Tax Working Group Public Submissions Information Release

Release Document

September 2018

taxworkingroup.govt.nz/key-documents

Key to sections of the Official Information Act 1982 under which information has been withheld.

Certain information in this document has been withheld under one or more of the following sections of the Official Information Act, as applicable:

[1] 9(2)(a) - to protect the privacy of natural persons, including deceased people;

[2] 9(2)(k) - to prevent the disclosure of official information for improper gain or improper advantage.

Where information has been withheld, a numbered reference to the applicable section of the Official Information Act has been made, as listed above. For example, a [1] appearing where information has been withheld in a release document refers to section 9(2)(a).

In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) of the Official Information Act.

[1]

26 April 2018

Dr Cullen
Chairman
Tax Working Group Secretariat
PO Box 3724
Wellington 6140
submissions@taxworkinggroup.govt.nz

Dear Sir

Re: Tax Working Group Submission

Introduction

Thank you for the opportunity to submit to the Tax Working Group. By way of background I have attached my biography, but would like to highlight my experience in reviews for successive Governments, namely:

-Chairman, Review of the Taxation of Investment Income (2004) which led to the managed funds PIE taxation regime which underpins inter alia Kiwisaver superannuation schemes;

-Chairman, International Fund Services Development Group (2010) which led to the tax changes necessary for NZ to become a funds domicile; and

-Independent Member, External Challenge Group to the Crown's Investment Statement (2018) which incorporates the Treasury's Living Standards Framework for the Four Capitals (Human, Financial, Social and Natural)

Comments on Terms of Reference

I note that several important areas are documented as out of scope in the Terms of Reference such as increasing any income tax rate or the rate of GST, an inheritance tax, changes to the taxation of the family home/land, and the interaction between the taxation and benefits systems (which is subject to a separate review).There are implications for these omissions such as potential overinvestment in the family home/land relative to other productive investments.

While it is not documented as out of scope there is no discussion called for on the interaction between central government taxation and local authority taxation (rates). The principle to discuss is that of subsidiarity-not changing the overall tax collection but devolving taxation from central to local government which allows Councils to have greater relative competitive autonomy over the setting of local taxes to meet local expenditures. The recent announcement of regional fuel taxation powers is helpful in that regard but much more work needs to be done to redress the imbalance of central government benefiting from the taxation of national policies (such as tourism) but expecting local ratepayers to bear the costs of that policy.

Finally I am not sure if there should be a taxation system objective that must result in the overall tax collection remaining at circa 30% of GDP. Clearly tax revenues should be required to balance the Crown's operating expenditures through the economic cycle, but a greater focus on expenditures can still result in a balanced budget with a lower overall tax burden.

Comments on Taxation Principles

Tax policy settings can be rife with troublesome boundaries some of which deserve ridicule. Classifications of foods that are or are not exempt from VAT in overseas jurisdictions are a good example. Although NZ relies on only three main sources of taxation-individual, company and GST- I endorse the comments made in the documents provided by the Tax Working Group about our current low rate, broad-based taxation system namely it is “justifiably commended internationally for being simple and efficient” and which “guiding principle is neutrality”.

It is important that policy makers continue to sustainably support these principles which contribute to greater long-term certainty of the rules of the game for taxpayers. Taxation policy volatility will lead to increased risk premiums and potentially adverse changes in economic behaviour.

There is also good execution of these principles in the design of NZ’s income taxation principles which is not highlighted at all in the Working Group’s public documentation. The first is the alignment to the marginal tax rate of the individual taxpayer. Individuals’ marginal tax rates drive their taxation of income from NZ companies (the imputation regime) and their taxation of income in the Portfolio Investment Entity (PIE) savings regime through Prescribed Investor Rates (PIRs) which is also a final tax. This is a largely efficient and fair taxation methodology.

The second is the use of the Risk Free Return Method (RFRM) to tax non-Australian overseas shares held within a PIE. This is currently set at 5%. Investors are taxed at their individual PIR on this return regardless of the actual total return of the shares. It provides a fixed revenue stream to the Crown at a RFRM rate that has been low enough to be acceptable to investor taxpayers, and successfully bypasses debates on the capital/revenue boundary.

I do support well flagged consensual evolution of policy under these principles.

Comments on Specific Challenges

1.Capital Gains Tax

NZ already has a capital gains tax. However it is not comprehensive, and there are concerns about how to consistently enforce it. I am not convinced that overseas jurisdictions have capital gains tax regimes that are efficient or neutral. Tax boundaries just seem to get shifted, and transaction costs rise for all parties. The Working Group needs to consider the taxation parable of the apple tree. If the seeds and resulting tree are the capital required, and the apples are the eventual income, do you tax the growth of the tree? At what points in its life do you tax it? Does this change risk appetite to plant trees? If it doesn’t bear fruit do you offer a rebate? When does income start? At budding? At picking?

Bypassing these boundary issues using a comprehensive low rate RFRM should be seriously considered.

2.Alignment of top marginal individual income/trust and company tax rates.

Taxing companies/PIEs at 28c but trusts and individuals at the top marginal tax rate of 33c is not efficient. It does lead to tax structuring and enforcement costs. There must also be some concerns about the global mobility of individuals on the top marginal tax rate who contribute a disproportionate amount of tax on a pro rata basis. These tax rates should all be aligned at the same rate ie 28c.

3.Individual tax brackets
While the Working Group does not have a mandate to increase tax rates there is a case for reviewing tax brackets, including disincentives to move up the brackets, methodologies to stop bracket creep, and the 0% threshold.

4.Company taxation.
I do not support more progressive taxation to favour small vs large businesses. How do you decide the boundary between small and large? Do we want the tax system to encourage large businesses to shrink?
The Working Group does need to address the inability of 0% taxpayers to use imputation credits. This is unfair. Addressing this improves Social Capital outcomes, a vital part of the Living Standards Framework.

5.Savings regime
Leave the TTE regime as it is. The PIR integration with PIE taxation is fair and efficient. An important additional benefit is that it is a final tax with no administration required by investors.
However when RFRM was introduced at 5% interest rates were much higher and there was no agreement on methodologies to adjust the rate. Arguably the rate should be 3% today. The Working Group should consider when RFRM should adjust.

6.Rental Property
The Crown currently proposes to ring fence taxable deductions for rental properties to prevent offsets against other non-property income (ie income unrelated to the rental property/properties concerned). The problem definition is that residential rental property is somehow favoured by the current approach. The solution is that deduction eligibility is only valid when the property rental income concerned is taxable. This may be common in commercial property structures, but not necessarily so in residential rentals. What is not clear is consistency of approach-is rental property in fact favoured? What are the consequences of the proposed changes? For example does it impact on the financing of small business who do use housing as collateral to raise debt? Does it discriminate between debt funded (where interest is deductible) and equity funded rental investors?
Holiday houses should not be taxed provided no income is earnt.

7.GST
The coverage of GST should be widened to include consumer goods purchased online from overseas. NZ retailers are unfairly penalised by being required to apply GST to all items sold locally wheras consumers purchasing online from overseas vendors with a value of less than $400 are not required to pay GST.
In the interests of fairness GST should apply at the border at a minimum flat $ rate per item. If the item purchased online is more than $400 the normal 15% GST rate should apply.

8.Environmental Taxation
The evolution of the Crown's Emission Trading Regime is the appropriate place for addressing carbon taxation and NZ's climate change obligations.
What has yet to be addressed are other costs to the health of our natural capital under the Living Standards Framework from urban and rural polluters of our land, lakes, rivers and seas. As these costs are not directly borne by the polluter, they do not have a direct financial incentive to manage or cease their pollution. The Working Group should consider whether changes to the NZ tax regime is the best place to encourage changes to polluter behaviour or whether it should be addressed outside the regime.

9.NZ taxation in a global context
NZ needs foreign investment whether it is inter alia to finance Crown, Local Authority or company debt, or to invest in new and existing listed and unlisted NZ enterprises. There are important attendant benefits including employment, transfers of skills and technology and the introduction to/expansion of foreign markets.
NZ should be at least a neutral destination from a tax perspective for both portfolio and direct investors from overseas. Foreign investors should not pay further NZ tax on top of their domestic tax. And any regime for non- residents should not discriminate against domestic firms wishing to compete globally.

I am very concerned about the current unclear tax policy frameworks for foreign investors which raises uncertainty and risk premiums, and results in poor tax revenues. The funds domicile progress, and changes to the Foreign Trusts regime are examples of an increasingly weak approach. Our opportunity is to improve our global capital markets reputation, attract investment to locate in NZ as a base for global activities and through a principled broad-based neutral approach thereby increase the Crown's tax base and revenues. The Tax Working Group should consider a work stream on these opportunities.

Conclusions
Overall the integrity of the NZ tax regime is strong. It can accommodate future economic change and still deliver required tax revenues through the cycle for the Crown. There is however room for evolutionary improvement, provided it enables taxpayers to plan with certainty.

I would be happy to share these thoughts further with you at your convenience.

Yours Faithfully

Craig Stobo
[1]

Biography for Craig Stobo

Craig Stobo was educated at Waitaki Boys High School (Milner Prize); Otago University (BA Hons First Class in Economics); and Wharton Business School, University of Pennsylvannia (Advanced Management Programme).

He has worked as a diplomat for the NZ and Australian Governments; as an economist for DFC/Zealcorp; as an interest rates products manager for Bankers Trust NZ; and also as CEO and Executive Vice President for BT Funds Management NZ Ltd after leading its establishment in 1992.

He has chaired the Government's Review of the Taxation of Investment Income in 2004 which lead to the PIE tax regime which underpins the managed funds (including Kiwisaver superannuation) industry; chaired the Government's International Fund Services Development Group in 2010; and chaired the Establishment Board of the Local Government Funding Agency (LGFA) prior to its incorporation in December 2011.LGFA is now the largest NZD bond issuer after the NZ Government.

Currently he provides corporate advisory services to domestic and global clients. He also has private equity and directorship interests in businesses including global equity investor Elevation Capital Management; national investment advisory firm Saturn Portfolio Management; oyster farmer and exporter Biomarine Ltd; and specialist Bannockburn grape grower Legend Terrace Ltd.

His independent directorships include chairing the Local Government Funding Agency, AIG Insurance New Zealand Ltd, and the NZX –listed companies Precinct Properties New Zealand Ltd, and Fliway Group Ltd (until its delisting in January 2018). He has also been appointed by Local Government NZ to the Establishment Board of the Local Government Risk Agency; and was a member of the External Challenge Group to peer review the Crown's 2018 Investment Statement.

March 2018