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FEEDBACK

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By email:	secretariat@taxworkinggroup.govt.nz
Feedback on:	**Future of Tax Interim Report**
From:	**Federated Farmers of New Zealand**
Date:	10 October 2018

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FEEDBACK TO THE TAX WORKING GROUP ON THE FUTURE OF TAX INTERIM REPORT

1. INTRODUCTION

1.1 Federated Farmers welcomes the opportunity to provide feedback to the Tax Working Group (TWG) on its *Future of Tax* interim report.

1.2 Federated Farmers congratulates the working group on producing a very thoughtful and well-written document. The interim report sets out very clearly a number of key challenges to the tax system and discusses options in an objective, even-handed manner.

1.3 We support a number of the interim report's recommendations, such as not to proceed with a wealth tax, land tax, exemptions from GST, change to the income tax and imputation structure, and a financial transactions tax. We are pleased that the Government has (in its 20 September 2018 letter) agreed that the TWG should not carry out any further work on those issues.

1.4 Federated Farmers acknowledges the interim report's discussion on extending the taxation of capital income (chapter 6) and changes to the tax system to support better environmental and ecological outcomes (chapter 9). Our feedback will focus mainly on those two issues although we will also provide some brief comment on the recommendations for business taxation (chapter 14).

1.5 In particular (and this is not a comprehensive list of the suggestions in this document), we ask that further attention be given to:

- Roll-over relief for capital gains tax (CGT);
- Double taxation of capital gains, in particular where land is the major component of the company's asset;
- Compliance cost implications of a CGT; and
- A wider, whole-of-government view of a framework for environmental questions.

1.6 Federated Farmers would welcome the opportunity to have further engagement with the TWG.

2. EXTENDING THE TAXATION OF CAPITAL INCOME

2.1 Chapter 6 of the interim report discusses capital and wealth. For the reasons set out in our submission to the background paper, Federated Farmers agrees with the TWG's decision not to recommend either a land tax or a wealth tax. We welcome the Government's direction to the TWG not to carry out any further work on those issues.

2.2 With regard to extending the taxation of capital income, two options have been put:

1. Extending the tax net – realised gains; and
2. Risk-free rate of return method.

2.3 We will discuss both options in turn, but before doing so we would like to remind the Group of the key points on capital gains tax from our earlier submission:

(a) Federated Farmers supports the current taxation regime that provides the ability to tax the earnings of individuals and firms that are in the business of

trading property but we are opposed to a 'comprehensive' capital gains tax (CGT). Our opposition is both philosophical and pragmatic. There are considerable challenges in making a capital gains tax workable. These include:

- *How to deal with double taxation or double losses (caused by capital gains and losses in the company being reflected in the share price, which is also subject to CGT)* [this is particularly acute for farming companies, which are typically tightly held, and where land is a major component of farming companies' assets (the other major asset is typically livestock – expanded on below)]*;*
- *How to deal with livestock Herd Scheme gains and losses which are currently regarded as being on capital account* [expanded on below]*;*
- *How to index gains so the inflation component is not taxed (the same issues currently exist with income tax on revenue account property and monies on deposit for interest)* [we understand that this might not be progressed]*; and*
- *How to deal with roll-over relief for intra-family and intra-group company transactions and for transactions involving Maori land and its owners.*

(b) The 'KISS' (keep it simple ….) principle should apply. If there is a particular problem about 'speculation', then perhaps the bright-line test might be a better solution.

(c) Without prejudice, we submit that no commitment to a CGT should be made until it has been established that the practical concerns can be addressed in a manner that is appropriate in the New Zealand context. This includes the need to keep compliance costs low.

2.4 These points have to a varying degree been touched upon in the interim report but are by no means resolved. Federated Farmers remains opposed to extending the taxation of capital income and we do not consider the interim report provides convincing reasons to alter our view. As it works towards its final report the TWG has much to do to resolve the points we have raised and raise below.

Extending the tax net – realised gains

<u>What to Tax</u>

2.5 Notwithstanding our opposition to extending the taxation of capital income, Federated Farmers agrees that 'what to tax' should be targeted in order to minimise the increase in the tax system's complexity and in the costs of compliance and administration. That said, we remain concerned that *any* extension will increase complexity. The greater the extension beyond current boundaries the more complexity and cost there will be both for taxpayers and Inland Revenue.

2.6 We note that Appendix B, which outlines more detailed design features, defines the 'family home exclusion'. We note that on most farms there will be a 'family home' for the owner. The Interim Report suggests an exclusion applying to the land the house sits on, up to the greater of 4,500 m^2 or the amount required for the reasonable occupation and enjoyment of the house (i.e., house and curtilage). This threshold will probably be appropriate in most cases but working out the area and value of a farm's 'family home' will increase complexity and compliance costs. We note the observation that some family homes will be owned by companies. This is particularly the case in the farming sector.

When to Tax

2.7 In terms of 'when to tax', Federated Farmers would be strongly opposed to an accrual-based tax where tax is payable at the end of a period even if the asset is not disposed of during that period. We agree with the discussion on valuation challenges, cash-flow pressures, and perceptions of unfairness raised in the interim report. These issues would be particularly acute for farming.

2.8 A realisation-based tax would be a better approach but as mentioned in the interim report, this runs the risk of encouraging 'lock-in' to postpone or avoid the tax liability on sale. Notwithstanding this, we agree that rollover relief would be necessary. As mentioned in our earlier submission, in the farming context rollover relief should be allowed for a 'similar asset swap' (for example selling a stepping stone farm and buying another farm to 'trade up') and for inter-generational farm sales (to assist with family farm succession). These forms of rollover relief would address two of our practical concerns with a capital gains tax.

2.9 A third concern is the double taxation that could occur when both the shares in a company and assets of the company are subject to CGT. This will be particularly stark for companies where land is the major component of the companies' asset, which would include farming companies. A simple solution might be to exempt shares in such companies from a CGT, and rely on taxing the underlying assets. Alternatively, where there is a 100% change of shareholding the asset base in the company should be reset. Under this alternative the problem is where share parcels of less than 100% are sold.

Livestock

2.10 We note the comments in the interim report about the rules for taxing livestock and how extending the taxation of capital income would apply to livestock taxed under the herd scheme. We agree that this needs very careful consideration. Some background and history on livestock taxation follows.

2.11 Livestock tax has always been a complex and fraught issue. Livestock is not like a shop's trading stock which is valued at a fixed point of time and where changes in value over the year are taxable. While taking such an approach for livestock might on the face of it seem simple, doing so would neglect the biological nature of the business where animals have the qualities of both a capital 'machine' and the product of a machine.

2.12 Major economic reforms, including to tax, were undertaken in the mid-1980s, and livestock tax was no exception. In December 1985 the Government announced major changes which came into effect following the passage of a 1986 Tax Bill. These changes involved the introduction of a 'herd scheme' and a modified standard value system called the 'trading stock scheme'. This has since been changed to a cost-based regime called 'national standard cost. Livestock valued under the national standard cost regime are treated as ordinary trading stock. Accordingly, they are not further discussed.

2.13 For livestock in the herd scheme, changes in national average market value (herd scheme values) from year to year are treated as being on capital account and are not subject to tax. In a company net herd scheme gains are treated exactly the same as other capital profits/losses. The introduction of a general CGT on business assets changes this herd scheme capital profits dynamic.

2.14 Federated Farmers would like to be involved in addressing this issue.

How to Tax

2.15 In terms of 'how to tax', in order to 'keep it simple', capital gains taxation should be calculated and collected in the same way as currently applies for disposals of revenue account property, with costs able to be deducted at the time of sale to arrive at a net capital gain.

Compliance costs

2.16 Appendix B also discusses other design issues such as how to treat capital expenditure, capital losses, transitional rules, as well as issues around taxation of:

- Shares in foreign companies;
- Non-residents;
- Partnerships and look-through companies;
- Companies;
- New Zealand shareholders in New Zealand tax resident companies;
- Trusts;
- KiwiSaver and other managed investment entities; and
- Corporate groups.

2.17 The extensive discussion of these issues only serves to reinforce how complex it would be to extend the taxation of capital income. The question it poses is would the added complexity and administration and compliance costs be worth the extra revenue? Although Table 6.2 on page 41 suggests that annual revenue will rise over time to around $6 billion in 2030/31, the projections are (as stated in the commentary), heavily design and detail dependent. For example, they do not take into account rollover relief which is likely to be essential to its workability let alone acceptability.

2.18 Further, the compliance costs of the planned introduction, which requires all assets to be valued at the date of the introduction, is compliance cost intensive, and will lead to valuation debates. For land and improvements rateable values cannot be relied upon and these valuations are always subjective. The alternative to this compliance cost intensive and uncertain process is to apply a CGT to assets acquired after the introduction date at values of acquisition from third parties. This would ensure that the CGT cost base is correct and would significantly decrease the compliance costs of the introduction of a CGT.

Risk-free rate of return method

2.19 Under the risk-free rate of return method, the taxable income would be calculated by applying a deemed 'risk-free rate' to the equity held by the owner in the asset (i.e., the value of the asset net of any borrowings) with the result then taxed against the taxpayer's marginal rate. The tax would be paid every year as opposed to when the asset is sold.

2.20 As discussed above Federated Farmers would be strongly opposed to what would effectively be a 'capital tax'. We agree with the difficulties outlined in the Interim Report. There are would be challenges (and costs) for farmers having to make annual asset valuations and for many farmers there would be serious cash flow difficulties, especially in years of low farmgate prices and/or adverse weather events, such as droughts, that impact on production.

3. ENVIRONMENTAL AND ECOLOGICAL OUTCOMES

3.1 Federated Farmers agrees that New Zealanders' wellbeing is inextricably linked to the wellbeing of our natural environment. With close to half of New Zealand's land area in agriculture farmers are important stewards of our land and water resources. From a business perspective it is in farmers' interest to manage these resources in a sustainable manner and it is also important to recognise that most farmers have strong social and cultural links to their land and care deeply for it.

3.2 A large and growing number of farmers have been taking action to address their environmental impacts and this has been driven by market demands and by stronger government policy and regulation in response to public perceptions. Progress is being made, as discussed in our earlier submission. Farmers, like all New Zealanders are realising that many of the practices of the past are no longer acceptable.

3.3 In saying this Federated Farmers is not downplaying the need for ongoing actions to improve environmental and ecological outcomes. As we said in our earlier submission we consider it inappropriate to consider tax in isolation as 'the solution' to environmental issues. Like the environment itself, consideration of how to care for the environment is complex and has a number of layers to it. Further, a number of environmental aspects, including those discussed in the background paper and elaborated on in the interim report, are being dealt with by other policy and regulation.

3.4 Federated Farmers is pleased the interim report's discussion recognises these points. We agree with its comment on page 61 that 'taxation is not necessarily be the best tool to change behaviour' and that 'sometimes it may be more effective for the Government to consider regulation or spending'. We endorse the approach that 'the merits of tax as a policy instrument should be assessed together with the merits of other tools and approaches'.

3.5 Federated Farmers also agrees that a framework approach should be used for considering taxation of negative environmental externalities. However, in saying this there must be one whole-of-government framework that guides all consideration (whether it is tax or regulation or whatever) of the various responses to environmental issues. While the proposed draft framework in Box 9.1 on page 63 appears reasonable in a taxation context, a wider coordinated whole-of-government context is even more important.

3.6 It is also concerning that there is a lack of consideration in the framework of the need to minimise administration and compliance costs from the proposed tax framework is, we feel, a glaring omission. Box 9.2 contains principles for taxing natural resources use does include a principle on administrative complexity but that does not explicitly extend to compliance costs.

'Opportunities' for environmental taxation

3.7 Several 'opportunities' have been identified for environmental taxation. All have been or are currently subject to policy work that seek to improve environmental outcomes:

- Greenhouse gas emissions; and
- Water pollution;
- Water abstraction;

- Solid waste; and
- Road transport.

3.8 On greenhouse gas emissions, there has been a particularly large amount of policy work, for example the Productivity Commission Inquiry into a Low Emissions Economy; the Zero Carbon Bill consultation; the work of the Interim Climate Change Committee on whether and if so how agricultural biological emissions should be included in the Emissions Trading Scheme (ETS); and reviews into Improvements to the ETS and Forestry and the ETS. It is likely that this work will result in New Zealand adopting an ambitious emissions reduction target and making changes to the ETS that delivers a much higher emissions price.

3.9 Water issues have also been subject to much work through the Land and Water Forum and policy work as set out in the Government's 8 October 2018 'Essential Freshwater' policy announcement. 'Essential Freshwater' is likely to result in stricter regulation on water quality and water allocation (e.g., an amended National Policy Statement for Freshwater Management and other regulation) as well as stricter compliance, monitoring and enforcement activity.

3.10 On water quality (i.e., pollution), Federated Farmers agrees with the Group's assessment that 'tax instruments are not well suited to all water pollution issues'. On water allocation (i.e., abstraction), we also agree that this 'is a particularly challenging policy area in New Zealand, owing to a range of different interest in the resources', including Maori rights and interests. Regulation, education, and support are likely to be more appropriate than taxes on both water pollution and water abstraction.

3.11 There is also a lot of work underway on solid waste, both in terms of regulation (e.g., the recently announced ban of supermarket plastic bags) and on the scope and rate of the Waste Disposal Levy. Caution is needed on substantially increasing the Levy. If it is raised to high too quickly it could result in more illegal dumping which would be a perverse outcome.

3.12 Road transport is already heavily taxed. Increases in fuel taxes have been a factor (along with increasing international oil prices, a falling exchange rate, and increasing margins for fuel companies) behind large increases in fuel prices to record highs. Although revenue from fuel excise duty, vehicle registration and licencing fees and road user charges is hypothecated to the National Land Transport Fund, the Government Policy Statement on Land Transport shows a growing proportion of that funding will be allocated to non-roading investments in public transport, rail freight, and walking and cycling. Environmental considerations have been very prominent in this growing proportion. Transport fuels are also subject to the ETS so as the emissions price rises, so will fuel prices.

Tax concessions

3.13 With regard to agricultural concessions it is important to recognise that the level of government support for New Zealand farmers is miniscule by international standards. In 2017 New Zealand's Producer Support Estimate was just 0.8% of gross farm receipts, compared to 1.7% for Australia, 9.6% for Canada, 9.9% for the United States, 18.3% for the European Union, 49.2% for Japan, 50.9% for Switzerland, 53.0% for Norway, 53.5% for Korea, and 55.7% for Iceland.

3.14 There are a range of tax concessions for agriculture in the Income Tax Act, mostly deducting types of expenditure which would normally be considered capital in nature. Much of this deductible expenditure has environmental benefits – for example:

- Destruction of weeds or plants detrimental to the land;
- Destruction of animal pests detrimental to the land;
- Fencing, particularly when fencing off waterways from livestock; and
- Planting trees or plants to prevent or combat erosion; provide shelter to the land; and prevent or mitigate detrimental effects on a waterway from the discharge of farming or agricultural contaminants.

3.15 There are others that, because they relate to improvements to the land for agricultural purposes, could be considered neutral or in some cases negative to the environment (for example, clearing land of scrub, stumps, and undergrowth; and re-grassing and fertilising pasture, and some fencing). We are not unsympathetic to the suggestion that concessions found to be 'degrading natural capital' should be removed but this should be subject to government support to manage any transition. We also agree with the suggestion that 'there may also be a case to consider further incentives for activities that generate environmental 'benefits'.

3.16 With this in mind, Federated Farmers strongly agrees with the TWG's assessment that costs associated with the case of land subject to a QEII covenant should be treated as deductible expenses. Another example would be stock crossings of waterways and stock water reticulation which is necessary when a waterway is fenced-off from livestock for environmental purposes.

Revenue recycling

3.16 Federated Farmers would support the recycling of revenue from environmental taxation, either through reducing other taxes or funding complimentary activities. We agree with the benefits of such an approach discussed on page 74 of the interim report.

4. THE TAXATION OF BUSINESS

4.1 Federated Farmers is a key representative of the business community, particularly of small enterprises.

4.2 Federated Farmers generally supports the interim report's recommendations on business taxation. They are well thought through and logical. We agree with retaining the imputation system and not changing the 28% company tax rate or the 33% trust tax rate. We also agree with recommendations not to introduce a progressive company tax or an alternative basis of taxation for small businesses. Instead the TWG found reducing compliance costs through the tax system to be a better approach.

4.3 We agree that a focus on compliance cost reduction would be helpful. The question becomes what opportunities are available? Firstly, Federated Farmers believes that the government should not seek to increase compliance costs. Extending the taxation of capital income would certainly increase compliance costs and small businesses would be disproportionately impacted. The same can be said of environmental taxation, particularly if agricultural biological emissions are included in the ETS or if taxes are imposed on water pollution and/or water abstraction.

4.4 Secondly, initiatives should continue to reduce compliance costs for those transacting with Inland Revenue. Significant progress has been made, including the greater use of accounting and payroll software and the increased ability for users of such software to communicate and transact with Inland Revenue through the internet. Technology-based initiatives to reduce administration and compliance costs should certainly continue but there are still taxpayers, especially in rural areas, who are unable to use technology (for example, due to lack of access to broadband internet or a lack of knowledge or confidence to embrace technology). Compliance with Inland Revenue requirements has become more difficult in recent years for businesses in isolated rural areas as the frequency of their postal service has fallen and a lack of access to reliable broadband has prevented them from shifting to internet based services. More funding should be made available to increase the coverage areas for broadband internet and to upskill people to use technology.

4.5 Thirdly, we agree that thresholds in the Income Tax Act that have not been reviewed for some time should be increased. This includes provisional tax and automatic deductions for certain types of expenditure. Although recognising concerns about fiscal costs we also consider it worth reviewing the thresholds for the write-offs for low value fixed assets.

4.6 Fourthly, we have one additional compliance cost suggestion not mentioned in the interim report. Charging resident withholding tax on interest and dividend transactions between family members and the family business is compliance cost intensive. Often this will be the only interaction with RWT that these family enterprises will have. From the perspective of these enterprises, the RWT is accounted for in an ad hoc way making it compliance cost intensive. The original objective of RWT on interest and dividends was to reduce evasion yet such evasion was not occurring in the family enterprise context. It should be removed for those enterprises.

4.7 Finally, the concern that originally prompted the promotion of a progressive company tax rate was not related to tax compliance. Our understanding is that the idea was promoted as a way to soften the cost impact for small businesses from the Government's increases in the Minimum Wage. While it is not in the scope of the TWG to critique wider government policies, it should acknowledge that small businesses' compliance costs concerns are far wider than just tax and that a whole-of-government approach is needed for addressing them. In this context Federated Farmers endorses the creation of the Small Business Council and of its mandate to take a strategic view as to how Government can best assist small business.

5. ABOUT FEDERATED FARMERS

5.1 Federated Farmers is a member based organisation that represents farmers and other rural businesses. Federated Farmers has a long and proud history of representing the needs and interests of New Zealand's farmers.

5.2 The Federation aims to add value to its members' business. Our key strategic outcomes include the need for New Zealand to provide an economic and social environment within which:

- Our members may operate their business in a fair and flexible commercial environment;
- Our members' families and their staff have access to services essential to the needs of the rural community; and
- Our members adopt responsible management and environmental practices.