Tax Working Group Public Submissions Information Release

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Future of Tax: Submissions Background Paper

KPMG New Zealand's submission to the Tax Working Group

30 April 2018

kpmg.com/nz

FUELLING PROSPERITY

We passionately believe that the flow-on effect from focusing on helping **fuel the prosperity** of our clients significantly contributes to ensuring that our communities, and ultimately our country and all New Zealanders, will enjoy a more prosperous future.

At KPMG we are all immensely proud of the contribution we make to the future prosperity of New Zealand.

This passion and pride is manifested in the approach with which we undertake all our work.

This commitment reflects our passion and belief that together New Zealand can maximise its potential, and that by helping inspire a market full of successful enterprises, we will in turn inspire a country of which we can be more proud.

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The Chair
The Tax Working Group

30 April 2018

Dear Sir

Future of Tax: Submissions Background Paper

We are pleased to present KPMG's submission to the Tax Working Group (the TWG).

KPMG's purpose is to fuel New Zealand's prosperity. The tax system plays a pivotal role in the lives of all New Zealanders. We are therefore concerned to contribute to the effective development of New Zealand's tax policy and administration.

We do this by fully engaging in the Generic Tax Policy Process (GTPP). This includes responding to Government and Inland Revenue policy documents and statements, and engaging with Tax Policy Officials and the legislative process. It also involves helping our clients to understand and comply with their tax obligations. The GTPP requires significant involvement by members of KPMG's Tax Team. However, we consider this investment necessary to assist with ensuring New Zealand's tax settings are fit for purpose.

We are generally guided by a Broad Base, Low Rate (BBLR) approach to taxation. We apply a business overlay, however. We consider it important that the practicalities and costs of a policy are appropriately considered. As a result, departures from BBLR can be and are justified.

The TWG has a broader focus beyond the usual measures of tax policy to include, particularly, fairness and the Living Standards framework. We have taken the opportunity of thinking about the tax system in a wider context but we have continued to test our response against the traditional measures.

One of our concerns is the extent to which the tax system should be used to deliver wider public policy objectives, rather than raising revenue efficiently and fairly (while minimising the cost to administer and comply) to fund Government spending.

That is not to devalue more holistic considerations in the development of tax policy. Those are important. The tax system does not stand in isolation. It works with and in context of New Zealand society. Further, tax policy may in turn impact on society. Tax policy has to have regard to that wider context. We have attempted to include those connections in our response, where possible. However, there remains questions of judgement throughout.

The TWG has been set an ambitious agenda and a demanding timetable. This makes it difficult for us to traverse the same grounds to make concrete and supportable recommendations. (This is particularly so as we prefer evidence-based decision-making. We have had insufficient time to consider and conclude on the full range of evidence.)

We recently said to the Finance and Expenditure Select Committee on the Base Erosion and Profit Shifting Taxation Bill, "we have as many questions as we have answers". We have used in our submission a series of "Judgement Boxes". These, as the name suggests, confirm that it is difficult to find a single right answer.

There are effects to be balanced and judgements to be made. As the societal context changes, the balance and judgements may change. We think it is important that, equally for policies supported and discarded, the factors considered and judgements made should be clearly stated.

We would be pleased to present on our submission to the TWG, if the opportunity is available.

Please do not hesitate to contact us, John Cantin on [1] or Darshana Elwela on [1] should you need any further information in relation to KPMG's submission.

Yours sincerely

[1] [1]

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Executive Summary

We describe the TWG's task as "doing a jigsaw puzzle with pieces that don't fit" or "like poking at jelly, pushing in one spot, makes another stick out".

It is difficult to provide a coherent, evidence based response to the TWG's requests. Our response is more focused on particular issues. This does not necessarily produce a coherent result. With that caveat, our main observations and responses are:

— Tax can be complex. It involves trade-offs and judgements. It is important that the trade-offs and judgements are transparent. This applies to a tax policy which is recommended by the TWG as well as for those policies that are not recommended. There is a role for the TWG to formalise and clearly state those judgements so they can be tested and, in time, reviewed.

— There is also an education role for the TWG on the basic principles and issues of taxation. This will be facilitated by making clear its assumptions and correctly stating the basis for a particular recommendation. It should consider recommending particular methodologies for reporting on the tax burden.

— We acknowledge the fairness case for a comprehensive capital gains tax. We can also see the opportunity that would provide for desirable simplification and rationalisation of the current ad hoc regimes which tax gains as income. However, it will not be easy to design a fully effective capital gains tax. The international experience confirms this. If one is to proceed (excluding the family home), we would prefer a tax as close as possible to the theoretical ideal, to minimise distortions. This means, for example, that it should be included in the income tax base with as few exemptions as possible. Targeted rules should be used to deal with specific problems. For example, a specific portfolio asset loss offset rule is better than a general loss prohibition.

— We consider a single company tax rate is best. However, integration of the personal and company tax bases should be considered as a solution to possible over taxation of small businesses. The Portfolio Investment Entity tax regime provides a possible framework for reform.

- The international dimension of income taxation is one of the areas of highest risk to New Zealand's tax system. New Zealand appears to be pursuing a tax policy ideal when it is not clear that the policy is ideal and when other countries are pursuing a self-interested approach. We are unconvinced that New Zealand's approach, given its need for foreign capital, is in its best interests. It should continue to pursue a global consensus which best fits its position in the world.
- Consideration should be given to options for reducing the differential taxation of savings. Fiscal constraints may mean that options for desirable reductions are limited. However, we would expect the TWG's total package to consider the trade-offs.
- The Māori economy has an important role to play in fuelling New Zealand's economic development. The Māori Authority taxation regime needs to be modernised to include the different commercial structures being utilised by Māori organisations. We note its objective is to tax Māori Authority beneficiaries at their own tax rates. This is also consistent with our integration comments above.
- To better target the "gig" and "sharing" economies (and address "black economy" concerns), we believe, on balance, a reporting regime for contract payments made to the self-employed is better than a withholding tax regime.
- Similarly, the current limitation on employees deducting their work-related expenses may no longer be appropriate tax policy. It reduces fairness in return for administrative and compliance cost savings. Technology, including Inland Revenue's Business Transformation programme, may reduce those costs so that fairness benefits have greater weight.
- New Zealand's GST regime is world class and we strongly urge the TWG to keep it this way. In our view:
  - The perceived benefit of zero-rating certain goods and services (e.g. healthy foods) to reduce their cost is unlikely to be the best means of targeting the social concerns.
  - The current "exempt" boundaries (for financial services and residential accommodation) should be reconsidered for their continued position as good tax policy.
- Corrective taxes can serve multiple purposes – to prevent an activity, to compensate for the social costs of that activity, and to contribute to general revenue. In implementing (or continuing with) a corrective tax, the tax policy should be clear about the desired objective and there needs to be good evidence that tax, and not a regulatory or other, response is the best tool. Care also needs to be taken that a corrective tax sends the right signal regarding who is responsible for remediating the perceived harm.
- We do not support wealth taxes or specific transactions taxes (such as stamp duties). Other tax bases are likely to be more efficient and effective and can be modified to achieve fairness objectives.
- We support the GTPP, but consider that greater trust in the GTPP needs to be built to address shortcomings in how it has been applied.
- There is a case for the Commissioner being limited in the positions she can take and for sanctions being imposed on failures of her process.
- The methodology for costing tax policy initiatives can inhibit good tax policy, especially for remedial amendments. The fiscal costing methodology should be updated to allow remedial tax changes.

Background

The terms of reference for the TWG are broad. They encompass the traditional focus areas for a review of the tax system, but also other issues, which require more holistic considerations. Their resolution involves judgements about whether the tax system should be used to achieve wider social and economic outcomes, rather than simply to raise revenue efficiently and fairly.

The TWG's Terms of Reference

The terms of reference for the TWG encompass a number of broad objectives. These include consideration of the fairness of the tax system, whether it is flexible enough to cope with the economic environment of the future (which is likely to be defined by the changing nature of work and new business models driven by technological advances) and, of course, whether it can raise sufficient revenue to fund future government spending. These are the traditional focus areas for a review of the tax system.

There are also a number of specific areas the TWG has been asked to consider, such as the impact of the tax system on housing affordability, the role of (and for) environmental and corrective taxes, whether there is the case for a different small business tax rate or changes to exclude GST on certain goods and services. These are more holistic considerations. They involve judgements about whether the tax system should be used to achieve wider social and economic outcomes, rather than simply to raise revenue in the most efficient and fair manner.

The current system

We make some observations and comments on the tax system in support of our response.

A function of base and rate

For any particular tax there is a simple formula:

Base x rate = tax revenue

The revenue raised is affected by both.

Since the reforms of the 1980s, the political focus has largely been on the rate – increasing or lowering personal, company and GST rates. There has, with the exception of a comprehensive capital gains tax, been a bi-partisan approval to changes to the base. The reality is that many equity objectives have been met by changes to the base, rather than to rate changes.

By way of anecdote…

> *"Post the 1980s reform a KPMG partner compared his tax paid, before and after. It showed a significant increase in tax despite the lowering of the highest personal rate from 66 to 48%".*

This illustrates that a singular focus on the rate is misguided. The total picture needs to be considered.

Types of taxes

We broadly divide taxes that tax:

What comes in

The income tax is an example. The debate is what should be taxed as income? Should this be a broad economic definition or the classical trust law based definition, which has been steadily broadened to include much of what is in the economist's definition? A capital gains tax would fall within the former.

Importantly, these taxes also require a definition of what can be deducted from income. This is important for most New Zealanders as they are unable to deduct any expenses incurred to derive salary and wages. They are taxed on their "gross" income from employment. This may play a role in how tax compliance by businesses is perceived, as we discuss later on in our submission.

The private and capital expenditure boundaries, which deny deductions, also affect the total tax payable.

What goes out

The GST, a consumption tax, is NZ's best example. The GST taxes private spending as well as activity (financial services and residential accommodation being two limited exceptions). Excise taxes are also taxes on spending.

User pays and corrective taxes are typically taxes on spending. New Zealand has multiple levies that finance Government spending in particular areas. These include certain ACC and EQC levies and excise taxes on alcohol, tobacco/cigarettes and fuel.

What you own

New Zealand's main example is local government rates – they are based on ownership and the value of property. The Fair Dividend Rate method, under the Foreign Investment Fund Rules, is another. A wealth tax and a land tax are other examples.

Balance

A single person, a household, and business, may be subject to some or all of these types of taxes. The appropriate balance between them is a matter of judgement.

That judgement needs to weigh efficiency and effectiveness, keeping in mind that ultimately the same people may be bearing the tax.

For example, a comprehensive land tax will affect salary and wage earners that are also owners of land. Therefore, when considering whether a land tax is appropriate the relevant questions would include:

- Is it more efficient to impose two taxes (i.e. taxing both their salary and wages and the land) or raise the same amount through taxing just one base (salary and wages)?
- Are there behavioural or other consequences that make the administrative and compliance costs of the land tax worthwhile?
- Are there changes to behaviour that make the tax problematic (e.g. emigration of the person and others which may ultimately reduce the value of the land tax base)?

The answers to these questions will be a matter of judgement.

We have attempted to set out our analysis of the different tax bases under the broad headings above. As the TWG's terms of reference and specific consultation questions overlap in a number of areas (e.g. the taxation of capital and the interaction of the tax system and the housing affordability objective), this may not be an exact fit.

Key propositions

We also highlight some key propositions which we have used in making our specific responses.

BBLR

New Zealand's current "BBLR" framework, which successive Governments have retained, has as its main drivers economic efficiency and, to some extent, equity (fairness). The principle is that by taxing different economic activities relatively uniformly, regardless of how they are carried on and by whom, the efficiency costs of taxation should be minimised. That should also contribute to horizontal equity. That is the broad intent, if not the exact result, of the current system.

Legal versus economic incidence of the tax

New Zealand imposes income tax on individuals and their various entities. They are the ones legally obliged to pay - they bear the "legal" incidence. The tax system uses businesses and various other intermediaries to charge and collect the tax that is due. This disguises who actually bears the tax - the "economic" incidence.

For example:

"A payroll tax looks like a tax on employers, but employees bear the tax because it is factored into employee remuneration."

This makes it easy for those advocating a particular policy to ignore this dimension (see our comments on removing GST from healthy food and the taxation of foreign direct investment into New Zealand).

We acknowledge that the evidence for who actually bears a tax is not always clear. For example, the economic incidence of company taxation potentially falls on customers, employees and shareholders. The extent to which any particular group bears the tax is not clear.

However, explicit consideration of who bears the tax is required to ensure appropriate tax policy judgements are made. The TWG should make explicit its assumptions on the economic incidence of tax when making its policy recommendations.

The difficulty of determining the economic incidence of a tax also means that those paying may confuse the tax they bear with the tax they collect or pay on behalf of others.

We consider there is a role for the TWG to make clear where it considers the economic rather than legal incidence of tax falls. This would make it easier to assess statements made on the contribution, or lack of, to the tax system by various stakeholders.

The paying "unit" and differing attitudes to tax and spending

Administrative and compliance costs factor into decisions on who legally has to pay a particular tax. This also disguises the position that ultimately it will be individuals who suffer the economic incidence of a tax. A company pays tax effectively on behalf of its ultimate individual owners, but legally pays that tax separately from its owners. This contrasts with social policy measures, such as *Working for Families* tax credits, which include income earned through an individual's company or trust to determine their entitlements.

The result of this effectively stricter test for determining a person's social assistance entitlements versus tax obligations is that some of the most complex rules apply to those earning the least.

Although this may reflect a view that there should be greater accountability for, and better evidence of a need, to justify Government spending, it is a notable difference of approach between the expenditure and income sides of the Government's ledger.

Testing who receives the benefit from tax paid

The submissions background paper reports, by income groups, tax and transfer payments of different household deciles. This focus provides some insights. However there are potentially misleading simplifications.

From a purely tax perspective, it ignores the GST, which all income groups pay. Taking that into account may reduce the highlighted "tax gap" between households in the highest and lowest deciles.

Further, the analysis potentially ignores the wider role of Government spending. At a direct level, a public servant in the top income band is, at least to the extent of their salary, fully funded by the tax system. Less obviously, someone dependent on consumer spending is also funded, at least in part, by the New Zealand transfers system providing money to be spent on their particular goods and services.

In short, such analysis, may suggest that the measure of the benefit from a tax is the return from the spending on it. This is relevant, for example, when considering corrective taxes or hypothecating taxes. It is less obviously relevant for taxes which fund general Government spending.

As with the incidence of tax, the assumptions made around who benefits from a tax need to be clearly articulated to ensure that appropriate policy judgements can be made.

Labour and capital taxation

The economic literature and theory consider the different effects of labour and capital taxation.

These concepts are not readily distinguished in New Zealand's system. For example, the engineer owners of a professional engineering company contribute both their personal labour and their capital. The return from that contribution will be taxed in both the personal and company tax bases. The personal and company tax systems do not generally distinguish between labour and capital. (The personal services attribution rules are an exception.)

There is a further complication in that the return to personal labour includes a return to human capital as well as physical endeavour. Note too that the other capital aspects of labour income, for example restraints of trade and share benefits, are increasingly taxed as labour income.

The lack of distinction is consistent with a BBLR approach. However, it does highlight a potential inconsistency in the taxation of assets which largely continues to make that distinction.

To the extent that evidence or theory suggests there are advantages to differential taxation of labour and capital, its implementation requires clear consideration of boundary issues. Firstly, what is labour or capital and, secondly, related questions of deductible expenditure.

1. Taxing what comes in

This part of our submission considers what we consider to be the traditional tax bases – taxing income however defined. It therefore considers extensions to what is currently in the income tax base as well as possible modifications to existing taxes.

A. Taxation of capital

This section comments on the taxation of capital, both the income from and the capital itself. (This includes what comes in and what is owned.) Included in this section are some general comments and consideration of: the company tax (as the closest to a capital taxation regime), capital gains taxes (and taxes aimed at improving housing affordability), and the taxation of savings.

1. General comments

BBLR in the context of taxation of capital

There is the question of whether BBLR is still the right tax policy framework for New Zealand when considering the taxation of capital. Alternatives include basing the level of taxation on the sensitivity of the behavioural response to the tax. This is arguably more efficient – taxing only those assets or economic activities which are insensitive to the tax, or taxing these more highly, creates less distortions.

However, there are trade-offs including the implications for the fairness of the system. For example, taxing land is considered very efficient by economists because it is in fixed supply (i.e. its availability does not shrink or expand as a consequence of the tax). In comparison, capital and labour are mobile. However, taxing land owners more heavily than business income (or employees) is likely to raise fairness concerns, particularly if the tax on land is not by reference to actual cash flows. Similarly, a lump sum tax (e.g. poll tax) is considered efficient because it is paid by everyone and the amount that is taxed remains constant regardless of income or wealth (i.e. the assets owned). It therefore does not alter individuals' economic decisions. However, lump sum taxes are regressive as they have no regard to the ability to pay.

There is also the inability to precisely estimate the sensitivity of different activities and investment decisions to tax. Therefore, there is a risk that policy makers could under or overestimate the behavioural impact, with the consequence that particular taxes may not be efficient (or as efficient as originally thought).

Taxation of inbound investment

One area where New Zealand's tax system incorporates a behavioural-based element in its design is the taxation of non-residents who provide debt capital. New Zealand's Approved Issuer Levy rules reflect the concern that New Zealand withholding tax on non-resident lenders will ultimately be passed on to New Zealand borrowers by way of a higher cost of capital. (The economic logic for this approach is that foreign lenders will demand a total rate of return that is set by reference to global rates, irrespective of the NZ tax cost.)

In our view, this is a valid concern for a country which is highly dependent on foreign capital to fund New Zealand businesses and households.

This is also a relevant issue when discussing New Zealand's corporate tax rate (and base) for equity investment by non-residents (i.e. Foreign Direct Investment or FDI).

2. Company tax

The tax rate on inbound equity investment is effectively the NZ company tax rate. (The repatriation of NZ tax paid profits attracts a nil withholding rate for FDI.)

However, the considerations for setting the New Zealand company tax rate are wider than just the tax rate faced by non-residents.

KPMG believes the relevant considerations here include:

Importance of company tax to the overall tax take

This poses challenges not only in terms of the rate, but the future sustainability of the corporate tax base having regard to international developments (discussed further below) and increasing global tax competition. The latter's impact is directly through company tax rate competition (with the US and UK leading the reduction in their headline rate to attract new investment) and indirectly through more aggressive positions being taken by various Governments and global tax authorities in claiming their shares of the global tax payable by multinationals.

In KPMG's view there is a risk that New Zealand's company tax base will not be sustainable (certainly not in terms of its current revenue raising capacity) in the medium to long term as a result of these pressures.

Desirability of company and marginal tax rate alignment

With imputation, the NZ company tax is effectively a form of withholding tax on resident shareholders, with a "top up" on distribution to those on higher rates. Therefore, misalignment of the company and top marginal rates is not as big a problem as in other countries.

In KPMG's view, this provides scope for some differentiation between the company tax and top personal rates, without importing significant integrity issues.

However, we acknowledge that there are limits to the sustainable differential between the company and top marginal rate (and other entity rates, such as the trust rate). That is, similar to the experience with the top marginal and trust rate differential in the early 2000s, a material misalignment over the medium to long term could give raise to unintended (but not unexpected) consequences.

Whether broader integration of capital and personal income tax is feasible

Imputation was introduced in the late 1980s as a solution to the double taxation of company profits for NZ shareholders. It relies on distribution of retained earnings for taxation to be levied at shareholders' rates. Further, it overtaxes those shareholders on lower rates than the company rate as imputation credits are not refundable and restricts the ability to pay out non-taxed amounts to liquidation.

NZ has other attribution regimes – the partnership and look through company rules – which mean investors, and not the entity, pay the tax. These have their own complexities and are not available for wide application.

In 2007, the multi-rate Portfolio Investment Entity (PIE) regime combined final entity taxation with attribution of income at investors' marginal tax rates (with some adjustments).

With the advance of technology, KPMG urges the TWG to consider whether broader integration of company and NZ shareholder taxation is feasible.

Impact of Australian company tax developments

Australia both as a source of, and competitor for, FDI will influence New Zealand's corporate tax settings. While small differences between the Australian and New Zealand company tax rates are unlikely to create significant imbalances or distortions, Australia repealing its imputation system or making deep company tax cuts will warrant a response.

In KPMG's view, this is an example where headline tax rates will be relevant to non-resident investors.

Under-taxation of New Zealand "economic rents"?

The question is whether there are economic rents (i.e. excess profits/returns above the global rate of return required by non-residents to invest here) that can and should be taxed. If not taxed by New Zealand, this would result in a windfall gain to foreign capital owners. This has been expressed as a concern in Officials' previous analyses.

KPMG accepts that there will be some industries and sectors where there may be economic rents. However, setting different tax rates for different sectors based on the existence of economic rents does not seem practical. The evidence to support or dispute the case is not likely to be easily available or robust. If there is strong evidence of economic rents, then specific changes would appear to be better than a blanket policy response. Again, given the sensitivity of the New Zealand economy to foreign capital, we reiterate the need for our business tax settings to be evidence based.

KPMG therefore urges caution in relation to differential company tax rates.

Separate company tax rates for small and large business

This includes setting differential rates for small and large business, which raise a number of concerns for us. In the context of a lower company tax rate for small business, this includes:

- *The rationale.* What is the problem that a lower small business tax rate is seeking to solve? This seems to be ill defined.
- *Targeting of the lower rate.* There is no consistent definition of a small business. Should this be based on turnover, number of employees, a combination of the two, or some other basis? How should it interact with the taxation of sole-traders, which are micro-businesses but not corporatised? What about small businesses operating through other entity structures, such as trading trusts?
- *The appropriate rate differential.* The higher this is, the higher the tax "cliff edge" when businesses cease to be small. In New Zealand there is already anecdotal evidence of small businesses not taking that next step to grow. The tax system should not, in KPMG's view, be a further disincentive for business to expand.

In KPMG's view, a better approach would be to address the specific tax issues and concerns facing small business.

This includes:

- The complexity of certain tax regimes, such as the potential application of the financial arrangements rules for businesses of this size, or the provisional tax rules. In relation to the latter, the Accounting Income Method (AIM) method is an example of how making it easier for small businesses to calculate provisional tax may be compromised. (In KPMG's view the take up may be adversely affected by the need to make tax adjustments to accounting income when AIM payments are not a final liability.)
- The need for simpler and clearer deductibility rules and higher de minimis thresholds for automatically deducting certain expenses. Small businesses should not be expected to have the sophistication of larger taxpayers when resolving capital/revenue issues.

Further, an integration regime for small businesses would appear to be a better option than differential tax rates.

The effect of integration would be to tax company business income at the shareholders' tax rates.

A "fair" allocation of international income – implications for NZ and other countries' taxing rights

As we have noted earlier, the taxation of international capital flows is very important to New Zealand as a capital importing and an exporting country. It is also one of the most difficult and, in our view, riskiest areas for New Zealand.

The previous international consensus on allocating taxing rights to countries is changing. The global economy makes change appropriate. However, the revenue needs of nations means, in our view, that a consensus definition of "fair" taxation is yet to be agreed.

We have described the OECD's Base Erosion and Profit Shifting (BEPS) international tax recommendations as an understandable compromise rather than a principled resolution to the problems. Other countries' implementation of the OECD recommendations, if they are implemented at all, is generally focused on self-interest (often based on domestic political considerations). New Zealand's approach has focused on tax principles, which leaves New Zealand as an outlier in the BEPS process.

The risk is the result of the BEPS recommendations, which were aimed at combatting double non-taxation, will actually produce double taxation. Income taxation can act as a tariff. The chair of the TWG recently noted that New Zealand's position is that tariffs are harmful to trade and consumers. In some ways, New Zealand is proposing to tax amounts that are not justified as amounts relating to business or economic activity undertaken in New Zealand. Increasing taxation in this way means New Zealand's response to BEPS has the potential to harm its position.

New Zealand's response should be reviewed to confirm its appropriateness, particularly in the context of the following international developments:

1. Tax base widening but with rate reductions overseas

Overseas countries' responses to BEPS have tended to be in two parts:

1. Implement base broadening BEPS measures that increase revenue; and
2. Reduce the corporate tax rate and/or introduce other relieving measures (such as "patent box" regimes, which apply concessionary tax rates to intellectual property held/developed in those countries).

New Zealand's response has been to implement the BEPS measures in full with no corresponding adjustments.

We note that New Zealand's ability to reduce the company tax rate is more nuanced than for most countries. The imputation system and the fact that companies have labour as well as capital income means that the company tax system is more aligned to the personal tax system, than in other countries. Differentiation in the base and rates can cause and has caused problems for the tax system.

However, the lack of any movement on the company tax rate to compensate for tax base changes means New Zealand will be potentially less competitive in the post-BEPS environment. The TWG should have regard to New Zealand's competitive position.

2. "User value" – defining the future tax base and taxing rights

The particular problems of identifying the fair allocation of the tax base of the digital economy have led the EU and the OECD to consider the appropriate method of taxing digital economy providers. The proposition being considered is that users of a digital platform provide value, so the users' country should be allowed to tax the platform provider. (The measure of that "value add" remains undefined but, to the extent taxes have already been introduced, the favoured measure is the income earned by the digital provider from business located in the relevant country.)

This proposition is superficially attractive but New Zealand should take care:

- New Zealand's user base is comparatively small. In any allocation of global profit, an allocation based on user numbers (population) will also be small.
- The proposition has wider implications that are more difficult to rebut from a principled perspective. As examples:
  - New Zealand's tourism industry is at risk of other countries seeking to tax its profits on the basis that its residents (the users) add value to its products and services.
  - Equally, countries importing New Zealand goods could argue that the profits of the New Zealand producer (and potentially even the salary and wages of New Zealanders who are employed in the manufacture of those goods) should be taxable in their country for the same reason.

From a value chain perspective, once value is disassociated from the places where the valuable inputs are provided and the value of customers is taken into account, it is difficult to argue the same argument does not apply beyond the digital economy. That has the potential to significantly erode New Zealand's tax base.

New Zealand therefore needs to carefully consider its position on the user value debate to ensure that it is not disadvantaged.

Taxation of foreign capital – the impact of debt vs equity

We have in our various submissions on New Zealand's proposed adoption of the OECD's BEPS recommendations noted that the taxation of foreign capital has not been addressed on a principled basis.

Capital is taxed where it is employed. However, equity provided is allowed no deduction while debt provided generates an allowable deduction so it is partly taxed in the country of use and partly in the country providing the funds.

New Zealand allows foreign capital to be provided in both equity and debt form. The effect of the tax rules is to allocate taxing rights to both the foreign country provider of capital and to New Zealand as the user of that capital.

The rate of tax on interest is less than the company tax rate. This naturally means that the total New Zealand tax rate on foreign capital is less than the company tax rate.

We consider that the New Zealand tax system, through this mechanism, has a proxy for allocating taxing rights between the country providing capital and New Zealand. We accept that where that allocation is drawn is a matter of judgement.

However, the consistent direction of change has been to allocate less to the capital provider's country and more to New Zealand. To the extent that income tax acts as a tariff and FDI is mobile, the risk of:

- not having a clear global consensus on allocating taxing rights for capital; and
- increasing effective tax rates

is that it reduces the available capital for New Zealand.

The TWG should consider the appropriate allocation of taxing rights for the provision and use of foreign capital.

Summary on the company tax

Our analysis illustrates that with the New Zealand company tax rate there is a fine balancing act between factors supporting change and the status quo. That balance will also shift over time, as other countries' tax policies (particularly Australia's) evolve. Accordingly, the case for the status quo is unlikely to be enduring.

However, we urge caution in considering:

- *segmenting the corporate base between small and large business, as we do not believe the appropriate case has been made; or*
- *retaining current settings because there is a risk that economic rents may otherwise be under-taxed while keeping the current rate risks over-taxing normal returns.*

Globally, the adoption of BEPS and declining company tax rates represents a potential challenge to New Zealand.

New Zealand's approach of adopting the OECD's BEPS recommendations but leaving the headline company tax rate unchanged will, in KPMG's view, impact our relative competitiveness, whilst providing no real assurance that our company tax base will not be eroded away.

3. Taxation of capital gains

This section of our submission deals with other ways in which income from capital can be taxed, starting with the most common form – a capital gains tax.

KPMG acknowledges at the outset that the absence of a general capital gains tax is increasingly a deeply held concern for many New Zealanders. This is generally on fairness grounds, which forms part of broader concerns around inequality and relatedly housing affordability. We note the TWG's questions in relation to a capital gains tax are explicitly linked to the latter.

The economic case for a capital gains tax is, other things constant, to improve both (unarguably) "horizontal" and (arguably) "vertical" equity. It improves horizontal equity by removing the under (or non) taxation of assets whose return is by way of capital growth rather than a regular cash flow (e.g. interest or dividends). It improves vertical equity as the economic literature suggests that those on higher incomes disproportionately make capital gains, as owners of the majority of capital assets, and therefore benefit most from their under (or non) taxation.

We note that New Zealand's tax system has been ad hoc in its approach to taxing capital gains as income:

- The most common situation where the gain is taxed is where an asset is acquired with the purpose or intention of sale.
- In the case of land, there are special rules which tax gains made in relation to certain (e.g. dealing, development, building or subdivision) activities, but also land that is not held for these purposes if that is disposed of within 10 years if the relevant activity is carried out at the time of acquisition (including by an associated person). The bright line rules are a further extension.
- The denial of tax depreciation for buildings has the same effect as taxing gains. This is because commercial buildings do depreciate, from obsolescence, as illustrated by the need to earthquake strengthen buildings.
- The New Zealand's financial arrangements and Fair Dividend Rate rules tax capital gains on an unrealised basis. These are often the most complex areas of the tax system and the source of greatest frustration for those affected. There are also other specific rules which also tax capital gains or elements thereof (for

example, the restraint of trade rules, the lease inducement rules and employee share benefit rules).

KPMG submits that if the TWG recommends a capital gains tax, then there should be a rationalisation of the existing range of ad hoc regimes, including those listed above.

Design considerations with a capital gains tax

The ad hoc extensions to New Zealand's income tax rules have been in response to specific tax base concerns. This is an approach which previous tax reviews, including the 2001 and 2010 Tax Reviews, have largely supported. This appears to be due to the practical implementation issues with introducing a comprehensive capital gains tax.

KPMG's submission does not re-iterate these issues as they have been well canvassed previously (we refer to the detailed work done by and for the 2010 Tax Review in particular). Solutions to those issues will need to be developed.

However, we do wish to highlight some specific areas which will need to be resolved if the TWG sees fit to recommend a capital gains tax:

1. Double taxation

A capital gains tax that applies to a company and the shares in that company will double tax. For example, say a company owns a capital asset that it realises for a gain of $100 (of which $28 is payable as tax) It does not distribute the gain as a dividend. A shareholder that disposes of all the shares in the company will face tax on a gain of $72 (i.e. as the net gain of $72 made by the company should be reflected in a higher share price), resulting in double tax. While we acknowledge this issue can currently arise (i.e. if both the company and shareholder are on "revenue account") a capital gains tax will make this double taxation issue much more widespread.

2. Over-taxation of inflation gains

This will be particularly problematic for long-held assets as the inflationary component of any taxable gain, even at low inflation rates, will be significant. The international experience is mixed. Some countries have attempted to inflation index and discount tax rates for capital gains. However, this comes at the cost of (often considerable) complexity.

Therefore, if a capital gains tax is recommended, we suggest incorporating this as part of the income tax system (i.e. tax payable on the nominal gain and at marginal rates) to maximise simplicity.

3. Application date

In KPMG's view, this is likely to be one of the "make or break" implementation issues with a capital gains tax.

In our view, the most equitable application is for gains made after the date of introduction to be within scope.

This avoids applying a capital gains tax to gains made before the application date (if those were taxed) and providing a tax preference to assets acquired prior to the application date (if those were exempted). However, this will require consideration of available valuation options for illiquid and less marketable assets and the use of cost for assets which have lost value since acquisition.

4. Application to PIE funds

A capital gain tax will be of particular relevance to investment vehicles that have exposure to affected assets.

KiwiSaver funds and other investment vehicles, which are multi-rate PIEs, are required to attribute income and losses to investors each year. This makes a tax which applies only on a future realisation difficult.

One option is to make a capital gain tax apply on an unrealised basis for such entities (similar to the application of the Fair Dividend Rate to foreign equities held by multi-rate PIEs). However, this will result in KiwiSaver funds (and other investment vehicles) being disadvantaged relative to direct investment.

Notwithstanding our earlier comment, this may support introducing a discounted rate of taxation on capital gains for such vehicles if a realisations basis is not practical.

5. Ring-fencing of capital losses

The rationale for ring-fencing capital losses is to prevent capital losses being brought forward to offset other taxable income.

However, if a capital gains tax is included as part of the income tax system, there should be no quarantining of capital losses in KPMG's view.

One of the advantages of including capital gains as income is that it should be designed so as to remove boundary issues between capital and revenue amounts. Ring-fencing capital losses will mean that advantage is not realised. We note the current ad hoc taxation of gains, other than under the residential bright-line test, does not ring-fence losses.

If there are specific concerns with respect to the ability to advance realised losses and defer gains (with respect to, for example, portfolio investments), targeted rules should be considered rather than blanket ring fencing.

6. The private expenditure boundary.

Much of the complexity of a comprehensive capital gains tax is due to questions regarding what assets should be included.

Assets such as family cars and boats, lottery winnings can be problematic from a compliance perspective.

One simplification that could be considered is to test whether the expenditure on such assets is denied as a tax deduction because of the current capital rather than private prohibition.

In other words, if the cost would be denied as a deduction because of the private expenditure rule, any gain or loss should remain non-taxable under a capital gains tax.

7. The capital/revenue boundary for personal services.

The capital/revenue boundary has continuously been eroded. The returns from human capital, for example, education and other attainments, are not separated from the return from personal exertion. Both are equally taxed. Other capital returns, for example, in relation to limitations on the right to work wherever desired under a restraint of trade are also taxed.

These extensions are justified on a BBLR basis.

They indicate that there is an element of inequity when all returns from a capital asset are not presently taxed.

The related design issue is, as these items are taxed, should expenditure which is currently treated as non-deductible be made deductible?

Amounts which need to be considered included the costs of obtaining qualifications for employment.

4. Taxation and housing affordability

The concern over the lack of a capital gains tax appears to be most particularly acute around residential housing.

As a general comment, it is not clear to us that a capital gains tax on residential rental property, which due to the TWG's terms of reference must necessarily be the focus of any capital gains tax which affects the housing market, would make housing more affordable.

Countries which apply a capital gains tax to residential rental properties do not uniformly show more affordable housing.

We acknowledge this observation is anecdotal. But this is necessarily the case as extricating the impact of tax settings from other variables on house prices is a difficult exercise due to both the time and the practicality of testing for the effect of other measures.

The point we would emphasise is that the TWG should be clear to highlight the support for its conclusions.

Assuming, however, that there is a tax impact on housing affordability, and that a CGT would help correct that (and that the TWG's own research confirms this), we respond to the TWG's specific design questions.

The family home exemption

It is not helpful that the TWG is unable to consider any form of taxation on the family home and/or the land beneath it. While this may reflect the prevailing political reality, in our view it does make the question of defining the appropriate base, conceptually, difficult.

It also means, in our view, that the answer to the question of whether the tax system adversely impacts housing affordability is even less clear.

This is because the relative under-taxation of the family home, which forms the single biggest asset class in New Zealand, must be a material factor if tax is a factor in house prices. While all OECD countries have family home (or principal residence) exemptions, not all countries fully exempt this. Some countries attempt to tax gains above a standard level, the aim being to still tax "high-value" properties (to preserve progressivity). *This design feature is worth considering if progressivity is a desired feature of a capital gains tax.*

Further, the exclusion of the family home means that potentially the reasons for its exclusion are not documented. We have in the accompanying Judgement Box attempted to document the pros and cons which support the constraint on the TWG's terms of reference.

We consider that the TWG should formally confirm and document the pros and cons so that the continued exclusion can be tested in the future.

Judgement:

Family home exemption from a capital gains tax

Pros:

- Not politically sustainable to tax the family home so
- Gains may be overstated as own labour to make improvements is not reflected in the cost base
- Deductions for mortgage interest would have to be allowed if the gain is made taxable, which are likely to be of most benefit to higher income earners

Cons:

- Reduces fairness (for example, it under-taxes owner-occupiers compared to renters)

Current taxes on residential land

The asset class that is typically perceived as benefiting most from the lack of a capital gains tax is residential investment (rental) properties.

This is notwithstanding the changes in 2010 to deny depreciation deductions and in 2015 and 2018 to tax such property under the "bright-line" test. Therefore, this asset class is already subject to a form of capital gains taxation. The Government's rental loss ring-fencing proposal, if implemented, will further raise the effective tax rate on residential rental investments.

KPMG believes the ring fencing proposal should be deferred until the full effect of the TWG's position and the Government's response to it is made clear.

There is an obvious overlap and possible changes recommended by the TWG would likely reduce the need for complex ring-fencing rules.

Economically, it is not clear why a residential property investment that is taxable on the rental stream only is different from, say, a share investment held on capital account that is taxable on the dividend stream only.

We note that equally, it is possible to have "dual purpose" interest expenditure to acquire a share as it is to acquire a rental property. The difference is that, practically, it may be easier to borrow to acquire a rental property but that is not a tax driven decision by the lender.

However, there is a perception that residential rental property investment is potentially more egregious than share investment, and should be an explicit target of reform. We note that an undefined use of "speculator" in this context is unhelpful to developing an appropriate policy response.

In our view, limiting the scope of a capital gains tax to a particular class of asset is not principled.

While current perceptions about unfairness in the taxation treatment of residential rental investment need to be addressed, KPMG does not believe that in itself should be a basis for treating this asset class differently.

The case for a specific tax on land needs to be evidence, rather than emotion, based. Again, the TWG's conclusions should be explicitly supported by evidence.

The case for a land tax

We have similar concerns with any other form of taxation that specifically targets land, such as a land tax, if the principal objective is to specifically increase taxation on land.

That should not be the driver in the absence of clear evidence that land is undertaxed relative to other assets, on a "like-for-like" comparison basis. (Discussion of land tax and other property taxes are included here, rather than under Part 3, due to their linkages with the housing affordability question.)

KPMG notes that economists' support for a land tax is based on a land tax being more efficient than other tax bases (and applying only to the land value, not any improvements). Its support is not based on correcting perceived or real under-taxation of land.

That efficiency argument is premised on application of the tax to all land. The inability to apply a land tax to the family home land is likely to considerably narrow the efficiency gain from introducing such a tax, whilst also reducing the potential revenue base. When New Zealand did have a land tax previously it was narrowly targeted, applying primarily to non-residential land, due to various exemptions that made it uneconomic and inefficient. Its practical application was limited.

Another practical concern with a land tax is ability to pay the tax, as it will apply regardless of how the land is utilised or whether it is sold or not. This will particularly impact land which cannot, or will not, be disposed of (so would therefore not be taxable under a realised capital gains tax, for example). Potential examples include certain Māori settlement land. This again raises equity concerns around who will end up bearing the tax.

We are also concerned around the potential macroeconomic effects from introduction of a land tax. Work done at the time of the 2010 Tax Review suggested the negative impact on land values (which given the family home carve-out will be borne by some residential rental but in the main non-residential landowners) could be between 17% and 26%, if a 1% land tax was introduced.

It is unclear whether this magnitude of economic impact would make a land tax politically acceptable, which impacts its feasibility in our view. That was a concern raised by the 2010 Tax Review.

The above factors makes a land tax difficult to support, in practice, particularly if other types of land are also exempted.

The case for other land-specific taxes

KPMG notes that stamp duties on land are common overseas. The closest examples are stamp duties that apply in the Australian states.

As stamp duties are transactions based, they are relatively inefficient compared to a land tax, for example.

Their revenue potential (like a land tax) is based on application to a broad base. The exclusion of the family home land will impact that revenue potential, if stamp duties are considered in New Zealand. (For example, we understand the majority of revenue that is collected in Australia from stamp duties is attributable to the sale of residential property, including the family home.)

Therefore, stamp duties on land are not supported on either efficiency or revenue potential grounds.

Overall conclusion on capital gains tax and land-specific taxes

The strongest argument for the adoption of a capital gains tax in New Zealand is fairness. This is both in terms of ensuring people with the same ability to pay (but with different assets or means) are taxed the same and also to ensure the progressivity of the tax system (which is a stated objective of the review).

We do not underestimate the impact of that argument, particularly for New Zealanders who have been "shut out" of the housing market.

The fairness objective is severely compromised, in our view, by any exemption for the family home and the land below it. Such an exemption is also likely, in our view, to impact on whether a capital gains tax can and will have any meaningful effect on housing affordability.

Finally, the fairness objective has to be weighed against the practical issues with introducing a capital gains tax, which this submission has briefly touched on, but others (including the previous tax reviews and the academic literature) have covered in detail. These are not simple design issues to be overcome. They involve some complex trade-offs.

The vast majority of OECD countries have capital gains taxes excluding or exempting the family home. It can be made to work (and it works better in some jurisdictions than others).

The question for New Zealand is whether a capital gains tax would improve the tax system overall. That will be a matter of judgement for the TWG.

We note its 2010 predecessor concluded that the implementation trade-offs did not justify the introduction of a general capital gains tax.

KPMG's analysis in 2018 approaches a similar conclusion but we have elevated the impact on perceived fairness and the ability to have follow on simplifications as positive indicators compared to the 2010 position.

As with other areas of the TWG's remit, it is important that it makes clear the factors it has taken into account in making this judgement call. These need to be transparent and testable so that its position can be readily confirmed.

We are clearer in our conclusions on the merits of a land tax. The likely exemptions mean it is unlikely to be an efficient replacement for other taxes while the estimated impact on the price of land to which it will apply is likely to make a land tax politically difficult. Stamp duties are not supported on either efficiency or revenue potential grounds.

5. Taxation of savings

One of the areas of policy concern noted by the TWG is the current taxation treatment of different savings (that is, capital that is invested for savings purposes, including retirement savings).

Figure 21 and accompanying commentary in the submissions background paper notes the different marginal effective tax rates that can apply to different savings options.

We agree that the current differential taxation treatment is problematic, from both a fairness and efficiency perspective.

Factors for consideration

We note that there are a number of factors that need to be considered:

1. The over taxation of gains attributable to inflation, which results in compounding savings in a bank account being taxed materially higher on their real return. (We note that this effect will also be observed for any taxed savings income that compounds, but the tax disincentive is most apparent for bank accounts.)
2. The introduction of specific regimes, such as the Fair Dividend Rate for taxing offshore share investments but also the financial arrangements rules which can tax both realised and unrealised gain on certain debt investments. We note that the rationale for these regimes is often mired in complexity and history. We have suggested earlier that a general capital gains tax may allow rationalisation of these rules. However, reform is warranted in any case.
3. The Portfolio Investment Entity ("PIE") taxation regime (introduced to complement the then Labour Government's KiwiSaver work-based savings scheme) is to ensure that saving through a collective investment vehicle is not tax disadvantaged compared to direct investments.

   A number of trade-offs have been made so that the tax regime is workable for managed funds:

   - The maximum PIE tax rate was based on the prevailing superannuation fund tax rate (i.e. then 33% compared to a 39% top marginal tax rate for individuals). As superannuation fund distributions were exempt, the then 33% on fund earnings was effectively a final tax.
   - The need to make PIE tax a final entity tax liability to remove KiwiSavers from having to file tax returns for their PIE income. A consequence of this approach was to have broader income bands at which the lower PIE tax rates still applied, to prevent over-taxation (of those whose only income was from a PIE as they would not get the benefit of NZ's marginal tax rate structure). This also reflected previous policy decisions to remove most wage and salary earners from income tax return filing.
   - The non-taxation of PIE trading gains on NZ and certain Australian share investments reflected the practical reality that such gains were generally not being taxed if made by individuals holding these equities directly.
   - A more restrictive (i.e. daily) version of the Fair Dividend Rate for PIEs than for individuals investing in offshore shares directly, to make that regime work for funds.

   In KPMG's view, the PIE regime needs to be viewed in that practical context, not as the introduction of deliberate tax concessions for retirement saving.
4. The under taxation of owner occupied housing, due to non-taxation of "imputed rents". The issue of taxation of the family home is, as noted earlier, unhelpfully outside the scope of the TWG's purview as it limits consideration of potential reform options.
5. Whether New Zealand's current "Tax, Tax , Exempt" (TTE) approach for retirement savings, which is an application of the BBLR approach, is appropriate. Most other countries apply either a EET, EtT, or some other variant thereof. The submissions background paper suggests that moving to an EET model would impose significant upfront fiscal costs, particularly if current universal Government entitlements in retirement are retained.

How should savings be taxed?

In the context of how savings are taxed, KPMG believes that the BBLR objective needs to be considered against the following:

The low effective tax rate on owned occupied housing.

The current tax system contains a significant "gap" in this respect. While the taxation of the family home is understandably a difficult and emotive issue, and there are a variety of different motivations for owning one's home, there is nevertheless a current tax advantage to saving (and potentially over-investing) in this asset class.

As the response of the TWG cannot be to increase the effective marginal tax rate on owner occupied housing, this leads to the inevitable conclusion that effective tax rates on other savings types should be reduced to introduce greater fairness and consistency in the taxation treatment of savings.

Judgement:

Reducing other savings tax rates to match taxation of the family home

Pros:

- Reduces/removes a tax advantage which is likely to incentivise over-investment in housing
- Consistent with BBLR approach for taxation of savings

Cons:

- Misalignment with tax rates on labour and business income, meaning potential deviation from BBLR in a whole-of-system sense
- Potential claw back of lower rate if not investing directly or outside the PIE regime
- Fiscal cost will need to be funded from elsewhere

The significant over-taxation of savings through debt instruments

Figure 21 potentially underestimates the effective tax rate on saving through debt instruments – for example, foreign currency denominated debt – as New Zealand's financial arrangement rules will fully tax any gains (including unrealised ones, if certain thresholds are breached), while potentially limiting the availability of losses (e.g. if the debt instrument is held with a "private or domestic purpose").

This can be a single-sided "bet" for investors from holding debt instruments. Similarly, the rules can give rise to significant volatility for those holding foreign debt liabilities (e.g. foreign currency denominated mortgages).

KPMG therefore believes that the scope and application of the financial arrangements rules need to be reconsidered as part of any savings tax reform.

Whether there is a social or public good reason for encouraging retirement savings through the tax system

This appears to be the justification for many jurisdictions adopting more concessionary models for taxing retirement savings. The EET model is considered by economists to be an "expenditure tax". That is, the income from such saving is not taxed as it compounds, resulting in a higher real return to such activity.

Given the challenges and risks noted in the submissions background paper, including the projected increase in NZ Superannuation and Health costs as a share of future Governments' spending commitments, KPMG believes it would be prudent to encourage greater self-reliance for funding some of these future costs through the tax system.

We make three observations in this respect:

- The current PIE regime is not a proxy for an EET model, for the reasons noted above. At best it can be said to replicate a TtE model (with the size of the middle "t" debateable). There is no broad equivalence, in KPMG's view, to the concessionary retirement savings tax regimes in other countries. Using Australia as an example, the Australian model utilises both explicit concessions for employee contributions (these can be made at concessionary tax rates up to an annual cap) and earnings in funds (which are subject to a significantly lower rate than the top Australian marginal rate).
- The submissions background paper notes that a move to an EET model accompanied with universal NZ Superannuation payments would impose significant fiscal costs. That, however, assumes that universality of superannuation is guaranteed in future. That assumption should be made clear so that if that

is no longer the position, the continued efficiency of a TTE model can be revisited.

— One distinction that can be made between New Zealand and other countries is that overseas Government funded retirement schemes and pensions are often means tested or separately and directly funded by specific contributions. The latter can be seen in the tables which compare the make-up of the total tax take for different countries. New Zealand is one of the few countries that does not have social security contributions. Any tax "concessions" also need to be measured against how retirement incomes are funded in other countries and restrictions on accessing Government entitlements for those considered to have the means to self-fund their retirement. If Government is "saving" on behalf of only part of the population, then the role of the tax system in encouraging (or discouraging) the rest to save needs to be considered.

Conclusion on the taxation of savings

The BBLR framework is not fully effective in relation to the taxation of savings at present.

Therefore, any discussion around greater consistency in the taxation of capital needs to incorporate consideration of appropriate steps to eliminate the differential in marginal effective tax rates for different savings types. This means considering reducing the over-taxation of savings compared to the taxation of owner occupied housing.

That appears to have at least partly been a motivation for the previous Savings Working Group's recommendations to reduce taxation rates on savings through bank accounts and to apply the PIE taxation treatment more broadly.

KPMG supports the TWG taking forward the analysis of the previous Savings Working Group, as part of its process.

B. Taxation and the Māori economy

The submissions background document notes the importance of Māori participation in the general economy, as well as encouraging the growth of the Māori economy, for New Zealand's overall economic and social prosperity.

KPMG agrees that it is important that the tax rules reflect the broad characteristics of the Māori economy. However, our focus is on the Māori Authority (MA) tax regime rather than broader questions that have been asked. In that regard, we consider there are others better placed to respond.

The MA tax regime is a compliance saving measure which taxes income at source at the tax rate applying (on average) to MA beneficiaries – 17.5%. This means most MA beneficiaries do not need to file tax returns to do a square up at the end of the year.

KPMG notes that there are a much wider range of commercial structures being utilised by Māori organisations than envisaged two decades ago, when the MA tax regime was introduced. This has given rise to a number of inconsistencies in how the MA tax rules currently apply.

If the MA tax rules operate effectively, we believe it can be a significant enabler for further Māori economic development. We therefore consider that the TWG should ensure the MA tax rules are achieving the desired result in the current business and economic environment.

We have set out in our submission some recommendations to help modernise the MA tax rules.

Background

The MA tax regime was designed to specifically meet the needs of Māori organisations who qualify for MA status. The MA tax rules have particular regard to the collective nature of land and other asset ownership structures, and cultural practices unique to those organisations. It also reflects the unique relationship that exists between Māori and Crown under tax law.

The MA tax regime is an elective regime and is available only to entities that meet the criteria of a Māori Authority as set out under tax legislation. For most entities, the criteria is limited to entities that receive and manage settlement assets, is an asset holding entity under the Māori Fisheries Act 2004, or is established under Te Ture Whenua Māori Act 1993 (or owns land subject to this Act).

The most significant aspect of the MA tax regime is that entities that qualify pay tax at a flat rate of (currently) 17.5% regardless of what type of entity structure is used. This rate is lower than the current corporate tax rate of 28% and the trust rate of 33%.

The MA tax rate was set with reference to the marginal tax rate that applies on average to MA beneficiaries. It was based on evidence (including census data at the time) that the vast majority of MA beneficiaries were likely to be on the lower marginal tax rates. As tax is deducted by MAs at (on average) the right rate, this minimises the compliance requirements on MA beneficiaries from having to file tax returns and seek refunds.

KPMG has discussed the TWG process and its objectives with a number of clients that are Māori organisations. These organisations, following the receipt of settlement assets, are now looking to the future and focusing on wealth creation and asset protection. They are making commercial decisions with long-term growth in mind, and no different to any other business, need to set up appropriate commercial structures to operate from and protect their valuable assets.

Due to the current limitations of the criteria to qualify for MA status, however, not all Māori organisations and their commercial structures will qualify, resulting in a higher than 17.5% tax rate being paid – i.e. the 28% company tax rate or 33% trust rate instead.

This results in beneficiaries of these entities potentially paying an overall tax rate higher than their marginal tax rate of 17.5%, with no ability to seek a refund by filing a tax return. (That is, the difference between 28% or 33% and their marginal rate is not automatically refundable).

This results in at best a cash flow timing disadvantage or at worst (and more likely) a real cost if there is no prospect of MA beneficiaries earning other income to utilise the extra tax paid. This is unfair.

The MA tax rules need to be updated to reflect the current economic and business environment that Māori organisations operate in and the different commercial structures they may choose.

The importance of Māori organisations economic performance for New Zealand

Māori economic development is an important driver of New Zealand's economy and Māori organisations have an important part to play.

These have evolved over the years beyond the traditional land-based industries and their asset base is now diversified across a number of industries including construction, transport, and recreational services. The growth in their asset base has exceeded the general growth rate for all New Zealand businesses (e.g. in 2013 Statistics NZ concluded the growth rate in the assets of Māori organisations was around 9% compared to 0.7% for businesses generally).

This growth is expected to continue as Māori organisations focus on long-term sustainability rather than short-term gain. KPMG's report, quoted in the TWG's submissions background document, provides further background and analysis.

The current and former Governments have recognised that if Māori are to significantly contribute to the NZ economy, tax rules are needed to ensure that the Māori economy in particular, of which Māori organisations form the backbone, is able to perform to its potential.

We note the MA tax rules have been hotly debated historically. In previous debates, concern was expressed that the MA tax rules would introduce favourable tax treatment based on race and it would provide a competitive advantage. The Government at the time supported a lower tax rate on MAs income on the basis it was about reducing compliance costs and removing unfairness in the system. That objective is still relevant, as the underlying principles behind the MA tax rules still apply today.

The MA tax regime is not a charitable or concessionary regime, but rather a special tax rate regime which aims to tax at source at a rate that is reflective of the average tax rate of MA beneficiaries (currently 17.5%) thereby reducing compliance costs for MA beneficiaries from having to file tax returns. Those on a higher tax rate still pay tax by paying a top up when they file their tax return. Those on a lower than 17.5% tax rate can also file a tax return to seek refunds, but will only receive this if they have other tax paid income. The bias, if there can be said to be one, recognises that those on lower tax rates will suffer a real and unrecoverable cost if the MA rate is set too high.

The business and economic environment has progressed since 2001 when the Government last engaged in an extensive review of the tax rules for Māori organisations, resulting in the MA tax regime. Māori are now engaging in business in a broader range of industries and entering existing and exploring new export markets. Māori economic development is not just about lifting productivity but also about ensuring processes, systems and structures in place are robust and effective to run profitable businesses.

Accordingly, the MA tax rules need to be updated to reflect that they now apply to a much wider range of commercial structures than envisaged two decades ago, when that regime was first introduced.

This means that there are gaps in the MA tax rules, which need to be addressed. If the MA tax rules are operating effectively, it can be a significant enabler for Māori economic development.

We consider it is timely for the TWG, as part of its deliberations, to consider how the MA tax regime can be modernised to ensure it is achieving the desired result in the current business and economic environment.

Options to modernise the MA tax rules

We have outlined some recommendations to assist the TWG in its considerations.

Recommendation 1

Entities wholly owned by a Post Settlement Governance Entity ("PSGE") should automatically qualify for MA status in line with the PSGE.

There is a potential for the underlying MA beneficiaries to pay a higher tax rate at 28%, resulting in a cash flow timing disadvantage or in a worst case a real cost if there is no prospect of applying the extra tax paid against other income.

By way of an example to illustrate this issue:

There are 2 neighbouring business operations. One is owned by a NZ corporate, the other by a MA. The MA pays tax at 17.5%, reflecting the marginal tax rates of the vast majority of its beneficiaries, and the NZ corporate at 28%.

If the MA wanted to separate the business risk from its culturally significant assets, it can choose to set up a wholly-owned company to undertake the business operations. This company would not qualify for MA status and therefore pay tax at 28% resulting in an additional tax cost of 10.5% to beneficiaries.

The ownership structure of the MA is the same – it seems unfair that an additional tax cost should arise simply due to what structure the MA chooses to operate its business. The issue here is ensuring that MA beneficiaries, that overwhelmingly are likely to be on tax rates lower than 28%, are not over-taxed (when in many cases they will not be able to receive a refund). Those on rates higher than 17.5% will still need to file a tax return to pay any top-up.

An alternative would be to allow the multi-rate PIE rules to apply to a wholly-owned subsidiary of a MA so that its income is attributed to the MA at 0%. However, in the absence of a fuller integration regime, this would be more complex than allowing a wholly-owned company to have MA status in its own right.

Recommendation 2

Dividends received by a MA with imputation credits attached at the rate of 28% should be refundable where the MA cannot utilise the excess imputation credits against other income.

This would reduce the effective tax rate on the dividend to 17.5% in line with the MA tax rate. Otherwise, the MA could end up with an effective 28% tax rate which is inconsistent with its MA tax status resulting in a cash flow timing disadvantage. This could also address the issue under recommendation 1, if a wholly-owned subsidiary of a MA is able to pay imputed dividends, with any excess imputation credits refundable to the MA.

By way of an example to illustrate this issue:

A MA's only investment holdings are in NZ shares. It receives fully imputed dividends from those shares. If the MA receives no other taxable income, it cannot use the imputation credits beyond its tax rate of 17.5%.

This will be a real cost to the MA and its beneficiaries as the overall tax rate would be 28% rather than 17.5%. A different answer would arise if the MA invested in cash term deposits with RWT deducted as excess RWT credits are refundable by Inland Revenue reducing the tax paid to 17.5%.

We note that there is precedent for refunding excess imputation credits with the current multi-rate PIE rules. A MA should be free to determine where it chooses to invest without worrying about cash flow timing disadvantages or differing tax rates.

Recommendation 3

The ability to group tax losses by MAs should extend to MAs that are not companies. MAs that are companies can currently only group their tax losses with other MA companies.

It is not uncommon for a PSGE to be established as a trust rather than a company. This should not disadvantage the PSGE in offsetting tax losses with group entities that are MA companies. This change would reduce the cash flow timing disadvantages that can arise under the current tax law.

By way of an example to illustrate this issue:

A PSGE has tax losses and its wholly-owned company (which is also a MA) is profitable. The company pays tax at 17.5% even though the PSGE has sufficient tax losses to offset the profits. Overall, the MA beneficiaries have made no economic gain yet tax is paid on the profits of the MA company. This creates a cash flow timing disadvantage which could be a real cost if the PSGE has no prospect of using the tax losses in future.

Recommendation 4

Imputed dividends paid to a MA should have no RWT deducted.

This is to ensure the MA does not bear the compliance burden of seeking a refund of the RWT (usually 5%) and suffering a cash flow timing disadvantage.

We note that this option can currently be achieved for a company shareholder if the company paying the dividend so elects.

C. Taxation of labour

We believe the labour taxation base taxes a combination of returns to (human) capital and exertion (physical labour). It is not clear that interaction is appropriately reflected when making judgements on how different tax rates are set.

It is important.

For example, New Zealand cannot simply increase the top personal tax rate to fund revenue shortfalls or tax reductions elsewhere. This may result in those particularly that have acquired human capital (through education) deciding to leave our shores. This reflects that human capital is comparatively more mobile than other factors, as that capital is in high demand worldwide. This is especially an issue for New Zealand, given the high proportion of our population already residing overseas (estimated to be the second highest in the OECD, after Ireland).

It also covers those who provide labour services as a "business" activity (i.e. operate as self-employed contractors) and those who provide labour services to a business (i.e. as employees). This distinction is important as the present rules can result in significant differences in the relative tax treatments, due to deductibility/non-deductibility of expenses.

The self-employed versus employee distinction also has implications for the sustainability of New Zealand's personal income tax base. The increasing shares of the "gig" and "sharing" economies are likely to see a larger part of the labour force moving from the employee to self-employed/contractor classification, with implications for the tax base.

We have set our below our views on how NZ needs to respond to some of these challenges.

Options to improve compliance

The effectiveness of New Zealand's PAYE system is based on it being a reliable third party withholding system (i.e. employers take on the responsibility of calculating and withholding PAYE on behalf of their employees).

For self-employed contractors, one option is to introduce greater third party withholding by businesses that engage contractors.

The NZ tax rules already require NZ businesses to withhold tax on certain contract payments. This option would extend the covered contracts.

The alternative option is to require information reporting only and maintain the status quo, whereby contractors are required to disclose and pay tax on their income by filing a tax return.

The information reporting option is likely to more closely meet the objective outlined in the submissions background paper of maintaining high compliance with low compliance costs, in KPMG's view.

We believe access to information can be as effective in ensuring compliance as withholding.

If self-employed taxpayers know that details of their activities are being disclosed to Inland Revenue by parties they contract with, this should improve compliance.

Effective third party reporting should allow Inland Revenue to construct an accurate profile of a self-employed contractor's gross earnings and target enforcement action where there is clear non-compliance or where there is a lack of access to information (e.g. where services are provided to non-residents or in the "black economy").

We note that this reporting framework is already being developed under Inland Revenue's Business Transformation programme. (We refer to the recently enacted legislation with changes to PAYE and investment income reporting from 2019 and 2020, respectively).

The withholding option, in contrast, raises boundary issues in terms of the scope of the rules and the deductibility of expenses.

The boundary concern is that some contractors are engaged for relatively long periods of time (via fixed term contracts that are renewed), as is common in the public sector, while others will be contracted for a matter of days, weeks or months. It may not be efficient to target the latter for withholding.

In terms of expense deductibility, some contractors provide services that contain a substantial capital component (e.g. a plumber), while others will provide labour-only services (e.g. a freelance writer). This means expenses will vary depending on the contractor. Further, contractors who provide labour-only services are treated differently from employees as they can deduct any work-related expenses.

One option would be to treat contractors on an equivalent basis to employees and deny a deduction for all their expenses. However, this seems overly harsh and requires judgement as to which types of contractors are providing capital-intensive versus labour intensive services, to the extent this distinction is justified. Other options would be to allow a standard deduction or introduce a lower rate of withholding to take into account deductible expenses. We note that all of these options are inherently arbitrary.

In addition, neither withholding nor reporting will address the issue of expense inflation (the flipside of under-reporting income).

Judgement:

Reporting of, rather than withholding on, contract payments to self-employed

Pros:

- Eliminates boundary questions (and may allow more contracts to be reported)
- Eliminates need to factor deductible expenses to determine a withholding rate
- Disclosure should encourage tax compliance

Cons:

- May still encourage "outside the books" activity
- Difficult to match as income information, but not expenditure, will be provided to Inland Revenue
- Imposes some systems development costs on businesses from having to report electronically
- Lack of comfort that Inland Revenue will actually use the information provided

Information reporting would avoid some of the boundary issues noted above. However, this option will require Inland Revenue to be resourced appropriately to use the information that is reported. We assume, however, that Business Transformation should allow it to more easily cross match information received from multiple third parties, and to pre-populate returns to make it easy for taxpayers to comply.

Employment limitation for claiming expenses

More fundamentally, considering how best to tax the self-employed leads to questions about the policy validity of the current "employment limitation" for work-related expense deductibility.

Historically, this removed wage and salary earners from filing income tax returns. However, with the Business Transformation design it is highly likely that individuals will have greater interaction with Inland Revenue. (This will be electronically and may require confirmation of pre-populated information, but there will be "touch points" in the system which can be used to prompt employees for information about their deductions.) Therefore, the current operational constraints around allowing expense deductibility for employees should not be an issue in the new system.

From a purely equity perspective, it is not fair that an employee is treated differently to a self-employed contractor providing the same services.

This also has consequences for how individuals may view tax equity in a larger sense. Much of the commentary around BEPS has focussed on how foreign businesses may not be paying their fair share of tax in NZ. This is often by reference to their domestic sales, not the profits of those business.

By way of example, a New Zealand wage and salary earner may conclude that a foreign multinational with \$100m of sales in NZ should pay tax on the \$100m because they pay tax on their \$60,000 salary without deductions. To them, this would be comparing "apples" with "apples" as in both cases the tax is on gross income. This is notwithstanding that the foreign business's actual NZ profit, after deducting expenses, may only be \$10m.

KPMG recommends that the TWG use Inland Revenue's Business Transformation as an opportunity to re-focus on the rationale and desirability of the employment limitation for expense deductibility.

Judgement:

Removing the employment limitation

Pros:

- Applies BBLR to equalise self-employed and employment tax treatment
- Increases fairness
- Requires employees to be proactive in confirming their tax position (may include cash jobs in their returns which they don't consider necessary currently)
- Makes personal tax payments more transparent

Cons:

- Increases interactions with Inland Revenue which has compliance/physic costs
- The cost of filing and administration may be greater than the benefits (but technology should assist)

The "black economy"

Non-compliance by the self-employed is a significant part of the black economy. We believe greater access to information, including from third parties, should assist with reducing non-compliance.

We refer to KPMG Australia's submission to Australia's Black Economy Taskforce and the thinking contained therein (available here). Many of these ideas should be applicable and adaptable to the New Zealand context.

Interaction between the tax and transfers systems

It is important that compliance is not viewed in isolation – instead, it should be viewed in the context of the broader tax and transfers systems.

Business Transformation provides an opportunity to consider whether it is possible to integrate social policy entitlements further into the tax system to get it right the first time.

This should include consideration of whether the existing rules for the abatement of social policy entitlements work appropriately for the self-employed.

If a withholding option is chosen for contract payments, the withholding deduction could potentially take into account social policy obligations such as student loan repayments, in a similar way to PAYE.

2. Taxing what goes out

This part of our submission considers New Zealand's GST as well as environmental and corrective taxation.

A. New Zealand's GST

> *"GST is simplest when applied across the board. There's definitely a case for taxing goods harmful to health, as NZ has long done w/ tobacco"*

Former Prime Minister Helen Clark on Twitter (12 October 2017), responding to a question on taxing sugar and fast food and taking GST off fresh food.

What is the primary objective of the GST?

The primary objective of the GST when introduced was to raise tax revenue in a manner that imposed the lowest possible costs on New Zealand as a whole[1].

Thirty years on, this objective, taken in the context of the overall tax regime, should continue to inform decisions made by the TWG in relation to the future of the GST regime.

> *"New Zealand's GST is one of the simplest and most comprehensive in the world."*

KPMG strongly agrees with the above statement in the submissions background paper. We believe this is a clear strength of the current GST regime, which the TWG should aim to preserve.

We believe this approach is important to achieving, as far as practicable, the original policy objective.

While the GST regime is not without issue, generally speaking, this approach minimises:

- Technical and practical issues and uncertainty; and
- Compliance and administrative costs.

Current use of exemptions

In our experience, the issues and uncertainty that arise under the current GST regime often relate to where the boundaries lie[2].

[1] In combination with changes to the taxation of income, the introduction of GST also played a role in reducing the distortions that existed within the New Zealand tax system at that time.

[2] Boundary issues currently primarily arise in relation to financial services and residential accommodation.

If the primary objective of the GST remains to raise tax revenue in a manner that imposes the lowest possible costs on New Zealand as a whole, KPMG consider that the current exemptions should not be expanded.

However, we do discuss the possibility of relaxing or removing current exemptions and options for reducing the associated costs.

Use of zero-rating to drive non-tax policy outcomes

The current exemptions generally deal with technical and practical issues in applying the GST to particular goods or services.

The submissions background document asks whether targeted GST exemptions, such as removing GST on (healthy) food, could also be used to:

- Make goods and services beneficial to the wellbeing of society more affordable, particularly for lower-income households; and
- In doing so, incentivise behaviour that is desirable.

We assume that the policy question being asked is whether to zero-rate these items, rather than exempt them, from a GST terminology perspective. Otherwise, these items would be "input taxed" (in the Australian terminology) meaning businesses would not be able to claim input deductions for their costs. As well as boundary issues, exempting these items would generate cascading problems (i.e. irrecoverable GST would be built into the cost rather than being charged on the value add) as well as apportionment issues for relevant businesses. Zero-rating, would still have boundary issues but the other problems are less likely to arise.

From a public policy perspective, KPMG supports the objective of increasing the affordability of goods and services that are beneficial to the wellbeing of New Zealand society. However, in our view, removing GST on these items may not be the most efficient or effective way to achieve that objective.

Removing GST on "healthy" food as a case study

A common public policy objective is to encourage greater consumption of healthy foods (or at least healthier alternatives). Its corollary would be to discourage consumption of foods that are considered unhealthy (note: a "sugar tax" is discussed separately). This has its basis public health policy.

The question is whether the tax system, specifically the GST, is an appropriate mechanism to help deliver this public health objective.

The first question this raises is what items should be within scope of any GST exemption? This goes to the wider public policy objective being sought. It is also where other countries have struggled with boundaries.

For example, Australia does not apply GST to fresh food, but does apply GST to cooked food (including restaurant and fast food). This means a store bought sandwich is subject to GST but the raw ingredients are not, if purchased at a supermarket. The consequence of this distinction is also that the ATO has had to publish detailed lists of what foods qualify for GST-free status and not. The UK's Value Added Tax has similar issues.

Closer to home, the Labour Party's previous tax policies have included zero-rating the GST on "fresh fruit and vegetables". That raises the question: what if those items are included in ready-made meals? Should those also receive the same GST treatment? And whose judgement should be relied up as to which foods are deserving of GST zero-rating rating – e.g. is it just fruit and vegetables; should it include staples, meats, dairy, etc?

In KPMG's view, notwithstanding being driven by the best of intentions, designing carve-outs of this type can be fraught as they require judgements that not everyone will necessarily agree with. This makes sustainability a potential issue

Secondly, we consider that further work should be done to confirm that the benefit of removing GST would be passed on to consumers. If it is not, the policy objective will not be met.

Globally, we understand that a variety of "anti-profiteering" and price monitoring and control measures have been used. Questions regarding the cost of food generally in New Zealand suggest that such measures may be impractical or difficult to implement.

In our view, there is a real risk that the benefit from removing GST cannot be measured, to ensure it is passed on. There is a further risk that even if initially passed on, it could be lost over time as prices change. Measures to ensure the benefit is passed on and remains with consumers would have a regulatory or compliance cost.

We understand that a focus may be to make healthy food, for example, more affordable for lower-income households, particularly given concerns regarding the regressive nature of GST. Again, while KPMG supports the broader policy intent, we doubt the GST system is the best means to deliver that.

Anecdotal evidence suggests that removing GST may not benefit lower-income households, based on their consumption patterns. The benefit may go to higher income households instead. That needs to be tested.

Judgement:

GST zero-rating healthy food to encourage consumption by low-income households

Pros:

- May reduce the cost of healthy food

Cons:

- Boundary issues are likely to be difficult for consumers and businesses – e.g. what is "healthy" and who decides?
- Will apply to all consumption of healthy food so not targeted to low-income households
- The revenue lost from availability of zero-rating to higher income households will need to be collected from other taxes

Wider empirical support in relation to consumer behaviours should be sought to ensure the removal of GST actually benefits lower-income households.

Given the question of whether the benefit from removing the GST would be passed on to lower income households, we consider that more targeted non-tax measures may be more effective.

Whether a rebate or grant scheme could be used to more effectively target assistance to lower-income households could be considered, although we appreciate that such schemes generally come with increased compliance and regulatory costs.

Extension of exemptions to other goods and services

We are aware that other countries provide exemptions beyond food. For example, Australian "GST-free[3]" goods and services include some education, medical and childcare services. We acknowledge that it may be easier to quantify the benefit, and verify that the benefit is in fact passed on, for these types of supplies compared to food. (In part because provision of these items are likely to be more tightly regulated than general supplies of food items, meaning greater scrutiny already.)

Our question here is one of scope and balancing public policy benefits against the complexity that will arise from narrowing the GST base.

A single exclusion may not significantly increase compliance and administration costs. However, there is a risk of "scope creep" which could call into question the integrity and coherence of New Zealand's GST.

If an objective of the GST regime is to address wider public policy outcomes (e.g. in health, education or other areas) or incentivise certain behaviours in the future, it is important that the TWG clearly outlines the scope of the exemptions and its reasoning. Failure to do so risks damaging the current simple and comprehensive GST regime, through scope creep, and creating distortions and inefficiencies.

[3] Zero-rated in New Zealand terminology

If GST exemptions are used to achieve wider public policy objectives or to incentivise behaviour, the TWG must clearly articulate the benefits against the additional complexity and risk to the GST base when outlining what exemptions should be made.

Effect of exemptions on compliance and administration costs

The above comments focus on the effectiveness of removing GST in achieving wider public policy objectives. Our experience in respect of current exemptions, and anecdotal feedback from our colleagues in other jurisdictions, leads us to believe that adding new exemptions will also create uncertainty and increase compliance and administrative costs. The further New Zealand moves away from the current relatively comprehensive GST regime, the more likely it is for errors to arise.

A simple example that is often used to illustrate the uncertainty that can arise in the context of GST on food is the UK VAT treatment of a Jaffa Cake[4]. Is it a cake or biscuit?[5] Such questions illustrate the need for certainty in relation to any exemptions or narrowing of the GST base to minimise uncertainty and costs.

The TWG needs to consider the effect of additional uncertainty and compliance and administration costs when assessing the benefit of removing GST relative to other options.

Changing the objectives of the GST regime

If the TWG decides that the future objectives of the GST regime are to influence consumption decisions, this change in objective should be explicit. The increased costs borne by registered persons should be acknowledged as a consequence of that decision.

Equity and fairness of the GST

KPMG acknowledges the potentially regressive nature of the GST.

The perceived regressivity from the introduction of GST in 1986 and subsequent rate increases in 1989 and 2010 were offset by income tax rate cuts and the provision of transfers to lower-income households.

We consider this is, in principle, the most effective means of addressing the regressive effect of the GST.

However, the "compensation" should be reviewed periodically to ensure it remains appropriate and sufficient to address the effects, rather than just considered at the time of any change.

We acknowledge that this may be adjusted through welfare system benefit changes that are made from time to time. However, it is not apparent that the effect of any tax mix change is explicitly factored into such decisions.

Changes to the GST rate

Increasing the GST rate

Increasing the GST rate is outside of the TWG's terms of reference. We believe this should have been included in the scope of the TWG's review as it is material to the discussion on the overall tax revenue mix for New Zealand, particularly given some of the risks and challenges identified in the submissions background paper, which may impact the sustainability of the company and personal income tax bases.

Lowering the GST rate

This should similarly be part of the discussion on the appropriate tax revenue mix for New Zealand

KPMG believes the current GST rate should be maintained at 15% given the efficiency and relatively low compliance and administrative costs of the GST regime compared to other taxes.

These factors were considered by the 2010 Tax Review as a rationale for its recommendation to increase the GST rate, in addition to the fact that New Zealand has a low GST rate by international standards (at 12.5% prior to and

[4] https://www.gov.uk/hmrc-internal-manuals/vat-food/vfood6260

[5] It was ruled to be a biscuit partly covered in chocolate and accordingly standard-rated.

15% post the 2010 rate change). Therefore, to the extent that revenue is raised from other, new taxes, we would support lowering the corporate and/or personal income tax rates rather than the GST rate. Alternatively, new revenue bases may provide scope for the GST exemptions discussed above.

Lowering the GST rate would benefit all consumers. In principle, and subject to any further work being done by the TWG, any regressive effects of the GST for lower-income households would remain. That alone would not appear to justify a lowering of the GST rate. In addition, a significant part of the benefit would be passed-on to non-residents visiting New Zealand. Whether this would have a positive, or any, effect on the tourism industry and New Zealand's overall GDP would need to be considered. To the extent there is a reduction in overall Government revenue that would need to be made up elsewhere (i.e. by New Zealand residents in other taxes that they pay).

In light of the above comments, we consider that further work would need to be done by the TWG to establish the rationale for lowering the GST rate as part of any rebalancing of the overall tax revenue mix.

Destination principle

We consider that the design of the GST regime, which is based on the "destination principle"[6], remains appropriate. This is consistent with OECD principles, which should serve to minimise the potential for double taxation. In addition, this reflects the generally accepted view that the alternative, being the application of GST based on the "origin" of the goods or services, has valuation and fairness issues.

Revenue authorities worldwide continue to look for new ways of increasing tax revenue. Looking forward, we consider that Government and Officials should remain alert to any proposed changes to the destination principle.

In particular, a GST regime based on the residency of the consumer would have a significant risk of eroding the New Zealand tax base in respect of tourism[7] and the export of goods and services.

Expanding the current GST base

1. GST on imported goods and (remote) services

KPMG supports the policy of applying GST to goods and services consumed in New Zealand. The proviso is that this should be done as efficiently and at the least cost as possible.

In this regard, we support a practical approach rather than looking to capture every last dollar of revenue.

2. Financial services

We have considered whether there is a basis for relaxing or removing the current financial services exemption, particularly given changes in technology since the GST regime was originally introduced. However, despite technological changes, we consider the fundamental difficultly in identifying and measuring the value added to many financial supplies on a transaction-by-transaction basis remains.

Alternatives could be considered if there is a need to expand the GST base. For example, in the case of money lent, the net interest could be used as a proxy for the services supplied. This has some attractiveness in terms of simplifying the current regime, as often a significant amount of time is spent on GST apportionment by lenders. However, the issue of what is paid for the service and for the time value of money remains.

On balance we believe it is preferable to maintain the current exemptions. This broadly aligns with international practice.

The effect of the financial services exemption does, however, have material effects. This creates a bias for

[6] That is, based on the jurisdiction where the goods and services are consumed

[7] Tourists generated $2.8 billion in GST revenue during the year ended 31 March 2016: www.tourismnewzealand.com/about/about-the-industry/

"insourcing" rather than "outsourcing" services to reduce the GST cost for investors. In addition, Inland Revenue's recent draft view on the GST treatment of investment management services provided to unit trusts has caused concerns in the funds management industry and has the potential to adversely affect savings[8]. We understand the latter issue is being considered by Inland Revenue. In our view, any cascading of GST as a result of exemptions should be addressed as a matter of urgency.

The insource bias could be mitigated through a Reduced Input Tax Credit (RITC) scheme, similar to that adopted in Australia. Under the scheme, the financial service supplier would be entitled to recover a percentage of the input tax on costs incurred. Typically, the rate is set so as to give the supplier an input tax credit estimated to be equal to the GST on the value added by the outsourced supplier.

From a longer term perspective, consideration should be given to whether zero-rating financial services is a more appropriate policy.

Briefly, work done in the early 2000s suggested that applying GST to financial services was the equivalent of taxing money flows rather than consumption. The appropriate response is therefore to zero-rate financial services. We acknowledge that there are fiscal consequences of such a significant change. However, if the TWG's analysis confirms this approach that is the right policy position to advance.

3. Residential accommodation

KPMG agrees with the comments in the submissions background paper that applying GST to rent creates practical and fairness issues.

In particular:

- Increased rental costs, including for the Government from increased accommodation supplements.
- The question of how rental properties would be brought into the GST net[9].
- The increased number of taxpayers required to file GST returns as a result.

Having said that, in theory, the cost of GST cascades into rent for the property cost and for property expenses.

Further, no GST is collected when a residential property is sold for private ownership (compared to a new build acquired from a developer). Therefore, applying GST to residential rents would have the effect of making the GST more explicit.

Judgement:

Removing the residential accommodation GST exemption

Pros:

- Treats residential rental equally with other activities
- Prevents the cascading of GST through the supply chain
- Removes the insource bias for services provided for residential property

Cons:

- The fiscal cost of input tax on residential property is likely to require a special rule
- The GST is likely to be passed on, to the full extent possible, to tenants raising rental costs

However, further thought would be required on the technical aspects of this.

[8] The specific issues relate to the boundary of what is the arranging of a financial service.

[9] A key issue would be dealing with the second-hand input tax credit under existing rules. In principle, this could be dealt with by deferring GST until sale of the residential rental property.

Similar to financial services, the current exemption also creates an insource bias. This is particularly relevant to social housing providers, who are encouraged to in source irrespective of the best outcomes for social housing tenants.

As the Government considers how best to provide services to social housing tenants, it should consider whether a scheme, similar to the RITC, could help deliver better outcomes.

Effect of future technology on GST administration and compliance

The broader question of technology and its impact on the GST system should also be considered by the TWG.

By way of example, in Brazil most companies are now required to issue invoices electronically and these invoices are subject to real-time approval by the Brazilian tax office. We are not suggesting a similar regime be adopted in New Zealand, as the issues driving the Brazilian regime (including significant non-compliance) differ from New Zealand. However, this demonstrates how technology can be used to change practices, particularly for transactional taxes, given the significant volumes.

The application of the Blockchain in the sphere of indirect tax is also becoming a much discussed topic. Whether the use of distributed ledgers can eliminate the need for tax invoices, a key aspect of the current regime, has been raised by some commentators.

The potential application of future technologies is beyond the scope of this submission. However, we believe Government and Officials should have a focus on future technologies and how they can continue to increase efficiency and integrity of information and reduce compliance and administration costs.

B. Corrective and hypothecated taxes

We consider below the case for corrective taxation regimes. The submissions background paper notes environmental taxation is an area where New Zealand lags behind other OECD countries (in terms of revenue collected as a percentage of GDP). The document also validly notes that the design and targeting of such taxes is critical.

Earlier in our submission (and in relation to the use of the GST system) we outlined concerns with using existing tax bases in a way which conflicts with standard tax policy objectives, namely raising revenue efficiently and fairly (and at least cost to Government and taxpayers). We note that these objectives are not generally relevant in the case of tax policies whose principal objective is to change behaviour.

Our concern is ensuring that, at the outset, it is clear what the objectives of a particular tax are.

What is the purpose of the proposed tax?

There are a number of existing excise taxes on tobacco, cigarettes, alcohol, and gaming, which qualify as "corrective taxes".

When considering any tax, it should be clear what its principal purpose is. Is the purpose of the tax to change behaviour, or to collect revenue to cover the costs of negative or harmful behaviours (i.e. a form of user pays), or to collect revenue for the "consolidated fund" (i.e. to finance general Government spending)?

The issue is that, in practice, these objectives tend to overlap.

If the tax is intended to influence/correct behaviour, to be successful the tax should raise little or no revenue. However, this creates an issue for Governments as such a tax cannot be relied upon to contribute to the consolidated fund.

The assumption must be that the tax will not be wholly successful in correcting the behaviour – there will still be those who undertake it. This means there must be sufficient revenue to cover the costs of remediating the behaviour. Accordingly, ensuring that the tax does not inappropriately transfer the costs of remediating from an individual or business's balance sheet to society as a whole is a related objective.

For example, if set up as a cost recovery tax, if the actual costs are greater than the amount raised, the Government is likely to have to fund that difference rather than the taxpayer or business responsible.

The success of behavioural taxation depends on the sensitivity of the particular activity/consumption to the tax that is levied. In economists' terms, if demand of the activity/consumption is "elastic", the tax will have most effect. If not, then a higher rate of taxation will be necessary to effect the desired behavioural change.

Demand for alcohol, cigarettes and tobacco (and to a lesser extent fuel) are generally considered to be "inelastic" goods. Accordingly, high rates of excise duty are likely to be necessary to change behaviour away from consuming these goods. This is illustrated, we believe, by the duty revenue currently collected from these items, which is not insubstantial, and ever increasing duty rates on cigarettes and tobacco in particular. This underscores a potential conflict for Government, the need (or certainly the desire) for the revenue balanced with the behavioural change objective of the tax.

This is compounded by the fact that excise duties, in KPMG's view, could well end up hurting the very groups they are intended to help.

There is evidence that excise duties on alcohol and cigarettes and tobacco tend to be regressive, as they will comprise a larger part of overall spending for those on lower incomes, compared to higher income consumers.

Therefore, assuming demand is relatively inelastic, the impact of higher excise duties may well be to substitute spending away from other household spending, to continued consumption of those items the Government would like to discourage.

To circle back to our first point, if excise duties were effective in changing behaviour, this should be reflected in the tax revenues collected being negligible.

This is not to say that excise duties are ineffective. The question is whether other regulatory approaches are more so.

High rates of duty may also lead to increased crime and 'black markets' in these goods, which have wider social implications.

The TWG should outline the clear purpose for corrective taxation and test whether corrective taxes meet the stated public policy objective.

Sugar tax

As with all corrective taxes, the introduction of such a tax should be evidence-based.

Consideration should be given to the social costs (e.g. greater obesity related illnesses and need for additional healthcare spending as a result) created by the consumption of sugar and the evidence of whether the introduction of a tax will mitigate this. We have not had time to review the evidence available from other jurisdictions that have introduced a sugar tax in some form.

We agree in principle that it is fair for taxes to be targeted to ensure that consumers bear the costs of their decisions (i.e. to mitigate "moral hazard").

However, we caution against singling out specific goods for corrective taxation.

While not public health professionals, we note that there will be other food types that can be said to also contribute to obesity, illness and related health issues. Why should those not face similar treatment?

In addition, any potential corrective tax solution should be weighed against the alternatives, e.g. targeted public education programmes and non-tax regulatory measures.

Judgement:

No sugar tax

Pros:

- Sends a price signal of the social cost of sugar consumption

Cons:

- Potential impact is not clear
- Likely to be regressive
- Difficult to estimate the actual cost of the behaviour so that the right tax rate can be set

Environmental taxes

The submissions background paper notes that New Zealand faces environmental challenges such as climate change and the loss of ecosystem services and native species.

We agree that these issues are important given the centrality of natural resources and the environment to our economy (through agriculture and tourism) and to the lives and wellbeing of all New Zealanders.

It is important that consumers and producers face the costs of emissions and other negative externalities on New Zealand's natural environment created by their consumption/production activity. Taxes may have a role to play in ensuring true costs are met but, again, the question is whether taxes are the best way to do this.

We note that on entry into force of the Kyoto Protocol, consideration was given to how New Zealand could best achieve its international obligations to reduce greenhouse gas emissions. A carbon tax was one option considered, but was ultimately rejected in favour of an emissions trading scheme. Again, this reflects judgements about different mechanisms that can be used to achieve the desired public policy objective.

We view environmental taxes as a subset of corrective taxes. Accordingly, the introduction of any new *environmental taxes needs to evidence-based and carefully tested against the alternatives*.

This include non-tax regulatory measures (including the success of existing measures such as the ETS in reducing New Zealand's emissions) and greater public education.

We note that the current Government is establishing a Climate Change Commission. *Any solutions that the TWG proposes should be mindful of other measures that might be considered.*

Hypothecated taxes

New Zealand uses a range of "hypothecated taxes" e.g. ACC and EQC levies and road user charges. The proposed Auckland Regional Fuel Tax is also a form of hypothecated tax. Its purpose will be to fund specific infrastructure initiatives in the Auckland region.

While there is some crossover with corrective taxes, we view hypothecated taxes as more akin to a user pays system (i.e. the tax is not trying to discourage a particular activity or type of consumption).

One of the benefits of hypothecated taxes is the direct relationship between the tax and the use of the revenue collected. This makes it easier for those being charged to judge whether the tax is justified.

One area we consider is worth exploring further is hypothecation in the taxation of retirement savings. That is, using taxes paid by KiwiSaver and other retirement schemes to specifically fund NZ Superannuation.

3. Taxing what you own

We have covered these taxes in earlier parts of our submission.

Some potential taxes on what is owned are covered earlier (for example, land tax was covered under part 1 due to its linkages with the housing affordability question in the submissions background paper).

A wealth tax is another example. For reasons similar to our analysis of a land tax and the difficulties with a capital gains tax, we consider that a wealth tax is a low priority tax to be considered.

It is also worth considering some of the quirkier wealth taxes that have historically been applied.

For example, a tax based on the numbers windows in the 17^{th}, 18^{th} and 19^{th} century in England. (As large mansions would have greater number of windows, the window tax was approximating the homeowner's wealth rather than their income).

One of the consequences of its introduction was windows being shuttered or bricked up to avoid the tax! This highlights the potential folly of some wealth taxes.

4. Other matters

There are many other matters which warrant consideration. A few of these follow.

The Generic Tax Policy Process

New Zealand applies the Generic Tax Policy Process (GTPP). Designed as a means of reducing the political cost of tax policy changes being made without bringing along voters or considering the practical implications and consequences of tax changes, the GTPP has been very successful, in our view, in improving both the quality and acceptability of tax policy changes. Within the context of BBLR, it has also assisted in reducing lobbying for and grating of exemptions and concessions which are a feature of many other countries.

GTPP works because of the commitment of Government, through ministers of varying political persuasions, to trust that the process results in a better tax system. The TWG should confirm that the system works to achieve that objective so that a high hurdle is set for future Governments to depart from the process.

However, we consider that its application is not perfect. We acknowledge that consultation does not require acceptance. It does however require that submitters agree that they have been listened to.

A recent example, which might be a relevant case study for the TWG, is the consultation on New Zealand's implementation of the OECD's multilateral instrument to amend double tax agreements (the MLI).

The MLI was recently the subject of Finance and Expenditure Select Committee consideration. Detailed comments and submissions were made on New Zealand's position, including by KPMG. This included criticisms of the National Interest Analysis prepared by Officials to support its adoption.

The Select Committee's report supporting the adoption of the MLI was surprisingly short, give the time and effort put in by submitters. In our view, it did not demonstrate that the submissions had been heard. (We are mindful, as our submission conceded, it was unlikely that New Zealand would not proceed to adopting the MLI. However, in our view, there were important points made that should have been addressed.)

Such instances (assuming that perception is reality) will tend to reduce the trust of submitters in the system.

The TWG should consider ways in which the GTPP can be improved to maintain its credibility.

Better view of the law – certainty

Inland Revenue is protected by the law from failure to follow process. An assessment is deemed correct except when challenged through the disputes process. This means that a taxpayer can only dispute the technical merits of the assessment but can be prevented from disputing a position with the Commissioner due to procedural failures.

Further the Commissioner, in our view, increasingly takes very narrow views of the law. Often these are not consistent with the expected policy outcome. (The Commissioner's view of the tax effect of debt capitalisation, requiring a law change to confirm the policy intent, is an example.)

Taxpayers are left, often on their own to dispute idiosyncratic views of the law or are required to seek amendments to take them back to the position it was always assumed to be (again, the debt capitalisation issue is a good example).

In our view, there is a good case to level the playing field by:

- *Removing the Commissioner's backstop against procedural failures on her part; and*

- *Limiting her ability to take positions contrary to the avowed policy positions communicated to Parliament (through Bill Commentary and Officials' Reports) and to the public (through Special Reports and Tax Information Bulletins).*

  We acknowledge that this will put pressure on Government and Officials to be clear about what is intended (and why) and to achieve it through the legislation. However, that is how it should be.

Fiscal costings

The fiscal cost or benefit of a particular tax policy change is important to the tax policy development process. However:

- There is limited consensus on this. Particularly whether the flow on benefits of a change should be captured in the fiscal costings. The TWG could usefully review and publish the position on the accepted method of preparing a costing.

- The fiscal costings assume the revenue currently collected is consistent with the law prior to the change being proposed. This is not the practical result where the tax policy is remedial.

Again using the debt capitalisation tax issue as an example, the fiscal costing for the amendment would have assumed that tax was being collected from debt capitalisations. The change to the law therefore had to factor an estimate of the fiscal cost of the law change. That is patently absurd. No such tax was being collected as it was never intended that it would. The budget forecasts, prepared on the basis of existing tax collections, would not therefore include any such future tax.

In our view, this fiscal costing methodology inhibits necessary improvements to the law to correct technical outcomes inconsistent with good tax policy. It calculates a non-existent cost which imposes a constraint on amending the legislation.

We acknowledge that fiscal costings are a good discipline to ensure that appropriate tax policy is the result.

However, we consider that this particular approach to costings should be changed. It should be possible to define the circumstances where it is reasonable to assume a nil fiscal cost of a remedial policy. The TWG should recommend accordingly.

Compulsory tax returns and involvement of citizens in the tax system

The current tax administration system tries to exclude as many individuals as possible from filing income tax returns. This has the advantage of reducing administrative and compliance costs, including the stress and strain ("physic costs") for individuals from dealing with Inland Revenue.

This is consistent with the view that the majority want nothing to do with Inland Revenue. The disadvantage is that it is not obvious what income tax is or is not being paid. Further, it is not obvious that tax should be paid it is due.

Technology and Inland Revenue's Business Transformation changes should lower the administrative costs of requiring income tax returns.

It should also allow the decision to deny expenditure against employment income to be revisited, as discussed earlier in our submission (as there will be some additional tax system touch points required).

The removal of the employee deductions and the standard deduction was originally justified by lowering of tax rates and subsequently supported by the need to exclude wage and salary earners from filing income tax returns. Both decisions are now many years old.

The trade-offs are no longer obvious and as a result KPMG does not believe that the current position of denying deductions for expenses incurred in producing taxable employment income is appropriate given the flexibility allowed under Business Transformation.

Contact us
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