Tax Working Group
Te Awheawhe Tāke

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The advice represents the preliminary views of the Secretariat and does not necessarily represent the views of the whole Group or the Government.

Some papers contain draft suggested text for the Final Report. This text does not constitute the considered views of the Group. Please see the Final Report for the agreed position of the Group.

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Coversheet: Follow up - issues raised by New Zealand Superannuation Fund

Paper for Session 21of the Tax Working Group
26 October 2018

Purpose of discussion

The Group is meeting with the New Zealand Superannuation Fund (NZSF) on 26 October discuss its submission.

The NZSF has proposed:

- tax incentives for nationally significant infrastructure projects
- a tax exemption for the NZSF.

This paper sets out the Secretariat's views of the pros and cons of –these proposals. It is an updated version of the paper we provided for the Session 16 meeting of 17 August. The paper has been sent to the NZSF ahead of this meeting.

Key points for discussion

- Does the Group agree with the Secretariat that tax incentives for nationally significant infrastructure projects should not be progressed?
- What further information (if any) does the Group require in relation to making a recommendation on the NZSF's proposal that it be tax exempt?

Recommended actions

We recommend that you:

a. Note the Secretariat's view that there should not be tax incentives for nationally significant infrastructure projects.

b. Note the Secretariat's view that the merits of a tax exemption for the NZSF could be fact-dependent and so, in the time available, the Secretariat has not reached a definitive view.

c. Discuss the tax exemption issue further with the NZSF if the Group wanted to comment on this issue in its final report.

d. Agree to the final report text attached to this paper.

Issues raised by New Zealand Superannuation Fund

Discussion Paper for Session 21
of the Tax Working Group

October 2018

Prepared by Inland Revenue and the Treasury

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1. Introduction

1.1 The New Zealand Superannuation Fund (NZSF) has proposed:

a) a number of measures to encourage non-resident sovereign wealth funds and pension funds to participate in Nationally Significant Infrastructure Projects (NSIPs), and

b) that the NZSF be exempt from tax (currently, it is taxable).

1.2 This paper responds to a request by the Group for the Secretariat to set out the pros and cons of these proposals.

1.3 The Secretariat does not recommend offering tax incentives for Nationally Significant Infrastructure Projects because there are significant drawbacks.

1.4 The Secretariat considers that the merits of a tax exemption for the NZSF could be fact-dependent and so, in the time available, has not reached a definitive view. We recommend further discussion with the NZSF if the Group wanted to comment on this issue in its final report.

2. NZSF submission on tax incentives for Nationally Significant Infrastructure Projects

2.1 The NZSF has recommended the implementation of a specific NSIP regime. It is intended "to provide certainty for investors and ensure New Zealand can compete with other jurisdictions in attracting long term capital that brings with it world-class expertise". The purpose of the regime would be to facilitate the attraction of direct capital investments by non-resident sovereign wealth and pension funds.

2.2 The regime would be targeted at large infrastructure projects in areas such as public transit systems, large-scale housing developments, communications, energy, and water reticulation assets.

2.3 Qualifying investors would need to have a demonstrated capability to deliver world-class projects and would need to make a commitment to contribute project expertise.

2.4 Qualifying projects would receive:

- A tax rate substantially less than the prevailing corporate tax rate, say half or less, set for a meaningful part of the life of the asset.

- No further tax impost on profit distribution to both domestic and foreign investors.
- Full deductibility of third party non-recourse funding.
- If tax laws are changed prior to the expiry of the term of the concession, the tax conditions relating to Nationally Significant Infrastructure are grand-parented until the end of the concession term.
- Ability to fast track other required regulatory approvals e.g. RMA approvals, and the provision of foreign skilled labour to enable rapid construction.
- Approval is project specific i.e. it survives any change of ownership.

Approach in Australia

2.5 Australia has recently introduced a regime that provides a reduced 15% rate for 15 years for Government-approved NSIP. However, it is our understanding that Australia's change was to replace a broader set of concessions that directly or indirectly relate to foreign investment in NSIP. These included the wind back of concessions for sovereign wealth fund investors and foreign pension fund investors by limiting their exemption from non-resident withholding tax on interest and dividends to portfolio investment, the removal of loopholes on stapled securities and the winding down of existing concessions for infrastructure assets. Accordingly, while it is true that Australia has introduced this new NSIP regime it appears to reflect a general tightening of preferences for these projects and a move in the opposite direction to that proposed by NZSF.

3. Pros and Cons of tax incentives for Nationally Significant Infrastructure Projects

Pros

3.1 There are two reasons to consider tax incentives: sensitivity to tax, and spillover benefits.

3.2 If investment is very sensitive to tax, and additional investment can take place without drawing away substantial amounts of labour and other resources from other more heavily taxed activities, taxing may discourage investment that is in New Zealand's interests. The potential for the company tax rate to drive up hurdle rates of return and discourage investment is a key reason why people are concerned about the effect of the company tax rate.

3.3 For example, suppose that projects that are particularly sensitive to tax, and which will proceed if taxed concessionally but not if taxed at standard rates, can be identified before investment is made and given concessionary tax rates. In this

case New Zealand will get the benefit of the investment without this reducing other activity substantially. In theory, this would provide a case for taxing projects that are insensitive to tax at higher rates and projects that are sensitive to tax at lower rates, or not at all.

3.4 There are also possible external benefits from some investments and not others. As an example, foreign direct investment may bring in knowledge of better ways of working (including how to manage large infrastructure developments). This additional knowledge may lead to broader "spillover" benefits that boost productivity in projects wider than the particular project.

Cons

3.5 In practice, targeted tax incentives will normally draw resources (capital and labour) toward the projects receiving the concession, and away from other industries. The costs of this will often be hard to assess.

3.6 As pointed out in the McLeod Review, calibrating taxes according to a project's tax sensitivity in practice is constrained by principles of fairness and by our inability to reliably measure the tax sensitivity of particular activities.[1] Under such a system it seems inevitable that lobbyists will argue that all investments they are considering are particularly sensitive to tax and require concessions.

3.7 Specific tax concessions for specific activities will lower the cost of capital for firms engaging in these activities. But they will often be drawing resources away from other activities that offer a higher return for New Zealand

3.8 The Secretariat does not consider that New Zealand has to offer comparable tax incentives to other countries for investment to take place. However, it is true that, if higher are taxes are imposed in New Zealand, the hurdle rates of return will also need to be higher.

3.9 The Government usually decides on what major infrastructure projects to complete, and it uses its own resources and private contractors to construct them. While most infrastructure projects are financed directly by the Crown, private financing is sometimes used where there is a value-for-money case for doing so. In order for the Government to make accurate value-for-money and prioritisation decisions, it should be able to compare costs across different infrastructure projects on a consistent basis, without less transparent costs from tax reductions on some projects making comparisons of true costs across different projects more difficult.

3.10 A regime that requires government approval before an investment receives a lower tax rate will inevitably favour a limited number of large projects over many,

[1] Para 2.11 of McLeod Review final report.

smaller projects that may, in aggregate, actually create higher living standards for New Zealanders than the large projects.

3.11 The Secretariat believes that capital productivity is likely to be enhanced by taxing investments as neutrally as possible, which will encourage investment to flow to the areas which generate the highest pre-tax rates of return. It considers that there should be a high burden of proof before moving away from neutral tax settings and does not believe that this burden of proof is satisfied in this case.

3.12 In the context of the Government being the ultimate purchaser of the infrastructure, or services from the infrastructure, tax concessions seem to add a layer of complexity to the question of the overall cost to the Government.

3.13 Finally, the Treasury's public-private partnerships (PPP) team has noted that, to date, it has not seen any issues with attracting interest from equity investors (either international or domestic) and therefore considers that there is no need to offer concessions to "attract" further investment.

4. Interaction with BEPS legislation and interest deductibility

4.1 Under the BEPS legislation, interest on non-recourse third-party debt for Government-approved PPP projects is not subject to thin-capitalisation limits.

4.2 The exemption was provided because the gearing levels of PPPs led to international investors being disadvantaged (as compared with domestic investors) due to features of the PPP model. In addition, it was virtually impossible for them to utilise the worldwide test that was intended to protect highly-geared projects that reflect normal levels of gearing for the industry. From the Crown's perspective these changes made sense as we were constraining competition and would otherwise incur a higher net cost over time.

4.3 The Secretariat asked the Treasury's PPP team whether they are aware of any other unintended impediments through the tax system that should be considered for amendment, and the PPP team were of the view that there were none.

5. Tax status of NZSF

5.1 The purpose of the NZSF is to invest money on behalf of the Government to help pay for the future cost of universal superannuation. The NZSF's assets are worth $38.9 billion (as at 31 May 2018). The NZSF is one of New Zealand's most significant financial asset holders.

5.2 Since its inception, income that the Crown derives through the NZSF has been subject to tax, based on the company tax rate.

5.3 The NZSF is one of the largest taxpayers in New Zealand. The Fund paid $676 million in New Zealand income tax on its 2016/17 returns.[2]

5.4 The other large Crown controlled investment funds, ACC and EQC, are not subject to income tax.

5.5 The NZSF submitted that it should be tax exempt in New Zealand. The NZSF comments that sovereign wealth funds of other countries are exempt from tax in their home jurisdictions.

5.6 The NZSF argues that, in a New Zealand context, a tax exemption would mean:

a) There would be no need to liquidate assets to pay tax.

b) There would be no need for the NZSF to pay the Government provisional tax with the Government then paying the NZSF contributions, thereby removing the need for practical work-arounds in terms of offsetting provisional tax and contributions.

c) Lower contributions would need to be made by the Government over time in terms of the funding formula in the New Zealand Superannuation and Retirement Income Act 2001.

5.7 In further discussions with the NZSF, two further costs were identified:

d) Foreign tax leakage due to other countries not recognising the fact that the NZSF is a sovereign wealth fund, because the countries rely on the domestic taxable status of the Fund to determine whether it is subject to tax in their jurisdiction.

e) Tax compliance costs for the NZSF.

[2] NZSF Annual Report 2017 https://www.nzsuperfund.co.nz/sites/default/files/documents-sys/NZSF%20Annual%20Report%202017.pdf

5.8 The impact on contributions should be considered in the context of the broader impacts on the government's fiscal position. A tax exemption would impact on tax revenues and capital contributions to the NZSF. A tax exemption would generally mean that lower capital contributions would be needed to offset the reduced tax receipts. However, there would be different fiscal impacts when capital contributions to the Fund are not in line with the legislated formula (such as suspension of contributions).

5.9 The Treasury notes that an advantage of the current situation is that it allows for future flexibility of the Government to manage its fiscal position by changing the level of contribution to the NZSF (as it could then be raising net revenue from the Fund).

5.10 In respect of the NZSF's international investments, the NZSF consider that if the NZSF were tax exempt in New Zealand it would be easier for the Fund to obtain exemptions from foreign tax liabilities, and it may open up other exemptions. (Tax exemptions, or immunity from tax, are granted by some Governments to sovereign wealth funds, or to tax-exempt entities of other countries). The fund paid total foreign taxes of approximately $14m last year.

5.11 We agree that foreign tax liabilities should be minimised, as they reduce the Fund's after-tax return to the New Zealand Government (in a similar way to other costs relating to investment). However, we expect that some of those foreign tax liabilities would still continue even if the NZSF was exempt. As an example, Switzerland has no domestic law concept of sovereign immunity for income earned by governments, and as such domestic exemption would not reduce Swiss taxes payable.[3]

5.12 We also note that amendments to the Income Tax Act were made in 2011 to assist the Fund to get exemptions that it is entitled to overseas, by clarifying that under New Zealand's tax law the NZSF is entitled to the benefits of New Zealand's tax treaties, and by making it clear that the NZSF is, from a New Zealand tax law perspective, a sovereign wealth pool of funds owned by the Crown rather than a separate, private, legal entity.[4]

5.13 Exempting the NZSF may lead to the following risks, at the margin:[5]

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[3] New Zealand also does not recognise sovereign immunity as grounds for a tax exemption when a foreign government-controlled fund invests in New Zealand, unless relief is provided in a DTA.

[4] https://www.ird.govt.nz/technical-tax/legislation/2011/2011-63/2011-63-remedial-matters/2011-63-amendments-to-tax-of-nz-superannuation-fund/leg-2011-63-amendments-tax-nz-superannuation-fund.html

[5] In addition to the risks listed, there is a general risk when a taxpayer is exempt that tax benefits are shared (intentionally or otherwise) when commercial arrangements with other parties are entered into This has previously been identified as a risk when considering whether the NZSF should be taxable.

a) There may be an incentive for the NZSF to invest in interest securities over equity (as the Fund would no longer benefit from imputation credits).

b) There may be an incentive for the NZSF to invest in in foreign equities rather than New Zealand equities (again, because the NZSF would no longer benefit from imputation credits).

5.14 It is difficult to estimate the likelihood of these risks materialising. There are examples of other Crown Financial Institutions, including ACC, that operate with a tax exemption without raising these concerns. On the other hand, the mandate of the NZSF is different to other Crown Financial Institutions.

5.15 Costs to comply with New Zealand tax for the NZSF are a cost that results in little benefit to New Zealand overall, given that costs must be paid out of returns to New Zealand. These costs are likely to grow in the future as the NZSF grows in size.

5.16 On balance, the Secretariat is of the view that there is a case to exempt the NZSF. The only significant downside is that the current arrangements allow for greater future flexibility of the Government to manage its fiscal position by changing the level of contribution to the NZSF. The main benefit is likely to be a reduction in compliance costs, and some small benefit from a marginal reduction in foreign taxes. The Secretariat is of the view that these issues would benefit from a discussion between the TWG and the NZSF at the meeting to inform a TWG view.

Appendix: Suggested final report text

The following is suggested final report text on the issue of the tax exemption for the NZSF. We have not prepared final text on the question of a lower tax rate for non-resident sovereign wealth funds and pension funds to participate in Nationally Significant Infrastructure Projects, but will do so after the TWG comes to a view on this issue.

Suggested text

The New Zealand Superannuation Fund pays New Zealand tax. This involves one arm of the New Zealand government paying the other arm, minus the costs of determining the tax liability (i.e., the compliance costs). The other significant Crown-controlled investment funds, ACC and EQC, are not subject to income tax.

Having the government-owned investment fund subject to tax is unusual globally. Some countries recognise the concept of sovereign immunity from taxes: that entities owned by other governments should not be subject to tax when they invest locally. Countries that do this will sometimes be looking to see whether the fund is exempt from its own government's taxes. The lack of exemption in New Zealand can make it difficult to argue that the fund should be exempt in the foreign jurisdiction. Foreign taxes are a cost to the fund that does not benefit New Zealand.

Making the fund tax exempt will not mean that no foreign taxes have to be paid as some countries do not have a sovereign immunity tax exemption, but it will make it easier to apply for exemptions when they are available and should result in some reduction of foreign taxes. The fund paid total foreign taxes of approximately $14million last year.

The main concern with making the fund exempt is the loss of flexibility. As noted above, in aggregate the loss of tax revenue is not a cost to New Zealand or the New Zealand government overall. The current funding formula requires the government to return most of the tax revenue it raises from the Fund through new contributions. But it does mean that the Government will have less flexibility going forward. If the fund is paying tax, the Government could reduce or suspend contributions and have a source of revenue to pay for public goods and services, without raising other taxes or borrowing. If the fund is not paying tax, in net terms the Government and citizens are no worse off, but public goods and services will have to be paid for by borrowing, having a lower operating surplus, or raising other taxes.

Overall, the Group recommend that the fund [be exempt from New Zealand tax/continue to be subject to New Zealand tax].