term temporary differences are removed from this analysis, because officials have used a four-year average ETR calculation rather than a one-year ETR calculation.

5. The industries with low unweighted average ETRs for significant enterprises over the four-year period were:

   i. Insurance and superannuation funds
   ii. Residential care services
   iii. Motion picture and sound recording activities
   iv. Primary metal and metal product manufacturing
   v. Rental and hiring services (except real estate)
   vi. Fishing, hunting, and trapping
   vii. Forestry and logging.

6. This supplementary paper provides additional commentary on why these industries have a low unweighted average ETR. For completeness, it includes each industry explanation that was provided in the April 2018 report.

7. At the request of the Group, we have also included an outline of the agricultural sector. Although this is not a sector that came to our attention in the analysis of significant enterprises, it is an important sector which came to our attention in analysis of small and medium enterprises.

8. We draw the Group members' attention to several matters:
   - The forestry and logging industry.is an industry where capital gains play a significant contribution to their low ETRs
   - A capital gains tax is not likely to address the low ETRs in the residential care services industry

- We have also identified the extent of untaxed realised capital gains reported to Inland Revenue by members of the agriculture industry.

9. Finally, we note that this report does not address commercial property companies, which have been identified as having low ETRs by other researchers.[1] Commercial property companies would typically have low ETRs because they make tax adjustments to remove the net change in fair value of investment properties, whilst deducting costs for tax purposes when they are incurred. The reason they are not identified in this report is because large commercial property companies are not included in the Inland Revenue significant enterprise population, which was the basis of this report. Inland Revenue's analysis of small and medium enterprise (SME) data from the IR10 Financial statements summary form did identify commercial and residential property companies as having a low ETR as well as reporting significant untaxed realised gains.

[1] "Corporate tax avoidance or corporate responsibility? An examination of the NZX 50 companies", Jilnaught Wong and Norman Wong, University of Auckland Business School, November 2017

(i) Insurance and Superannuation Funds

Explanation provided in April 2018 report based on a sample of tax adjustment schedules

Significant tax adjustments that <u>decrease</u> the effective company tax rate:	Unrealised gains *Increase in value of shares*
	PIE adjustments *Including untaxed gains by PIEs as well as other PIE adjustments.*
	Interest adjustments *Mainly differences in accounting and tax treatment of derivatives (for example interest rate swaps).*
	Life insurance and superannuation fund adjustments *Life insurance companies and superannuation funds have specific tax rules applicable to them to address their unique circumstances. These lead to a number of tax adjustments for these industries.*

Significant tax adjustments that <u>increase</u> the effective company tax rate:	Life insurance and superannuation fund adjustments *Life insurance companies and superannuation funds have specific tax rules applicable to them to address their unique circumstances. These lead to a number of tax adjustments for these industries.*

Supplementary explanation: Superannuation funds

10. Superannuation funds do not have specific rules for calculating taxable income under the Income Tax Act, unless they are treated as a portfolio investment entity (PIE). Special tax rules apply when a superannuation fund is registered as a PIE.

11. The following items in the financial accounts are typically adjusted for tax purposes (and, based on our sample, in aggregate have reduced the ETR):

- Superannuation funds do not include member contributions or member distributions in their calculation of taxable income.
- Superannuation funds often have large foreign investment fund (FIF) adjustments. Under the fair dividend rate (FDR) method, dividend income along with realised and unrealised gains and losses on most non-Australasian shares is not subject to income tax. Instead, FDR income (broadly, five per cent of the market value of the investment) is taxable to the superannuation fund.
- Realised and unrealised gains and losses on most Australasian shares are also ignored for tax purposes if the superannuation fund is registered as a PIE, the New Zealand Superannuation Fund, Government Superannuation Fund or National Provident Fund.
- Financial arrangements subject to the accrual rules can result in differences between taxable income and accounting income.

Supplementary explanation: Life insurance

12. Life insurers are subject to a special tax regime, with special rules for calculating taxable income on two bases – a shareholder base and a policyholder base. The ETR is therefore not an effective measure of the appropriate level of tax. The main differences between accounting and taxable income can be summarised as follows:
    - New tax rules for life insurers were introduced in 2010. A five-year grand-parenting period gave rise to transitional adjustments that decreased the ETRs over the 2010 to 2016 income years.
    - The movement of policyholder liabilities included in the net profit before tax is not subject to tax, which can increase or decrease the ETR depending on the movement.
    - Special tax rules deal with the unique timing and allocation issues inherent with life insurance products. Special rules also apply to life financial reinsurance which treat the relevant reinsurance treaty as a financial arrangement for tax purposes.
    - Acquisition costs for selling policies, such as commissions, are deferred for accounting purposes but deducted up-front for tax purposes.
    - As is the case with superannuation funds, life insurers have large PIE and FIF investments which are subject to specific tax rules.

(ii) Residential Care Services

Explanation provided in April 2018 report based on a sample of tax adjustment schedules

13. Most residential care service groups are in a tax loss position and do not have an ETR. Others operate as charities and claim a business income tax exemption under section CW 42. Irrespective of whether they are in a tax loss or tax profit position, if a residential care service group is not tax exempt then it typically makes the following significant tax adjustments.

Significant tax adjustments that <u>decrease</u> the effective company tax rate:	Unrealised gains and occupation rights adjustments *In addition to revaluations of properties owned by residential care services this includes adjustments made for sales of occupation rights.* *Occupation rights are effectively interest free loans that a resident provides to a retirement village that roughly matches the value of the property a resident is moving into. When a resident leaves, the village repays the loan (minus a fee) and enters into a loan with a new resident based on an increased value of the property.* *Some villages appear to treat the increase in the value of the loan as income for accounting; however the difference is not taxable.*
	Deferred management fees *Some firms have management fees that are payable when a resident of a retirement village leaves the village. There can be differences in when they are recognised as income for tax and accounting purposes.*

	Interest adjustments *This is mainly interest that is deducted for tax purposes but has been capitalised into the cost of the asset for accounting purposes*
	Tax depreciation being greater than accounting depreciation

Supplementary explanation

14. Residential care service groups do not have specific rules for calculating taxable income under the Income Tax Act. The form of the agreement between an operator and a resident will give rise to different tax consequences.

15. It is common for retirement villages to use "ingoing fees" (the entrance price), "exit fees" (a percentage of the ingoing fee when the resident leaves, eg 2% pa capped at 20%) and "exit entitlements" (a resident who leaves may receive an amount from the operator when the unit is sold to a new resident).

16. There are different views as to whether the economic gains should be taxed under current law. In general, retirement village operators claim that residents make an interest-free loan to the retirement village operator (usually around 80% of the price for outright purchase) in return for a right to occupy a unit.[2] When the occupation right terminates and a replacement resident is found, the retirement village operator refunds the advance subject to certain deductions such as a 20% deferred management fee. The economic gain to the retirement village operator is equivalent to the difference between the original advance refunded to the exiting resident and the replacement advance paid by the new resident.

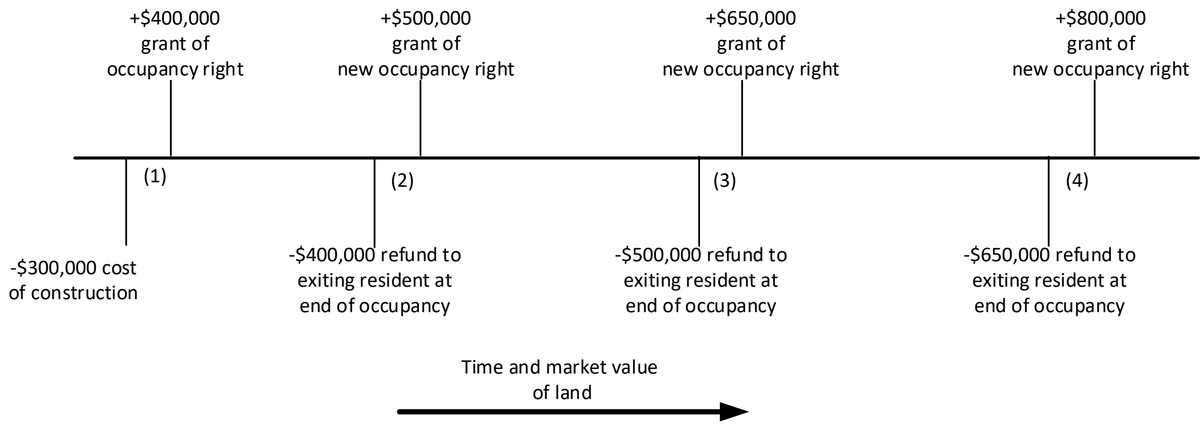
17. However this economic gain does not give rise to net income for tax purposes. This is because the replacement advance is fully repayable in the future (on the exit of the new resident). Accordingly any income arising on receipt of the replacement advance is immediately offset by an equal deduction for its future repayment[3]. This tax treatment is not altered by the fact that certain fees are offset against the future repayment.

18. A capital gains tax would not change this tax outcome. The tax outcome arises from the immediate offsetting of the replacement advance's future repayment (resulting in no net income), rather than the characterisation of that replacement advance as income or capital. We note that Australia has the same issue with taxing its retirement village operators, despite having a comprehensive capital gains tax.

[2] Some retirement villages structure the payment as a refundable lease premium, but this does not change the tax result.
[3] This is under either the current financial arrangement rules (where the payments are structured as a loan) or the ordinary deductibility rules (where the payments are structured as refundable lease premiums)

19. The following example outlines the tax treatment of a typical residential care unit.

Residential care: tax treatment of a single unit



- Retirement village makes a cash gain on each new grant of an occupancy right for the unit, which occurs every 7 years on average. The gain equals the new grant price less the refund of the old grant price.
- The grant price is proportional to the current market value of the unit (80% of the freehold value). So the retirement village makes a cash gain on each new grant provided the land's market value has increased.
- Cash gain is $100,000 at (1), 100,000 at (2), 150,000 at (3), 150,000 at (4)
- The cash gain is returned as a realised profit for accounting purposes and used to pay dividends to shareholders.
- For tax purposes, the cash gain is ignored. Instead tax only sees a series of refundable lease premiums (or loans). Since each payment will definitely be refunded in full, it is never returned as income.
- Retirement villages also enjoy some tax deferral benefits in respect of depreciation and the deferred management fee. However, it is the above tax treatment that causes their persistently low effective tax rate.

(iii) Motion Picture and Sound Recording Activities

Explanation provided in April 2018 report based on a sample of tax adjustment schedules

Significant tax adjustments that <u>decrease</u> the effective company tax rate:	Non-assessable receipts *From Large Budget Screen Production Grant (government grants are excluded from taxable income but are included in determining a company's accounting profits)*

Significant tax adjustments that <u>increase</u> the effective company tax rate:	Non-deductible expenditure *Production costs incurred using a government grant (expenditure incurred using a government grant is not deductible for tax but is included in determining a company's accounting profits)*

Supplementary explanation

20. The film industry can access accelerated deductions under section DS 1-4 of the Income Tax Act, which has a timing impact on ETR calculations. Expenditure incurred acquiring film rights or film production expenditure can be expensed over a specified time frame.

21. Section DS 2B also provides that when a film asset is created with the intention of being sold, the expenditure is treated as expenditure on revenue account property.

22. Large Budget Screen Production Grants (LBSPGs) have the most significant timing impact on taxable income. They are excluded from taxable income, however production costs incurred using a LBSPG are not deductible for tax.

23. In the absence of other adjustments, assessable income will remain the same as accounting profits over time. Therefore, whilst the ETR using a four-year average identified this industry as having a low ETR, over a longer time period the ETR would be closer to the statutory tax rate.

(iv) Primary Metal and Metal Product Manufacturing

Explanation provided in April 2018 report based on a sample of tax adjustment schedules

Significant tax adjustments that <u>decrease</u> the effective company tax rate:	Unrealised gains *Fair value adjustments of assets*
	Untaxed realised capital gains *Including sales of intangibles*

Significant tax adjustments that <u>increase</u> the effective company tax rate:	Non-deductible capital losses *Sale of fixed assets*
	Tax depreciation being less than accounting depreciation

Supplementary explanation

24. Primary metal and metal product manufacturing groups do not have specific rules for calculating taxable income under the Income Tax Act. The low average ETR for this industry reflects tax adjustments made by industry members under the general tax rules, the most significant of which are outlined in the above table and in section 4 of the April 2018 report (reproduced in Appendix A).

25.

(v) Rental and Hiring Services (except Real Estate)

Explanation provided in April 2018 report based on a sample of tax adjustment schedules

Significant tax adjustments that decrease the effective company tax rate:	Tax depreciation being greater than accounting depreciation
	Non-assessable receipts *Trust distributions*[4]
	Overseas income adjustments *Non-taxable foreign dividends*

Supplementary explanation

26. Rental and hiring services groups, which include car rental companies, do not have specific rules for calculating taxable income under the Income Tax Act. The low average ETR for this industry reflects tax adjustments made by industry members under the general tax rules, the most significant of which are outlined in the above table and in section 4 of the April 2018 report (reproduced in Appendix A).

(vi) Fishing, Hunting, and Trapping

Explanation provided in April 2018 report based on a sample of tax adjustment schedules

Significant tax adjustments that decrease the effective company tax rate:	Untaxed capital gains
	Overseas income adjustments *Non-taxable foreign dividends*

27. For the fishing hunting and trapping industry, many investments are included in the accounting profit but are not included in the taxable income as the shareholdings are too small to be consolidated for the tax analysis. This may skew the results towards a lower rate than would otherwise be the case.

Supplementary explanation

28. Fishing, hunting and trapping groups do not have specific rules for calculating taxable income under the Income Tax Act. The low average ETR for this industry reflects tax adjustments made by industry members under the general tax rules, the most significant of which are outlined in the above table and in section 4 of the April 2018 report (reproduced in Appendix A).

[4] The adjustments have been listed as they were stated in the firms' tax adjustment schedules.

29. We note that several significant members of the fishing industry have overseas subsidiaries, so their ETRs are lower as a result of the tax policy setting not to tax active Controlled Foreign Companies.

(vii) Forestry and Logging

Explanation provided in April 2018 report based on a sample of tax adjustment schedules

Significant tax adjustments that decrease the effective company tax rate:	Unrealised gains *Forestry revaluations (timing) and land revaluations (permanent)*
	Accounting value of depletions (timber harvested) differ from the tax value of depletions *This increases the effective rate for some firms and decreases it for others. It is a timing adjustment.*
	Amortisation adjustment *For example, capital and harvest roads are amortised at different rates for tax and accounting.*
	Spread back of timber sales income *Timber sales income is able to be spread back to the previous three tax years. The effect is to decrease taxable income in source (current) year and to increase taxable income in destination (previous) years.*

Significant tax adjustments that increase the effective company tax rate:	Accounting value of depletions (timber harvested) differ from the tax value of depletions *This increases the effective rate for some firms and decreases it for others. It is a timing adjustment.*

Supplementary explanation

30. The forestry industry can access accelerated deductions under section DP 1 of the Income Tax Act. Expenditures associated with forestry (such as planting and tending costs) can be expensed for tax purposes. For accounting purposes these expenditures are generally capitalised against harvest proceeds.

31. Section EI 1 also allows taxpayers to allocate income from the sale of timber between the income year in which they derive it and any one or more of the previous three income years. To take advantage of this concession, the person who has disposed of the timber must apply to the Commissioner.

32. Tax adjustments relating to the above provisions, combined with the recognition of unrealised gains and losses for forestry revaluations for accounting but not for taxation, can result in significant timing differences between taxable income and accounting profits for this industry.

33. Significant permanent differences between taxable income and accounting profits include non-assessable IFRS land revaluations. This permanent classification is made on the basis that the land is a capital asset for the forestry companies and gains on sale will not be taxable.

34. We note that the thin capitalisation rules did not apply to ownership syndicates, which are typically used by non-residents for forestry investments, until the acting in concert changes took effect from the 2016 income year. High interest deductions can result in groups reporting accounting and tax losses. These loss-making groups are not reflected in the aggregate industry ETR calculation (because their ETRs are all 0%), although they make the same types of adjustments between accounting and taxable income as other forestry groups.

(viii) Agriculture

Effective tax rates, tax losses and untaxed realised gains

35. The agriculture sector was not specifically identified in the April 2018 report to the Group. It is not an extreme outlier for significant enterprise ETRs and it is dominated by Fonterra, a cooperative.

36.

37. We have subsequently reviewed small and medium enterprise companies (companies that do not fall within the definition of a significant enterprise, ie they do not have a consolidated turnover above $80 million) which identify themselves as being in the agriculture industry. The information they supply on the IR10 Financial Statements Summary distinguishes between accounting profits and taxable income and it requires taxpayers to identify "untaxed realised gains / receipts".

38. Using this IR10 information and information from income tax returns, at the SME level the agriculture sector is not an extreme outlier of ETRs - it has a four-year average (2013-2016) weighted ETR of 26%.

39. However, the agriculture industry has significant losses and the loss making companies are not included in the above ETR calculation. There are approximately 16,000 companies that have identified themselves as being in the agriculture industry in total (using a four year average, 2013-2016). Typically, 8,000 or 50% of these companies report current year tax losses (ignoring losses brought forward). Those tax losses total approximately $900 million per annum. In comparison, the 8,000 profitable companies report total taxable profits (ignoring losses brought forward) of approximately $1,200 million per annum.

40. Untaxed realised gains are significant for this industry. On average, approximately 1,600 SME companies in the agriculture sector report untaxed realised gains on their IR10 form each year. These gains were $400 million per annum using a four year average (2013-2016).

Tax rules

41. While normal tax rules apply to farming, there are some tax incentives. Certain farm expenditures are able to be written off or accelerated at faster than their economic life. These concessions are longstanding, and were designed to encourage investment in these assets.

42. The expenditures for the farming industry include:

- immediate deductions for minor expenditures, such as:

- the destruction of weeds, plants and animals that are detrimental to the land;
- the repair of flood or erosion damage;
- the clearing of scrub, stumps and undergrowth;
- the construction of fences;
- the re-grassing and fertilising pasture;

- erosion and shelter planting, and ornamental tree planting.

- accelerated depreciation for more major improvements to farm and horticultural land, such as the drainage of swamps, construction of dams and earthworks, and airplane strips, and crop supporting frames) and various freshwater and sea aquaculture-related improvements.

43. The income equalisation scheme is also listed as a tax expenditure. This longstanding scheme enables those earning income from farming, forestry or fishing to smooth their income across tax years. While others with lumpy income cannot generally smooth their income in this way, at least conceptually income smoothing may assist in improving horizontal equity among taxpayers earning the same income over their lifetimes.

44. There are specific trading stock rules for valuing livestock on hand each year. One option (the herd scheme) enables stock, such as dairy cows, to be treated as capital assets, as they are more akin to machines than being grown for slaughter. The scheme is popular with those who have relatively stable herds, as increases in livestock values from year to year are ignored in those cases when undertaking trading stock adjustments for tax purposes. Moreover, when an animal is sold for more than its herd scheme value, only the excess is treated as income. This scheme is a factor to consider in any design of a comprehensive capital gains tax.

Appendix A: Types of tax adjustments by significant enterprises

The most significant adjustments which decrease taxable income relative to accounting profit recorded are[5]:

Untaxed realised gains *Mainly sales of subsidiaries, shares, businesses or brands. Also includes realised gains from the sale of land, however, these were less significant for significant enterprises.*	At least $2.2 billion
Unrealised gains *Unrealised gains for shares, land and intellectual property. Unrealised gains for both land and shares were significant for significant enterprises.*	At least $1.3 billion
Overseas income adjustments *Mainly untaxed foreign dividends.*	At least $1 billion
Non-assessable receipts *Includes government grants, settlement payments, and limited partnership distributions.*	At least $400 million
Tax depreciation greater than accounting depreciation *Note this is a temporary adjustment. A temporary adjustment means it will be reversed out over time; however it is unclear over what time period this will occur.*	At least $800 million
Lease and financial arrangement adjustments *This is where the treatment of leases and financial instruments is different for accounting and tax. These are generally temporary adjustments.*	At least $150 million
Capitalised interest *This is interest that is capitalised into the value of an asset for accounting purposes but is deductible for tax.*	At least $50 million

The firms in the sample had approximately $13 billion in net taxable income for the year.

5 Some modifications have been made to address confidentiality concerns. All of these figures are provided as "at least $X" as they are from a sample of significant enterprises. The results for all significant enterprises are expected to be larger.

The most significant adjustments which increase taxable income relative to accounting profit recorded are:

Reversal of accounting impairments *An accounting impairment is where the assets of a company are reduced in value on their balance sheets. This reduction in value reduces accounting profit but is not deductible for tax.*	At least $1.1 billion
Non-deductible capital losses *Mainly from sales of fixed assets.*	At least $600 million
Non-deductible expenditure *Mainly impairments and write-offs of goodwill, expenditure incurred for a listing of a company or a company amalgamation, and non-deductible expenditure from using a government grant.*	At least $280 million
Interest adjustments *Includes adjustments such interest allocations and thin capitalisation adjustments.*	At least $100 million
Tax depreciation greater than accounting depreciation *Note this is a temporary adjustment.* *This adjustment will also include instances where tax depreciation is less than accounting due to the value of the asset including capitalised interest.*	At least $500 million
Lease and financial arrangement adjustments *This is where the treatment of leases and financial instruments is different for accounting and tax. Note, that these are generally temporary adjustments.*	At least $500 million