Tax Working Group

Te Awheawhe Tāke

Tax Working Group Information Release

Release Document

September 2018

taxworkingroup.govt.nz/key-documents

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.

Preparing the Tax System for the Future

Discussion Paper for Session 4
of the Tax Working Group

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.

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 Treasury

TABLE OF CONTENTS

**NB: The forward agenda referred to in this document was a provisional forward agenda that the Tax Working Group has since amended. It has therefore has not been included in this document release but will be released at a future date.

1. Executive Summary

The purpose of this paper is to act as the basis of a discussion to clarify, to the extent possible, the Forward Agenda for the Group. It seeks the Group's guidance on how officials can best help you establish priorities for work in a number of areas. The paper identifies a number of future trends that will affect tax policy and administration in New Zealand. It also explores the relationship of the tax system to important policy areas of the Government.

Officials have identified a number of important questions on which the Group may wish to focus their deliberations. These include:

- Whether the current tax settings are sustainable given expenditure pressures from the aging population;
- How to respond to concerns about inequality;
- Improving the efficiency effects of the tax system by addressing divergences between taxable income and economic income;
- Examining how the tax system could help respond to environmental concerns;
- The implications of international trends to reduce company tax rates for New Zealand's company tax rate; and
- Whether and how the tax system should be changed to respond to pressures on the existing, and future, gap between the top personal tax rate and the company tax rate.

There are other important issues that officials intend to address in papers for the Group's consideration, but which (in our provisional view) may warrant less time by the Group, either because they are being dealt with through other channels; or because the tax system is likely to play a secondary role in addressing the issue. These include:

- The changing nature of work;
- Changing offshore business arrangements;
- The sharing economy; and
- Housing affordability.

2. Introduction

1. The purpose of this paper is to act as the basis of a discussion to clarify, to the extent possible, the Forward Agenda for the Group.

2. The paper identifies two types of challenges that will face the tax system in the future. First, the paper identifies a number of trends in New Zealand and abroad, which may pose challenges to the New Zealand tax system. These trends could put at risk the tax system's ability to provide the funds necessary to support government spending requirements. They could require adjustments to tax policy, legislation and/or administration and compliance. Second, initiatives in the tax system could play a role in achieving the Government's broader policy objectives. The paper draws on the four capitals of the Living Standards Framework that contribute to wellbeing: human, social, financial/physical, and natural. It identifies priority issues impacting the four capitals and makes some preliminary comments on the role that the tax system could play in furthering the Government's objectives.

3. With this paper, officials are seeking guidance from the Group on the key issues that it would like to examine and any material or analysis that would aid the Group in its deliberations. The paper is not a complete list of all issues to be explored by the Group. For example, the taxation of retirement income and the possibility of providing a progressive company tax are significant issues that have already been placed on the Group's work programme, and are therefore not in detail addressed in this paper.

4. The paper is organised as follows

   - Section 3. Identifies some expected future trends and how they might impact the tax system;
   - Section 4. Raises some known government priorities, particularly in the areas of social, economic, and environmental concern and outlines their implications for the tax system;
   - Section 5. Identifies a number of taxation issues that arise within the four capitals of the Living Standards Framework;
   - Section 6. Outlines the allocation of the issues raised in this paper over the Forward Agenda; and
   - Appendix. Provides the Forward Agenda as of February 16 and the Terms of Reference

5. For each topic, highlighted boxes outline comments by officials on possible work going forward based on the general considerations.

6. It is recognised that the Group will be able to amend its priorities on the basis of public submissions and other information that may arise in the course of the work.

Questions for the Group

7. The scope of the issues contained in this paper and other issues that have already been selected for analysis is large. The Group has a reasonably constrained timeframe available for analysis and decision. One purpose of this paper is to ask if there are areas, which may be important, but which may be addressed by the Government outside of the Group process.

8. In the following sections, the paper identifies a number of areas of potential interest and some of the issues that they raise for the tax system. Officials are seeking the direction of the Group on the following questions with respect to these issues.

1) Does the Group wish to have further work in the area identified in the section?
2) Are there other aspects of the issue, not noted in the paper, that the Group would like explored?
3) Is there any further information that the Group would like with respect to the issue?

3. Expected Future Trends

9. It is a brave person who dares to predict the future. Who in 1987 would have predicted the fall of the Berlin Wall, China joining the world economy, the Internet, digital commerce, etc.? On the other hand, some areas of future change can be anticipated based on current trends and it would be prudent to examine whether there are initiatives that could be started now to help deal with the future challenges they may pose to the tax system. Moreover, even in the face of uncertainty, there may be changes to the tax system that could make it more robust, resilient, and flexible in responding to the shocks arising from a constantly evolving economic and social environment. The following is a short list of trends that can be identified today, which are likely to persist into the future, and that may warrant anticipatory actions.

a. Long-term fiscal outlook

10. While current government finances are relatively strong, fiscal pressures are projected to increase significantly over the next 40 years. In common with most of the developed world, New Zealand faces an aging population. This will lead to greater demand for government services, particularly health care, and rising New Zealand Superannuation expenses. At the same time, slower growth in the labour force is expected to weigh on economic growth.

11. The Government's fiscal objective for the tax system is to support a sustainable revenue base to fund government operating expenditure around its historical level of 30 percent of gross domestic product (GDP).[1] If the Government is to continue providing healthcare and superannuation with current settings in the long term, then options include increasing the level of revenue, adjusting spending on other transfers or publicly provided goods and services or pre-funding of future liabilities such as through the New Zealand Superannuation Fund.

Projections for Government Expenses and Revenue (per cent of GDP) based on a scenario of historical spending patterns[2]

	2015	**2030**	**2045**
Primary expenses	28.4	31.1	33.8
Primary revenue	28.9	29.8	29.8
Primary balance	0.5	(1.2)	(4.0)

12. In analysing possible ways to increase revenues, the Group is restricted by its Terms of Reference that precludes study of tax rate increases. In that case, revenues can be raised in two ways. First, the tax base could be increased by growth in the economy; second, it could be increased by broadening the tax base, by introducing new taxes, or by improved administration of existing taxes.

[1] Gross domestic product (GDP) is the total value of goods and services produced in the economy in a year.

[2] Taken from the Treasury's 2016 Statement on the Long-Term Fiscal Position – *He Tirohanga Mokopuna.* Primary expenses are government expenses excluding debt-finance costs. The primary balance is revenue excluding investment revenue less primary expenses. These projections represent a "what if" scenario.

13. What are the implications for tax policy? The first implication is to be careful about changes that structurally reduce the revenue base unless they are offset through other fiscal measures. That is, avoid changes that narrow the tax base and increase the risks of revenue shortfalls. Second, identifying and eliminating situations that lead to lower taxation of particular sectors, individuals, or arrangements can increase revenue, fairness, and efficiency at the same time.

14. The tax system can influence future economic growth. Most government spending is linked to wage growth (directly or indirectly), so higher economic growth cannot be a full solution to long-term fiscal imbalances. That said, improved economic growth via higher labour force participation would improve the revenue base and help manage spending pressures.

15. The current tax system will face changes of its own due to the aging population, even if spending requirements do not increase. The tax mix will change. Taxes on capital income (for example, interest on term deposits, dividends, etc.) and consumption (for example, GST) may become relatively more important and taxes on labour income relatively less important as a source of future revenue, if the proportion of those earning capital income relative to labour income increases. Over time, it is likely that a focus on capital income taxation will be more and more important in ensuring that the tax system is as fair and efficient as possible.

16. The flexibility of the tax system is important for the future. At the same time certainty – the ability to signpost the desired direction of tax policy and avoid unexpected policy shocks – is also important.

b. International trends

17. A number of international trends may have an impact on New Zealand.

Falling company tax rates in other countries

18. Company tax rates internationally continue to drift downwards. Among OECD countries, the average company tax rate has fallen from 33% in 2000 to below 25% in 2016. New Zealand's tax rate has also fallen, from 33% to 28% over the same period. The recent dramatic reduction of the US corporate tax rate to 21% would lower the average OECD company tax rate, and could induce other countries to follow. Especially if Australia follows this trend, this could raise the issue of whether New Zealand should follow suit.

19. The level of the company tax rate is also important in discussions on effective taxation of closely-held companies and their shareholders, which is examined in more detail in the next section.

20. There are a number of arguments in favour of a reduction. Standard economic assumptions of a small open economy suggest that company taxes are borne by local labour, and replacing them with an equal revenue tax on labour income would be efficiency enhancing. At what point might policy makers be concerned that a higher than average rate could discourage profitable inbound investment? If New Zealand's rate was to become much higher than other countries, there is an increased risk of base shifting strategies.

21. But there are important considerations on the other side.

22. Reducing the company rate to reduce base shifting may cost more than the base shifting itself, so it may be a costly way to protect the tax base.

23. More importantly, there are questions as to whether a company tax rate reduction is in New Zealand's national interest. This is not an area where there is a clear consensus among economists, as recent discussion concerning the reduction in the US corporate tax rate has shown.

24. The standard open economy assumption argues for zero taxes on income for inbound investments, a prescription that is entirely ignored by OECD countries. The conclusion relies on strong assumptions.

25. A key assumption is that firms only earn normal profits. That is there are no economic rents. This assumption is too strong. To the extent that rents are location-specific, their taxation does not lead to an increasing cost of capital in a jurisdiction. Reducing tax on non-residents earning rents in New Zealand would reduce New Zealand's national income and would increase potential future revenue gaps.

26. The amounts involved could be significant. The taxation of companies owned by non-residents raises significant amounts of revenue. In the 2016 income year, non-resident-controlled companies in New Zealand paid nearly $4 billion of company income tax, which is around 36% of the total corporate tax take. This figure does not take into account tax attributable to non-resident ownership of companies in New Zealand that are controlled domestically. Foregone revenues from a company tax rate cut would need to be found from domestic sources.

27. This discussion is related to questions about how much of the company tax is currently borne by non-residents and how much is shifted onto New Zealand sources, such as labour. Again there is no analytic consensus. To the extent that there are rents and other more technical assumptions (i.e. whether New Zealand international borrowing costs are sensitive to amounts of inbound FDI), there will be a reduction in the portion of the tax shifted onto New Zealand labour.

Comments by officials

Assessing at what level the company tax rate should be set is a complex issue with significant implications for future revenues and the structure of the tax system. The Group may wish to develop a position on the question and officials therefore recommend that it be covered in more detail in a future meeting.

Changing cross-border business arrangements

28. Changing business arrangements, such as in the digital economy, are putting pressure on current taxation frameworks. While many examples are derived from digital industries, new ways of doing business can affect a much broader set of sectors. Issues can arise for domestic income taxes and GST.

29. Cross-border shopping is an example. In New Zealand, the total consumer online shopping market has been estimated to be $4.7 billion in 2015, with $2.1 billion spent on purchases from offshore and an average estimated growth rate of 18%[3]. There is also a significant business to business e-commerce market.

[3] MBIE estimate based on Nielsen data and BNZ online retail sales data.

30. Fundamental concepts underlying the international allocation of income are also being put under pressure. Questions arise in determining who is taxed and how their income is measured. For example, Uber and Air B&B arguably carry on substantial businesses and earn profits in New Zealand without a physical presence. In that case, they are not subject to income tax.

31. Revenue derived from New Zealand without local operations can escape New Zealand tax. For example, an offshore advertising business may derive revenue from New Zealand businesses without paying New Zealand tax on the resulting profits.

32. There are other risks to the tax base that may occur as traditional ways of doing business are disrupted. In this case, the problem is not just one of allocation, but of changing economic patterns of business and profits. This could be a fiscal risk if profits earned by businesses making up a large portion of the tax base, such as banking were to fall. For example, if financial transactions could be undertaken through an internet platform without a base in New Zealand, the business may effectively move offshore; and others' profit margins may be squeezed by extra competition.

33. Changes in international business arrangements (e.g. digital economy) have put pressure on OECD mechanisms for allocating income among countries. The OECD acts as a forum for countries to work out concepts and the rules of the game in the area of international taxation.

34. While individual countries are free to choose how and to what extent they adhere to OECD frameworks[4], they provide a basis that facilitates the development of bilateral treaties between countries. The treaties give the rules under which taxpayers in the two countries are taxed on their cross-border transactions and arrangements.

35. This type of issue would typically be addressed through international cooperation at the OECD. There is currently a substantial work programme at the OECD discussing the issue of how to allocate income among counties for the newly evolving cross-border business arrangements. New Zealand is fully participating in this work.

36. Different countries will have different interests in this area. It is the type of area where it is a difficult process to reach consensus. In fact, the first attempt did not arrive at a conclusion. This has led a number of countries, including the EU and the UK to contemplate equalisation taxes to address the issue. These proposals are somewhat ad hoc, and it is not clear that they are consistent with existing tax treaty obligations. They are currently being examined as part of the work at the OECD on the digital economy.

Comments by officials

This is an important area that is likely to expand in the future. Many of the solutions are likely to be multilateral. New Zealand is participating fully in related work at the OECD. The Group will be provided with a full paper on our international tax

---

[4] The United Nations has also developed a model tax treaty that is used by a number of developing countries.

frameworks for its next meeting to help you decide to what extent you wish to pursue this issue, given this work in international fora.

Base Erosion and Profit Shifting (BEPS)

37. Much concern has been raised about companies with cross-border operations arranging their affairs to shift income to low tax jurisdictions or to eliminate tax payable altogether. This issue is related to, but is distinct from, the challenges discussed in the previous section. In that section the primary issue was the allocation of the tax base between countries. In principle, the income is taxed somewhere. With BEPS, the issue is whether there are artificial schemes to shift profits in a way that undermines worldwide taxation.

38. The issues can be confounded because some of the same companies can be exemplars of both.

39. BEPS issues have attracted considerable public commentary from time to time. It is considered offensive that some of the world's most profitable companies can use offshore structures to avoid tax. The OECD has done considerable work in this area.

40. New Zealand has been ahead of the curve in addressing BEPS issues. A number of anti-arbitrage provisions were included in the reform of the international tax system undertaken in 2007. More recently, a significant amount of work has been undertaken on BEPS at the OECD, and recommendations were made in a number of areas. This has allowed New Zealand to extend the work started in the international tax reform and a number of anti-BEPS initiatives are in the process of being enacted. The Terms of Reference for the Group clarify that the technical details of the current suite of BEPS changes are out of scope.

Comments by officials

BEPS is an area where New Zealand has undertaken significant initiatives based on the work in this area undertaken at the OECD. It has been included in this report because it is related to and informs the discussion on changing cross-border business arrangements.

c. Pressures on the domestic tax base

41. All tax bases are tested by taxpayers as they attempt to ensure that they do not pay more tax than indicated by tax legislation. In some cases, the law may fail to achieve the taxation result intended by the government. In many cases, the problem can be corrected by targeted amendments to the law. But in others, more general changes, which raise broader issues of policy, could address the issue. In that case, they could be of interest to the Group. Some current examples of pressures include:

Maintaining integrity of taxation of closely-held companies and their shareholders

42. Any increase in the gap between the top personal and company tax rates would exacerbate a problem in domestic taxation that has become evident recently. Company tax rates could fall, either generally in response to international trends, or in a more targeted manner, with a lower tax rate for small businesses. Or personal tax rates may increase in order to meet growing demands of revenues or to increase

the progressivity of the personal income tax system. Currently the top personal tax rate is 33% and the company tax rate is 28%. In principle, this gap is recovered when dividends are paid out to shareholders. However, there is evidence that some closely-held companies are able to avoid this tax impost.

43. New Zealand has had experience when tax rates diverge. Between 1999 and 2010, top personal tax rates were higher than trust or company tax rates. Considerable tax planning, generally involving trusts, was used to avoid the 39% rate.

44. The 2010 budget eliminated the gap between the top personal tax rate and the trust tax rate (the primary problem with the 1999-2010 system). The company tax rate was reduced to 28%, somewhat reducing the gap between it and the top personal tax rate that existed prior to 2010. The changes eliminated the tax benefits from many of the structures that were exploited prior to 2010. There was a question of whether existing anti-avoidance rules could deter tax avoidance under the new rate structure.

45. Unfortunately, experience has shown that the current gap (five percentage points, 33% versus 28%) between company and top personal tax rates is leading to tax planning to avoid the extra five points of tax on distribution. This would worsen in the future if the gap between the top personal tax rate and the company tax rate were to widen.

46. Tax planning reduces the fairness of the tax system. Horizontal equity is reduced as taxpayers on similar levels of income pay different amounts of tax. Vertical equity is reduced as higher income individuals are more likely to be able to exploit the possibilities. And of course it reduces government revenues.

47. Many of the tax planning strategies rely on the conversion of taxable dividend income into non-taxable capital gains. So, introducing a capital gains tax is a possible response. There are other possible measures including examining full integration which would be a fundamental reform of the imputation system. Other more partial adjustments could also be examined.

Comments by officials

This is an important area that has implications for tax revenues, and the fairness and efficiency of the tax system. It is a matter of judgement whether the current gap in tax rates warrants a reaction; and, if so, what would be the best way forward. Clearly taxing capital gains is one possible systemic response.

The border between income and capital gains

48. In New Zealand, income that is revenue is taxed at full statutory rates, while income in the form of capital gains is tax exempt. In some cases, the line between these concepts is ambiguous and subject to interpretation. All other things being equal, taxpayers would wish to have their income treated as capital gains and be free from tax.

49. Recent examples where this border has required administrative or legislative reactions by the government include:

- real estate, whether the gains from the sale of a rental property should be on revenue or capital account; and
- certain employee share and option schemes, which the government concluded had the effect of converting a portion of the remuneration of employee that would normally be taxable wages into capital gains, consequently escaping taxation.

Comments by officials

These issues underline the structural role that capital gains taxation plays in the tax system. Determining the line between income and capital treatment has traditionally been a difficult area. Officials recommend that the Group consider these integrity issues holistically as part of the future sessions on business taxation and capital gains.

Compliance pressures and opportunities

50. As the Group heard from MBIE, there are a number of significant trends in the economy that have labour market implications. This paper has already touched on the issues that may arise from an aging population. From a tax perspective, other relevant issues discussed were the potential increase in contract workers and the general changes in business practices from technological advancement.

51. These trends in working arrangements and business structures could have an impact on the effective administration of the tax system. In most cases, these trends do not raise significant conceptual or policy issues in the measurement of income. Rather, they could have a significant impact on the structure and effectiveness of tax administration.

52. As more labour is supplied through short-term contracts, rather than traditional long-term employment contracts, more taxpayers that formerly would have been treated as employees may become self-employed. Workers may have a series of more short-term contracts and less enduring relationships with employers. This has a number of implications:

- Employers report the income of the employee to the government, and tax is withheld from employee pay-cheques by the employer and remitted to the government; the self-employed are responsible for reporting their income and remitting tax;
- Employees are very restricted in deducting costs from their income as compared to the self-employed;
- Levels of non-compliance are estimated to be higher for the self-employed as compared to employees;
- It is generally harder and more costly to identify taxpayers, measure income, and collect taxes due from the self-employed than employees.

53. Changing business organisation, such as the sharing economy (Air B&B and Uber), raises issues of effective tax administration. It is potentially hard to identify and tax owners and operators. Issues apply to both GST and income tax.
54. New technologies will require adjustments to tax administration. For example, block chain technologies may allow sizable transactions to be made without using traditional intermediaries. This could undermine third party reporting and withholding of tax. Encryption hides the transaction and removes information that can be used in audits.
55. But new technologies are not all doom and gloom. They may open opportunities to make administration more effective. Moreover, out of date administrative procedures may impose unnecessary compliance costs on new ways of doing business.
56. These issues, while potentially involving significant revenues, do not pose conceptual problems. Rather they may be administrative in nature, involving administrative responses.
57. It is desirable to begin developing systems now as part of Business Transformation. New technology may provide opportunities as well as challenges. Potential initiatives include:
    - Identifying other intermediaries who can report transaction and/or withhold tax; for example, Air B&B could be required to register and report rentals or Uber could be required to register and withhold tax from payments to taxi drivers;
    - Platforms that link service providers to customers could be required to report transactions;
    - Extending withholding commitments on payments made to independent contractors.

Comments by officials

This clearly is an important area with potential implications for the continuing effectiveness of revenue collection. Unlike some issues, it does not pose conceptual issues, but puts strain on current tax collection mechanisms. As such, reacting to it falls within the mandate of Business Transformation and the Commissioner of Inland Revenue more generally. The question is whether this is an area that the Group would wish to consider or whether it falls within business as usual for Inland Revenue.

4. Using tax to protect and build the four capitals

58. There are a number of areas where the tax system could contribute to achieving government objectives.

59. Taxation contributes directly to achieving the Government's objectives by providing the funds necessary for vital government programmes. However, the impacts of the tax system extend well beyond meeting the Government's fiscal objectives. The tax system touches almost all areas of the economy and broader society.

60. This section frames the many potential Government objectives using the Living Standards Framework. The Living Standards Framework provides a way of understanding intergenerational wellbeing using four capitals: social, human, financial/physical, and natural. The Group has expressed an interest in applying this framework especially when considering the performance of the tax system as a whole.

61. Changes to the tax system could help address many of the challenges New Zealand faces in protecting and enhancing the four capitals. This section provides an overview of these potential changes for the Group to consider where they might want further advice.

62. While tax provisions may provide a potential response to a priority, it should always be considered whether a grant or other type of intervention would be a more efficient way to achieve the goal of the Government. It is important that provisions be designed to achieve the goals in the most cost-effective manner possible. That is, the solution should be targeted to the problem at hand. This is increasingly important in a fiscally constrained environment.

a. Social and human capital

63. Social capital refers to the norms and values that underpin society. Human capital refers to people's skills, knowledge, and physical and mental health – the things that enable people to participate in work, study, recreation, and in society more broadly.

64. There are a broad range of issues impacting the long-term social and human capital of New Zealanders. This paper focuses on two particularly pressing challenges impacting these capitals: income and wealth inequality; and unaffordable and low quality housing.

Inequality

65. In a number of countries over the last thirty years, there has been a concern about rising levels of inequality of income and/or wealth. High income and wealth inequality risks harming social capital if it undermines social trust and New Zealanders belief that they are living in a fundamentally fair society. Governments may wish to implement policies to reduce income and/or wealth inequality. Taxation provides a direct instrument to affect the distribution of income and wealth. The long-term effects of any changes on the distribution of income once prices have adjusted may be more difficult to predict.

66. Fairness in the distribution of taxes can be measured as vertical equity or horizontal equity. Addressing situations where lower levels of tax relative to income occur can improve horizontal equity, as taxpayers with the same income would pay the same

taxes. Economic efficiency can be improved at the same time if the more equal taxation removes distortions on behaviour. Vertical equity solutions through taxation are constrained by the terms reference of the Group as they preclude increases in tax rates or the introduction of estate or inheritance taxes. Nevertheless, a number of changes to the tax base can affect vertical equity.

Increasing taxes paid by low effective tax rate individuals

67. Eliminating tax revenue shortfalls can increase vertical equity to the extent that shortfalls are larger for individuals with higher incomes. For example, capital gains increase as a percentage of income as income increases and so taxing capital gains makes the tax system more progressive. Preventing the avoidance of dividend taxation by closely-held companies is also likely to enhance vertical and horizontal equity. Study of high wealth individuals may reveal other issues in taxing such individuals, such as deduction of interest expenses with the offsetting taxation of the related income.

Capital gains taxation

68. The taxation of capital gains affects a number of areas covered in this paper. It would provide a large and growing source of tax revenue to reduce future revenue shortfalls. It could be seen as responding to concerns about inequality as capital gains increase as income increases. It would act to protect the income tax base and support fairness, for example, by preventing individuals from avoiding the top personal tax rate on income through the use of closely-held companies.

69. New Zealand has not introduced a capital gains tax in the past because of concerns of behavioural impacts and complexity, especially given that any practical capital gains tax would depart from its theoretical ideal. The evaluation of any proposal would depend critically on the details of the proposed tax. Alternatives that extend income taxation less comprehensively than taxing all capital gains could also be explored.

Comments by officials

Whether capital gains should be taxed raises a variety of complex policy and technical issues and is implicated in a number of areas in this paper. It is expected that the Group would devote considerable time to discussing whether and how to implement taxation of capital gains. The Group may wish to indicate any particular areas that they would like see covered in officials' future work on this topic.

Wealth taxes

70. Wealth taxes provide a potential revenue base to close funding gaps in the future and could make the tax system more progressive. Most countries apply a form of wealth tax with the taxation of real property. Within the OECD, more broadly-based wealth taxes have been more prevalent in Europe, but have been falling in popularity.

71. A wealth tax could also provide an alternative to capital gains taxation that would address some of the same issues. It would not deal with current problems in taxing shareholders of closely-held companies

72. The relationship of a wealth tax to an existing income tax raises important issues. One argument for a wealth tax is that the income tax is failing to comprehensively tax income from capital. With the exception of capital gains and owner-occupied housing, New Zealand's income tax system applied to capital income is quite broad-based.

73. However, any practical capital gains tax would still allow a deferral of tax, as it would only apply when assets are sold. One possibility would be to use a wealth tax as a minimum tax that would provide a floor level of tax.

74. Finally, a case for a wealth tax could be made that we need to fill future revenue gaps and that is where the money is and that there are direct social benefits from reducing the inequality in the distribution of wealth.

Comments by officials

As the Terms of Reference explicitly refer to wealth taxation, a paper is being prepared on the subject for future consideration by the Group.

b. Housing

75. Unaffordable and low quality housing is negatively impacting several capitals, including human capital, through its impact on people's health. The tax system affects the housing sector in a number of ways. Owner-occupiers are neither taxed on their imputed rent from housing nor on any capital gains arising on the sale of the principal residences. This can distort decisions to save, invest, and consume housing. Suppliers of rental properties may not be taxed on capital gains on their properties if they are held for investment instead of resale. Finally, there may be proposals to use the tax system as an instrument to improve housing affordability.

76. Taxation can distort housing decisions in a number of ways. Taxation of owner-occupied housing has been excluded from the review as part of the Group's Terms of Reference. A number of possible tax initiatives could have an effect on the housing market including; taxing capital gains (including on sales of rental housing), land taxes, and the deductibility of interest on vacant land.

Comments by officials

Housing affordability is an area of high priority for the Government and is explicitly mentioned in the Group's Terms of Reference. Officials will be providing a paper on the topic. It is not clear whether tax initiatives will have a substantial role in addressing problems in this area.

c. Financial/physical capital

77. Taxation, by affecting after-tax cash flows of businesses, savers, and workers, can influence the amount and allocation of key economic and financial flows, and in turn, financial/physical capital stocks. It is important that tax works in a way to promote an efficient allocation of scarce resources and that it does not impede productive and sustainable growth.

78. Lower effective tax rates can arise in different sectors of the economy, different taxpayer groups, or different types of income.

79. Analysis can identify such situations and explore what aspects of the tax system cause them. Causes can arise from explicit policy decisions to provide incentives or exempt certain types of income or may result from unintended tax avoidance opportunities. Differences between economic and taxable income may arise from timing differences or be permanent.

80. Work is underway to identify low tax situations, determine if the variations arise from policy or problems with the tax system and bring forward analysis to the Group.

Raising low effective tax rates

81. Some industries appear to face lower effective tax rates than others and some individual taxpayers appear to pay lower levels of tax relative to their income or wealth than ordinary income earners. This has implications for both the fairness and efficiency of the tax system. In some cases, these variations are the result of explicit policy decisions of the Government to promote certain activities. In that case, the question is whether the tax system is the best instrument to achieve the Government's policy objectives. In other cases, lower effective tax rates may result from unintended consequences of certain tax provisions. In that case, the provisions leading to the reduced level of taxation should be examined to determine if changes are appropriate.

82. Examples of situations that could lead to lower effective tax rates include expensing of capital costs, deductions for depreciation that exceed economic depreciation, non-taxation of capital gains, or mismatches in timing between the deduction of costs and the recognition of the related income. Work is being untaken to identify these issues.

83. Changes that increase low effective tax rates in principle provide a way to improve efficiency while increasing government revenues. New Zealand's income tax base is already comparatively broad by international standards. Therefore, there are likely to be relatively few opportunities for such changes. Moreover, the provisions leading to the reduced taxation of the sectors are likely to be seen to fulfil other government priorities. As many are longstanding, there may be considerable resistance to their elimination. Nonetheless work is underway to identify sectors of the economy with low effective tax rates and to analyse the reasons for these rates and whether they raise any policy concerns.

Investment incentives

84. Incentives to improve productivity and growth are perennial candidates for base-narrowing tax provisions. For the most part, they are likely to be productivity-reducing and they suffer from the problems with all tax incentives.

85. Tax incentives can be theoretically justified in situations where there are positive externalities. These issues are explored in Section 4.b. below.

Disallowed deductions

86. There are a number of areas of longstanding concern to businesses, where deductions are not allowed for costs that can be considered to be valid costs of doing business. Examples include so-called black hole expenses or asymmetric treatment of gains and losses. Black hole expenses, such as feasibility costs, are costs of doing business that do not qualify technically as deductible. Others, such as for buildings with an expected life greater than fifty years, are explicitly denied depreciation deductions. If other measures raised revenues that were to be recycled to businesses, allowing such costs to be deductible could be efficiency enhancing. These amendments would reduce revenue.

Comments by officials

Officials believe that building a robust and resilient tax system based in the principle of broad tax bases most effectively promotes the objective of increasing efficiency and productive growth. Does the Group agree with this assessment? Officials plan on explicitly covering low effective tax rates in a future paper.

d. Natural capital

87. Natural capital refers to all aspects of the natural environment that are needed to support life and human activity. In addition to providing a life-supporting ecosystem, it underpins our primary industries, and plays a central role in New Zealand’s national identity.

88. As the Group heard from the Ministry for the Environment, New Zealand has significantly depleted many of its natural capital stocks, and indicators are continuing to decline in some key areas. Nearly 75% of native forests and 90% of native wetlands have been cleared. Water use is exceeding environmental limits in some parts of the country, and key indicators of water quality have worsened at many sites. Globally, there is widespread concern that planetary boundaries are being exceeded in areas such as climate change and species loss, putting at risk critical global processes.

89. Governments have a range of instruments that they can employ to achieve environmental goals. Governmental actions on the environment can be direct governmental measures or through market-based instruments. These instruments include:

Direct governmental measures

- Regulations;
- Government investment in environmental projects;
- Public education and promotion of environmentally responsible behaviour;

Market-based instruments

- Cap and trade systems;
- Pollution taxes, such as a carbon tax;

- User charges for commonly-owned natural resources, (such as royalties on mining); and
- Tax incentives.

90. Whether to intervene and the choice among instruments depends on the specifics of the environmental issue.
91. Negative externalities provide clear economic grounds for applying corrective (Pigovian) taxes. Such environmental taxes have been argued to be best suited to situations where there is an environmentally harmful externality which is readily measurable and whose damage can be reasonably estimated.[5]
92. There have been examples internationally of successful environmental taxes to reduce polluting behaviour. Examples include reducing reliance on "dirty" types of diesel fuels or reducing use of fertiliser. And pricing carbon can be an effective way to reduce fuel consumption, greenhouse gas emissions, and promote a switch to alternative energy sources.
93. If a corrective tax is in place, then there is little rationale for incentives to induce "good" behaviour. For example, if there is a carbon tax, then taxpayers will have an incentive to invest in solar panels where appropriate.
94. Tax will not be the best tool for all environmental issues. More local issues or situations where there are difficulties in measuring pollution might be better dealt with through direct action measures, such as regulation.
95. Environmental taxes are sometimes suggested as a substitute for traditional tax bases, in addition to correcting market failures. For example, carbon taxes are often suggested as allowing a reduction in income taxes. This is seen as providing a "double-dividend". There are some risks in taking this approach. Successful environmental taxes can be self-extinguishing. That is, if they are successful, the taxed activity is reduced, so they do not provide an enduring basis for reducing more traditional taxes. On the other hand, more targeted environmental taxes have sometimes been rebated to industries through other programmes to reduce negative impacts on competitiveness.

Comments by officials

As the Terms of Reference specifically identifies taxation's impact environmental and ecological issues, officials anticipate providing a full paper on them at a future meeting.

[5] The McLeod review identified three criteria for environmental taxes: the external impact of the adverse activity or use should be uniformly distributed and the impact of each unit should be the same; the adverse activity or use must be measurable to be able to apply the tax; and the marginal net damage of the activity must also be measurable to be able to set the level of the tax.

5. General considerations for assessing future work

96. There are a number of overarching concepts that underpin officials' advice on the future work for the Group on the trends and issues identified in the preceding sections.

Comments by officials
Does the Group agree with the considerations outlined below?

a. The importance of coherent frameworks

97. Coherent frameworks build a natural resilience and flexibility into tax systems. Consistent treatment across activities and arrangements means that changes in the economy are less likely to result in unexpected revenue shortfalls. The economy can develop without facing unintended barriers to its evolution.

98. Moreover, such changes that are necessary can be more easily developed and introduced when there is a clear policy framework to analyse issues. A general understanding of frameworks by taxpayers helps them anticipate how novel situations will be treated and more accepting if treatment can be demonstrated as fair and consistent with general policies.

99. Incoherent policies carry the risk of unintended consequences both for the economy and for government revenues.

b. Broad bases are coherent

100. In the income tax system, maintaining a broad base means trying to measure the economic income arising from an activity. Taxation of economic income is a coherent basis for taxation as it applies consistent taxation across different sectors and activities and reduces distortions and tax-induced inefficiencies. In the absence of externalities, taxing economic income leads to an efficient allocation of economic activity. This promotes productive investments.

101. Broad bases reduce the potential for revenue shortfalls arising from changing economic and social environments. They also promote fairness (especially horizontal equity), as taxpayers with the same income pay the same amount of tax. Broad-based tax systems are generally simpler, as they avoid targeting and reduce the potential for unintended consequences.

102. Maintaining a broad tax base provides a robust and resilient source of tax revenues to fund government social, economic, and environmental priorities. Broadening the tax base enhances robustness and reduces the chance of unintended revenue shortfalls. It also improves horizontal equity and can contribute to vertical equity.

103. In contrast, tax incentives are sometimes suggested as a way to increase certain desirable activities. Incentives might be economically justifiable if a positive externality exists.

104. The McLeod Review was very sceptical of this rationale because the world is full of spill-overs and the rationale provides a vehicle for rent-seeking lobbying and a precedent for narrowing the tax base. Their view was that a very high bar should be established for introducing incentives on the basis of positive externalities.

105. Incentives can be very cost-ineffective:

- If they are given to an activity that would have occurred in any event (infra-marginal investments);
- It is hard to target a desired activity, resulting in leakage of benefits in unintended ways; and,
- Targeting can add considerable complexity to the tax system.

106. Many countries have experimented with tax incentives, including New Zealand. In New Zealand, significant tax incentives were introduced in the 1970s and 80s in an attempt to spur and direct economic activity. There was generally a negative experience with problems such as:

- build-up of losses;
- unexpected revenue shortfalls;
- tax avoidance activities;
- large companies and high income individuals sheltering income from taxation; and
- questionable effectiveness in achieving policy goals.

107. This experience was common internationally and led to significant base-broadening and compensatory reductions in tax rates in many OECD countries.

108. The concept of broad bases also applies to GST. New Zealand has one of the broadest bases of any of the value-added taxes in the OECD. There are no major categories of consumption that are not subject to the tax. This leads to simple administration and protects the revenue-generating capacity of the system.

c. Are fundamental reforms needed?

109. Over the past fifteen years, the New Zealand tax system has been the subject of a series of reviews. Some have been very comprehensive, looking broadly at the entire tax system; others have been more-targeted at specific areas of concern. While the tax systems of all countries are under constant scrutiny and subject to continual tinkering, New Zealand's reviews have often been more formal than business as usual maintenance and have examined possible fundamental changes to the tax system.

110. Previous reviews have looked a wide variety of potential fundamental reforms of the New Zealand tax system, including:

- Nordic tax system (where labour income is taxed at higher rates than capital income);
- Allowances for corporate equity (ACE) systems (where a company is allowed a deduction for a percentage of its equity – similar to the interest deduction it would have received had it been debt financed);
- Irish tax system (where the company tax rate is set at a low level).

111. The general conclusion has been that a traditional income tax system provides a better way to go forward. The major exception to this pattern was the International Tax Review which led to a substantial reform to the system, at least in its conceptual basis.

112. Accordingly, the expectation is that future work would concentrate on making improvements within existing taxation frameworks, rather than revisiting fundamentals.

6. Allocation of issues over Forward Agenda

The forward agenda referred to in this document was a provisional forward agenda that the Tax Working Group has since amended. It has therefore has not been included in this document release but will be released at a future date.

.

7. Appendix: Terms of Reference and Forward Agenda

a. Forward Agenda as of 16 February 2018

The forward agenda referred to in this document was a provisional forward agenda that the Tax Working Group has since amended. It has therefore has not been included in this document release but will be released at a future date.

b. Terms of Reference

23 November 2017

Tax Working Group – Terms of Reference

The Tax Working Group has been established by the Government in order to examine further improvements in the structure, fairness and balance of the tax system.

The New Zealand tax system has been justifiably commended internationally for being a simple and efficient system. The Government's starting position is that the guiding principle for the New Zealand tax system – namely, that tax should operate neutrally and as much in the background as possible – is sound.

The Working Group will consider what improvements to this framework could improve the structure, fairness, and balance of the tax system. In particular, the Working Group will consider the impact on the tax system of the likely economic environment over the next decade.

The Government has the following objectives for the tax system:

- A tax system that is efficient, fair, simple, and collected;
- A system that promotes the long-term sustainability and productivity of the economy;
- A system that supports a sustainable revenue base to fund government operating expenditure around its historical level of 30 per cent of GDP;
- A system that treats all income and assets in a fair, balanced, and efficient manner, having special regard to housing affordability;
- A progressive tax and transfer system for individuals and families; and
- An overall tax system that operates in a simple and coherent manner.

The Working Group should report to the Government on:

- Whether the tax system operates fairly in relation to taxpayers, income, assets, and wealth;

- Whether the tax system promotes the right balance between supporting the productive economy and the speculative economy;
- Whether there are changes to the tax system which would make it more fair, balanced, and efficient; and
- Whether there are other changes which would support the integrity of the income tax system, having regard to the interaction of the systems for taxing companies, trusts, and individuals.

In examining the points above, the Working Group should consider in particular the following:

- The economic environment that will apply over the next 5-10 years, taking into account demographic change, and the impact of changes in technology and employment practices, and how these are driving different business models;
- Whether a system of taxing capital gains or land (not applying to the family home or the land under it), or other housing tax measures, would improve the tax system;
- Whether a progressive company tax (with a lower rate for small companies) would improve the tax system and the business environment; and
- What role the taxation system can play in delivering positive environmental and ecological outcomes, especially over the longer term.

In considering the matters above, the Working Group should have due regard to the overall structure of the tax system to ensure it is fair, balanced, and efficient, as well as simple for taxpayers to understand and comply with their tax obligations.

The following are outside the scope of the Working Group's review:

- Increasing any income tax rate or the rate of GST;
- Inheritance tax;
- Any other changes that would apply to the taxation of the family home or the land under it; and
- The adequacy of the personal tax system and its interaction with the transfer system (this will be considered as part of a separate review of Working for Families).

In addition, the focus of the Working Group should not be on more technical matters already under review as part of the Tax Policy Work Programme, including:

- International tax reform under the Base Erosion and Profit Shifting agenda; and
- Policy changes as part of Inland Revenue's Business Transformation programme.

The Working Group will be able to recommend further reviews be undertaken on specific issues which the group considers it has not been able to explore sufficiently, or that were excluded from its Terms of Reference but which could benefit from being considered in the context of its recommendations.

The Working Group's membership will include individual(s) with expertise in Maori community and business environments.

The Working Group will be supported by a secretariat of officials from Treasury and Inland Revenue, and it will be able to seek independent advice and analysis on any matter within the scope of its Terms of Reference. The Working Group will have an independent advisor to analyse the various sources of advice received by the Working Group and help to analyse and distil the information to assist the Working Group's deliberations. The Working Group will be expected to engage with the public in developing its recommendations.

The Working Group should have its first meeting no later than February 2018, issue an interim report to the Minister of Finance and Minister of Revenue no later than September 2018, and issue a final report to the Minister of Finance and Minister of Revenue no later than February 2019. These dates may be varied with the consent of the Minister of Finance.