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 6: Measures to improve efficiency

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. In the event the Group decides to implement tax changes that increase revenue, there is a question about whether and how this revenue could be "recycled" to improve the structure, balance and/or fairness of the overall system.

2. We outline several potential revenue-negative policy changes, restricting ourselves at this stage to the taxation of business income. Other measures to improve productivity and efficiency more generally will be looked at in a later paper.

1.2 Content and scope

3. This paper provides a brief overview of:
   - Indexing the tax base for inflation
   - Reinstating building depreciation deductions
   - Loss continuity
   - Greater deductions for black hole expenditure.

2. Issues

2.1 Introduction

4. A business income tax system is most neutral when it reflects the economic income or loss of the entity over the relevant period. This is done by taxing economic income, and providing deductions for economic losses. In the New Zealand income tax system we do not generally tax capital gains, and as a consequence do not generally provide deductions for capital losses. The issue of capital gains is not addressed in this paper, and will be addressed in a later paper on capital gains tax.

5. All of the areas that could be potentially changed are revenue negative (i.e tax would fall). In that context, these may best be considered as part of an overall package of changes. To ensure the taxation of business income is as neutral as possible, making the tax base more reflective of economic income and losses should always be a priority over cutting rates for a given amount of reduced revenue.

2.2 Indexing the tax base for inflation

6. One distortion in the income tax base is the inclusion of the inflationary component of income and expenditure. If we allowed the base to be inflation-indexed, we would have a more neutral income tax system. However, such an approach has material compliance and administration costs. Some of the changes that would have to be made are:
   - excluding the inflationary component of interest from income tax,
   - disallowing a deduction for the inflationary component of interest deductions,
   - allowing an inflationary uplift for the depreciation tax value of assets,
   - adjusting the cost price of inventory for inflation.

7. While these would be significant changes, under the current, relatively neutral system, not adjusting the tax base for inflation is probably one of the biggest distortions. This may seem surprising when inflation is so low, but an important corollary of current low inflation seems to be current low risk-free returns. As such, the proportion of nominal risk-free returns that are attributable to inflation is material.

8. Fully indexing the tax base for inflation has been implemented in only a few countries during times of very high inflation, due to the additional complexity of tax compliance. More information on the impact of inflation in the tax system will be provided at a later meeting. Such a change would affect more than just business income tax.

2.3 Building depreciation deductions

9. Depreciation deductions allow a deduction for the expected decline in the value of a capital asset (e.g. machinery, which declines in value due to wear and tear) over the income tax year. If we could accurately measure the value of all assets without undue compliance and administration costs, we would allow a deduction (and tax accruing gains) for the actual gain or loss. But that is impossible, and so we have a depreciation regime.

10. It is important that the depreciation rules reflect (as best as they can) the economic depreciation of the particular asset. If the depreciation rate is set higher than the economic deprecation, that asset is favoured relative to other assets, and tax will incentivise investment into that asset over other assets. If it is set lower than the economic depreciation of the asset, then that asset is disfavoured relative to other assets, and tax will disincentivise investment into that asset.

11. The largest potential problem with the current depreciation rules is the treatment of buildings. From 1 April 2011, all buildings receive a 0% depreciation rate. This implies that buildings do not depreciate, and are expected to last forever, provided that repairs and maintenance are undertaken[1]. Prior to 1 April 2011, the economic depreciation rate was 2%, implying that buildings were torn down on average after 50 years.

12. It seems unlikely that buildings to do not depreciate at all, particularly industrial buildings. If they do depreciate, the current depreciation rules will disincentivise investment in buildings relative to a more neutral treatment. This will result in lower overall economic welfare in New Zealand relative to a more neutral tax system.

13. If New Zealand were to tax capital income more broadly, including gains on the sale of land and buildings (other than the family home), then other rules that disincentivise investing in buildings could also be removed, such as the prohibition on deducting a loss from the sale of a building.

2.4 Loss continuity

14. Some businesses do not make money every year. If the tax system were completely neutral, those businesses that make a loss would receive a cash payment from the government of the business tax rate multiplied by the amount of the loss. Because of the risk of fraud (that is, fake losses reported to the Inland Revenue being used to fraudulently receive payouts), the tax system does not allow a cash payment for the loss. Instead, the tax system allows the business to carry the loss forward to be offset against income in future years. The table below provides an example using a 33% tax rate.

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[1] Repairs and maintenance are separately deductible. This means that the depreciation rates should reflect the economic depreciation of an asset receiving appropriate repairs and maintenance.

15.

	Year 1	Year 2	Whole period
Income	$100	$400	$500
Expenses	$200	$200	$400
Profit before tax	($100)	$200	$100
Tax	($33)	$66	$33

16. The ability to carry losses forward ensures that the business pays tax on the $100 profit made over the whole period. If losses were unable to be carried forward, the business would be taxed at a rate of 66% rather than 33%. Such a treatment would discourage businesses that had lumpy profits (profits in some years, losses in others), or ventures that were risky. It also is important for fairness reasons: without allowing losses to be carried forward some businesses would be taxed more heavily than others because their activity's income-earning process happens to not coincide with our income tax legislation's arbitrary 1-year period system.

17. While the above shows the sense in allowing losses to be carried forward, there are limitations on doing so under current rules. One important aspect of our restrictions is the loss continuity rule. In order to carry forward losses to a future period a company must maintain at least 49 percent continuity of shareholding. Without this rule, taxpayers would be able to trade losses (for example, a profitable company could purchase a dormant company with a stock of losses), which would open government up to similar revenue risks as cashing out losses directly. This treatment of losses will, at the margin, distort business decisions. For example, risky projects will be more attractive to large and otherwise profitable businesses compared to a small start-up company, as there is a risk the latter would never turn a profit and therefore would be unable to effectively utilise its losses.

18. Another way to liberalise the ability to get symmetrical tax treatment for losses would to allow loss carry-backs (given effect by allowing carry-forward of net income), subject to reasonable restrictions to manage revenue risks.

19. Allowing for greater symmetry of losses and gains will improve the neutrality of the tax system.

2.5 Black hole expenditure

20. Where expenditure results in an economic loss, but there is no deduction allowed under the Income Tax Act, the expenditure is described as "black hole expenditure". Black hole expenditure is an economic distortion, and a purely neutral tax system would not have any instances of black hole expenditure. The current tax system does, in large part because of uncertainties about the capital/revenue boundary. Because we do not tax capital gains, it is important that

we do not provide deductions for capital losses. As a consequence, there can be some borderline expenditure that does not receive deductions.

21. If we broadened the taxation of capital income to include capital gains, we could allow deductions for more expenditure that resulted in a capital loss.

3. Conclusion

3.1 Summary of analysis

22. We have identified four reform options that would improve the neutrality of the tax system. The most significant of these is inflation indexing the tax base. After that, the reinstating of depreciation deductions on buildings is likely to have the largest effect, followed by the two other options.

23. A more detailed analysis of these options could be undertaken and presented to the Group, with a fuller analysis under the frameworks agreed by the Group.

3.3 Questions for the group

24. The question we suggest the Tax Working Group focus on is:

- Noting time constraints, would the Group like a fuller analysis of:
- Inflation indexing the tax base?
- Reinstating building depreciation deductions?
- Allowing greater loss continuity?
- Allowing greater deductions for black hole expenditure?