Tax Working Group Information Release

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This paper contains advice that has been prepared by the Tax Working Group Secretariat for consideration by the Tax Working Group.

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

Appendix 2: Company tax rate issues

Background Paper for Sessions 6 and 7
of the Tax Working Group

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The Tax Working Group will release its interim report containing its recommendations in September and the views of the Group will be informed by public submissions alongside Secretariat advice.

March 2018

Prepared by the Inland Revenue Department and the New Zealand Treasury

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1. Introduction

1.1 Purpose

1. This paper sets out issues relating to the company tax rate and thin capitalisation rules in an international context.

1.2 Content and scope

2. This paper covers the question of the company tax rate, primarily from the perspective of the level of capital invested in New Zealand, taking into account the effect of the company tax rate on foreign investors, who are an important source of investment in New Zealand.

3. The paper looks at:

   - New Zealand's company tax rate compared to other OECD countries.
   - The question of thin capitalisation rules, which provide for a maximum level of debt attributable to New Zealand investment.
   - International tax competition and New Zealand's response.
   - Whether it would be in New Zealand's interests to have a lower company tax rate.

1.3 Summary of analysis

4. At 28%, New Zealand's company tax rate is relatively high by international standards. As at 2017 New Zealand's company rate is the 10th highest in the OECD, with the unweighted OECD average being 24.9%[1]. Despite this, in the view of the Secretariat it would not be in New Zealand's interest to cut the company tax rate.

5. New Zealand relies heavily on inbound investment to fund its capital stock, and as a result, if tax is an undue impediment, New Zealand will ultimately have lower capital stock. This can result in lower wages for New Zealanders. This is generally because workers are more productive when using more capital.

6. The effects of a company tax cut would be:

   - Greater capital investment in projects that are viable at the lower company rate (but would not have been viable at the higher previous rate), with corresponding benefits for labour productivity due to increased capital investment.

[1] This statistic does not include the recent corporate tax rate cuts in the United States, from 35% to 21%.

- Reduced pressure on base erosion and profit shifting – multinational companies that are able to shift profits out of New Zealand would have less of an incentive to do so with a lower New Zealand company tax rate.
- Windfall benefits to those who have invested in New Zealand in the past.
- Loss of taxation on location-specific rents (rents arising from factors that are linked to a location - such factors could include resources, or access to particular markets that allow above-normal profits to be earned).
- Increased integrity concerns from New Zealand investors sheltering income in companies, although this may be ameliorated through other policies, including a capital gains tax.

1.4 Overall thoughts

7. Overall, in the Secretariat's judgement, the above effects when considered together (while pointing in different directions individually) suggest that a company tax cut is unlikely to be in New Zealand's best interests.

8. It is important to note that flexibility may become more important over time. While the Secretariat's judgement is that there is no need to cut the company rate, future governments may want to raise the top personal rate without raising the company rate, or cut the company rate without dropping the top personal rate. If so, measures that allow for a greater degree of difference between the top personal and company rate will be important.

9. Location-specific rents are an important part of the judgement in recommending not cutting the company rate. We intend to report in later meetings on environmental resource rental taxes and a financial activities tax, but ask the Group if they would like analysis of supplementary taxes on economic rents to be analysed for the interim report.

1.5 Questions for the group

10. The questions we suggest the Tax Working Group focus on are:

- Would the group like material on the company tax rate to be included in the interim report?
- What should be the broad conclusion of that material?
- Would the group like additional information on taxing rents differently to be analysed for the interim report, noting that we will report at a later date on environmental resource rental taxes, and on a financial activities tax.

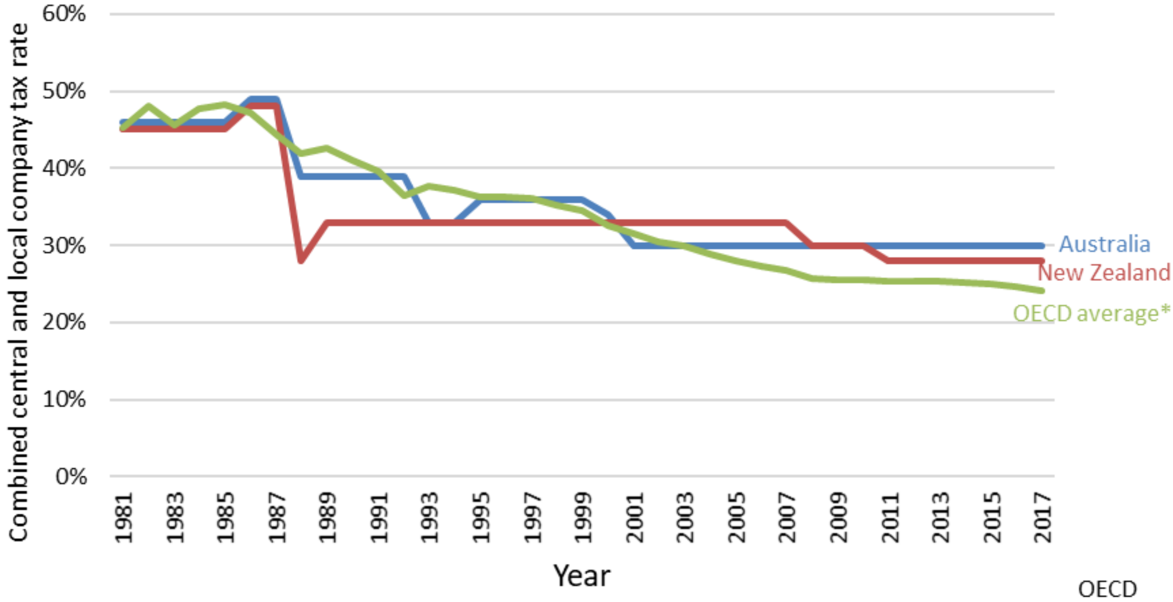
2. Issues

2.1 New Zealand's company tax rate

11. At 28%, New Zealand's company tax rate is relatively high by international standards. For domestic shareholders, New Zealand's *imputation regime* means that the final tax rate on investments in companies is normally taxed at the shareholder's marginal tax rate[2]. When factoring in imputation, New Zealand's tax rate on domestic shareholders is the sixth lowest in the OECD. Foreign shareholders do not receive imputation credits and for them it is the company rate that is relevant.

12. As at 2017 New Zealand's company rate is the 10th highest in the OECD, with the unweighted OECD average being 24.9%[3].

Figure 21: Historical trends in statutory company tax rates



OECD

13. New Zealand has reduced its rate in recent years (in 2007 it was 33%), but other OECD countries have reduced their rates more than New Zealand, resulting in New Zealand climbing up the OECD rankings of corporate tax rates. As at 2017, OECD corporate rates were[4]:

OECD member	**Corporate rate (including sub-central government)**
United States	38.9
France	34.4
Belgium	34.0

[2] This is done by companies attaching an imputation credit for the company tax paid when it pays dividends to domestic shareholders.

[3] This statistic does not include the recent corporate tax rate cuts in the United States, from 35% to 21%.

[4] Again, noting that the United States has since dropped its central government corporate rate from 35% to 21%.

Germany	30.2
Australia	30.0
Mexico	30.0
Japan	30.0
Portugal	29.5
Greece	29.0
New Zealand	**28.0**
Italy	27.8
Luxembourg	27.1
Canada	26.7
Austria	25.0
Chile	25.0
Netherlands	25.0
Spain	25.0
Korea	24.2
Israel	24.0
Norway	24.0
Denmark	22.0
Sweden	22.0
Switzerland	21.1
Slovak Republic	21.0
Estonia	20.0
Finland	20.0
Iceland	20.0
Turkey	20.0
Czech Republic	19.0
Poland	19.0
Slovenia	19.0
United Kingdom	19.0
Latvia	15.0
Ireland	12.5
Hungary	9.0

14. When examining incentives to invest in New Zealand it is the *effective* company tax rate that is more relevant than the statutory rate. The effective company rate takes into account tax base issues, including deprecation rates, methods of financing, as well as the statutory rate. If investment is financed entirely with equity, the statutory rate is relevant. For investment funded by debt, the interest paid is deductible against the income tax base in New Zealand. Accordingly, the New Zealand tax paid on the underlying income is the non-resident withholding tax at a rate of 10% or 15%, depending on whether the residence country of the parent is a treaty country or not. However, interest deductions are limited by specific rules in legislation to limit the reduction in tax that could be achieved through debt.

2.2 Thin capitalisation

15. The single most important tax base issue in determining New Zealand's share of the taxes payable on income earned on foreign direct investment (FDI) is the method of financing employed by the parent company of the New Zealand

operations. In particular, is the New Zealand subsidiary financed by debt or equity from the parent?

16. The distinction between debt and equity is largely arbitrary in related-party situations. The overall risk to the parent company is not generally affected by choices between these two methods of financing the operation of subsidiaries. The arbitrary nature of the distinction means that in the absence of any restrictions a New Zealand subsidiary could be financed almost exclusively with debt which might lead to interest deductions offsetting most or all income otherwise taxable in New Zealand.

17. The amount of tax payable to New Zealand on the investment is substantially affected by the choice. Investments funded by equity are subject to full taxation at the 28% company tax rate on the income generated by their New Zealand operations. On the other hand, as noted above in paragraph 14, for investment funded by debt, the interest paid is deductible against the income tax base in New Zealand. Accordingly, the New Zealand tax paid on the underlying income is the NRWT (non-resident withholding tax) at a rate of 10% or 15%, depending upon whether the residence country of the parent is a treaty country or not.

18. Thin capitalisation rules can play an important role in restricting interest deductions so that they do not unduly erode New Zealand's share of tax. A company is said to be "thinly capitalised" if it obtains a lot of its funds as debt. It is "thinly capitalised" because the equity portion of investment is low. The Income Tax Act has "thin capitalisation rules" to limit the amount of debt able to be attributed to New Zealand investment.

19. Unlike in many jurisdictions, New Zealand's thin capitalisation rules apply to unrelated party debt, as well as related party debt. Rather than a parent lending directly to its New Zealand subsidiary, it could arrange for the subsidiary to hold much higher third-party debt than the parent. This can be a close substitute for direct lending by a foreign parent. Accordingly, the rules respond to concerns about third-party borrowing being done through New Zealand in a manner that erodes the tax base. Australia's thin capitalisation rules also apply to both related and unrelated-party debt. Thin capitalisation rules limit base-erosion by a variety of BEPS schemes that rely on increasing interest deductions.

20. While the underlying policy framework for thin capitalisation is an apportionment of debt among countries, a safe-harbour ratio of debt to assets, below which interest is not restricted, simplifies compliance with the rules. The safe harbour was changed in 2010 from 75% to 60%. This change has been paralleled in a number of other jurisdictions, notably Australia, which has a thin capitalisation framework similar to New Zealand's.

21. Thin capitalisation rules on inbound investment could potentially increase both tax revenue and national income through the replacement of debt with equity. At the same time, they could discourage investments that would otherwise be economic by raising taxes on such investment.

22. Choosing thin capitalisation thresholds will involve trade-offs between the potential effect on the pre-tax cost of capital and level of investment on the one hand and the benefits to New Zealand arising from having taxes paid in New Zealand on the other.

23. Moreover, there are other issues that may be important. An important consideration when the thin capitalisation safe harbour was reduced from 75% to 60% was that 75% was an extremely high level of debt that would not be seen in arms' length situations. Thus, the former safe harbour was seen as allowing an unreasonable stacking of debt into New Zealand. New Zealand's actions here can be seen as an early response to concerns about BEPS.

24. It should be acknowledged that the thin capitalisation safe harbour is ultimately a judgement call. There is no hard evidence which would allow us to determine an "optimal" safe harbour ratio. New Zealand already collects the most company tax as a percentage of GDP in the OECD, and the Secretariat not aware of any strong grounds for tightening thin capitalisation rules further.

2.3 International tax competition and New Zealand's response

25. Sometimes commentators suggest that New Zealand should cut its company rate to be "competitive".

26. There are three key elements to international tax competition:
    - competition between countries for tax base;
    - competition for business headquarters; and
    - competition for foreign investment.

27. In terms of competition for tax base, lower rates overseas may incentivise firms to shift profits out of New Zealand into a lower-tax country with deductible payments such as interest, or transfer pricing measures. New Zealand has specific and general anti-avoidance rules to mitigate this risk, but the greater the difference between foreign and domestic company tax rates, the greater the incentive to look for ways around our rules. Having said that, lowering tax rates is likely to be an expensive way to reduce profit shifting, since it lowers taxes on the tax base that remains in New Zealand.

28. In terms of competition for business headquarters, there may be some New Zealand firms with substantial foreign shareholding that will choose to leave New Zealand if foreign rates are low enough or New Zealand rates are high enough. However, for New Zealand companies with a substantial New Zealand shareholder base, the New Zealand tax settings mean it is advantageous to remain New Zealand headquartered (as tax paid in foreign jurisdictions cannot be passed on as a credit to New Zealand shareholders, whereas New Zealand tax can).

29. New Zealand relies heavily on inbound investment to fund its capital stock, and as a result, if tax is an undue impediment, New Zealand will ultimately have lower capital stock. This can result in higher prices and lower wages for New Zealanders. This is generally because workers are more productive when using more capital.

30. However, on competition for foreign capital, the international "competition" aspect is sometimes overstated. Generally, if an investment makes sense in New Zealand with a 28% company tax rate, it does not suddenly become uneconomic because a foreign country drops its rate from (say) 30% to 25%. If the foreign country attracts such a large amount of capital due to its tax cut, it may raise the required return on global capital. In that case, projects that were viable in New Zealand may not be viable after the tax change. However, required returns on global capital are affected by many things, only some of which are tax related. More importantly, the fact that it was caused in this instance by an overseas tax change does not imply that New Zealand must react with a tax change of its own. The converse of this is that it may be in New Zealand's interests to lower its company tax rate to attract foreign capital (discussed below), but this is independent of whatever is happening overseas (aside from the transfer pricing issue).

2.4 Is it in New Zealand's interests to cut the company rate?

31. This brings us to the question of whether it would be in New Zealand's interests to lower the company rate. There are costs and benefits of such a decision. The following table sets out the relevant considerations and which direction they suggest setting the company tax rate.

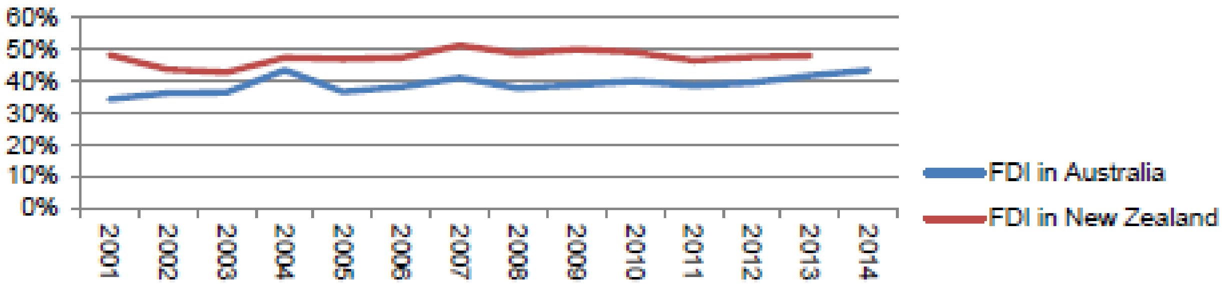
Issue	**Points towards a company tax rate which is…**
Increase foreign direct investment and labour productivity in New Zealand	Lower
Reduce profit shifting	Lower
Tax non-residents on location-specific economic rents	Current level or higher
Tax non-residents on existing investments	Current level
Maintaining tax system coherence/integrity – including fairness concerns	Current level or higher

32. A company tax cut would result in some non-viable projects becoming viable. Under some very strong assumptions (including perfect mobility of capital and no economic rents), any corporate tax rate that applies to foreign direct investment is not in New Zealand's interests, as it simply increases the pre-tax rate of return until the post-tax rate of return equals the global rate of return, and New Zealand imports less capital and has a lower-productivity economy. There are no studies we are aware of on the sensitivity of FDI to the company tax rate in New Zealand. International studies generally report quite high sensitivities. The sensitivity of FDI to domestic company taxes is likely to differ markedly across countries. New

Zealand is a very long way from the rest of the world. Much FDI to New Zealand may be associated with supplying goods and services to domestic markets. At least traditionally, it will often be hard to do this without establishing a base in New Zealand. In this case, tax is much less likely to play a critical factor in investment decisions. If companies can supply goods and services to New Zealand without a physical presence, then the company tax will not apply to them anyway (under current frameworks) and so the company tax is irrelevant.

33. As illustrated in Figure 1 below, the two recent reductions in the company tax rate in New Zealand (from 33% to 30% on 1 April 2008 and from 30% to 28% on 1 April 2011) did not cause a surge of FDI into New Zealand. Nor did it show up in New Zealand's level of FDI increasing relative to Australia's. Australia had no cut in its company rate over this period. This is not a sophisticated analysis - many things were happening at the same time, such as the Global Financial Crisis, and other tax changes (for example, New Zealand's second company rate cut in 2010 was accompanied by tighter thin capitalisation provisions and a tightening of depreciation rules). But it should at least cause us to question any assumptions that company tax cuts are likely to be a silver bullet for increasing the level of FDI into New Zealand.

Figure 1: Stock of FDI as percentage of GDP



34. A further caution against cutting the company rate is that this would mean reducing taxes on location-specific rents. Economic rents are returns over and above those required for investment in New Zealand to take place. Location-specific rents arise from factors that are linked to a location. Such factors could include resources, or access to particular markets that allow above-normal profits to be earned. Economic rents are likely to be larger in a geographically isolated market like New Zealand where supply of certain goods and services is likely to require a physical presence in New Zealand.

35. These returns can be taxed without discouraging investment into New Zealand. This is because a portion of the rent would still accrue to the investor, ensuring that the investment would still be viable despite taxation.

36. Economic rents are an efficient source of taxation, but are especially valuable when they are earned by non-residents. Because New Zealand gains (through greater tax revenue) but does not bear any of the costs, New Zealanders gain at the

expense of non-residents. When the economic rents of New Zealanders are taxed, New Zealand gains at the expense of particular New Zealanders.

37. A cut in the company tax rate will also provide windfall benefits to those who have invested in New Zealand in the past.

38. One important part of the reason for why other countries have tended to reduce their corporate rates over time is that the competition for tax base and location of companies is likely to be far more important in countries that are close substitutes. In Europe, it is likely that a business could supply the entirety of the area in any one of a number of countries. In that case, a tax rate decrease may attract businesses that were otherwise largely indifferent as to location.

39. A reduction in the New Zealand company rate would negatively impact on the integrity of the overall tax system as people would be likely to shelter income in companies to avoid the top personal rates. The top personal tax rate, and the rate for trusts, is 33%. The 5% rate differential between the company and personal tax rates already encourages tax-sheltering arrangements, and the rewards from these arrangements increase the greater the differential.

40. All of this leads us to conclude that, on balance, in the judgement of the Secretariat it would not be in New Zealand's best interests to lower the company tax rate.

41. At the same time, this assessment is very much a judgement call. The Australian Treasury has modelled the effects of a company tax cut in Australia. The modelling finds gains in consumption and national welfare from reducing the corporate rate[5] (0.3% increase in consumption and 0.1% improvement in welfare when the loss of revenue from the 5% corporate tax rate cut is made up by increasing personal income tax). While these gains are positive, they are small. Their modelling allows for some economic rents but does not to our knowledge allow for the possibility of sunk capital.

42. Of course, there are other dimensions of wellbeing aside from national income. At an aggregate level the impact on fairness derives from the assumed impact on national income. If national income declines because foreign investors' benefits from the reduced tax on economic rents is greater than the benefits to New Zealanders, this is likely to be regarded as unfair. If national income increases because the benefits to New Zealanders are greater than the loss of tax on economic rents of foreign investors, then at an aggregate level a company tax rate reduction may be regarded as fair, provided the benefits to New Zealanders are distributed in a fair manner (either as a result of the company tax cut itself, or through redistribution of the gains).

43. Even if national income increased, if, as a side product there were a material increase in tax sheltering because of the different rates for companies and

[5] Treasury Working Paper 2016-02, "Analysis of the Long Term Effects of a Company Tax Cut".

individuals, the increase in national income may not justify the increase in unfairness caused by the increased tax sheltering.

44. There is also the question of whether the integrity problems from having a different top personal and company rate can be fixed. One way of mitigating the problem is broadening the taxation of capital income to include capital gains. This is because many of the tax-sheltering arrangements make use of the non-taxation of capital gains. The result is that if New Zealand taxed gains on shares, there would be greater flexibility for having different company and top personal tax rates. It is important to note that flexibility may become more important over time. While officials' judgement is that there is no need to cut the company rate, future governments may want to raise the top personal rate without raising the company rate, or cut the company rate without dropping the top personal rate. If so, measures that allow for a greater degree of difference between the top personal and company rate such as the broader taxation of capital gains will be important.

2.5 Taxing rents

45. Economic rents can be an attractive target for taxation because, in principle, taxing them does not deter investment on the margin. As noted above one of the reasons that this paper concludes that reducing the company tax rate does not appear to be in New Zealand's best interests is the existence of location-specific rents.

46. We have been asked by a member of the Tax Working Group whether or not it would be sensible to attempt to tax these rents at a higher tax rate than ordinary income. Providing a full analysis of this issue would be a substantial task. It is assumed that the ordinary company tax would continue to apply. The rent tax would be a supplemental tax.

47. There are a number of potential mechanisms. Two that have been discussed considerably in the literature (although not generally in combination with an ordinary income tax) are:

- **Cashflow tax** – where capital expenditures as well as current expenditures are immediately deductible, there is no deduction for interest expenses and all receipts are taxable; and
- **Allowance for Corporate Equity (ACE) tax** – which would operate along similar lines to a standard company tax except that a normal return risk-free return on equity would be deducted from income.

48. Of the two, the ACE is most distant from current taxing concepts as it requires the measurement of equity which is likely to be difficult with groups of companies and (if extended to unincorporated businesses) for these businesses. A cashflow tax can be calculated from amounts that are already required for income tax purposes.

49. In principle the net tax could be added to, or subtracted from, the income tax currently payable.

50. Assessing the implications of these changes is a substantial task. Officials have not had sufficient time to make a proper analysis. Therefore, officials ask the Group if they would like analysis of supplementary taxes on economic rents to be analysed for the interim report. We intend to report in later meetings on environmental resource rental taxes and a financial activities tax.