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Regular commentary from our experts on topical tax issues

Issue 1

2017 Tax Working Group – a trip down memory lane

The 2017 TWG will focus on fairness and balance. A further tax switch may be in sight. Real thought about what that means is required.

However, the 2020 general election will intervene so implementation is a key caveat.

Snapshot

A new Government, a new Tax Working Group ("2017 TWG").

The Sixth Labour Government has released the terms of reference and appointed the chair of the third broad review of the New Zealand tax system since 2000. The MacLeod Tax Review reported in 2001 to the Fifth Labour Government and the Victoria University Tax Working Group in 2010 to the Fifth National Government. Each followed a new Government's election in 1999 and 2008. That is starting to look like a post-election tradition.

The 2017 TWG's terms of reference are available **here**. Additional details, including the other members of the group, are to be announced shortly.

We have summarised below the key objectives of the 2017 TWG and our initial thoughts. (For those interested in a bit more context, our detailed analysis outlines the considerations and findings of the last tax review and makes some observations on what has changed since 2010 and some thorny issues the 2017 TWG may need to consider).

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Key objectives, considerations and limitations

A key objective is "fairness". This is framed in the context of how income, assets and wealth are taxed and promoting the right balance between the productive and speculative economy.

Another is raising sufficient revenue to fund Government expenditure at around 30% of GDP.

The terms of reference also direct the 2017 TWG to specifically consider:

- The economic environment that will apply over the next 5 to 10 years.
- The taxation treatment of housing and land (other than the family home).
- Whether a progressive company tax rate could improve the business environment.
- The role of taxation in delivering positive environmental and ecological outcomes.

The 2017 TWG's scope excludes consideration of raising tax rates, taxing the family home or inheritances, the interaction between tax and social policy, the Base Erosion and Profit Shifting ("BEPS") tax reforms and Inland Revenue's Business Transformation ("BT").

A proposed timeline for the 2017 TWG is outlined in the side bar. The process is reasonably tight.

Our initial thoughts

The last tax review looked at whether New Zealand's tax policy settings were fit for purpose in a post Global Financial Crisis ("GFC") world. The driver then was tax system efficiency and sustainability. The accepted recommendations largely rebalanced and reweighted the tax system away from income tax to GST.

Since 2010, the BEPS project has moved the "fair share of tax" debate to the top of the agenda. The 2017 TWG terms of reference raise expectations that fairness rather than efficiency will be given greater weight. This raises questions of how capital, including foreign direct investment and investment in the housing market, is taxed compared to labour. At the same time, we are seeing a trend towards lower corporate tax rates. New Zealand will not be sheltered from these global developments.

There are also indications the 2017 TWG may place less emphasis on tax experts and more on those with wider business and societal experience. In our view, this is not necessarily a bad thing. Effective engagement requires a diversity of viewpoints to be heard and reflected.

The following are some of the thornier issues that might "tax" the 2017 TWG's thinking:

- There is scope (and possibly expectations) for its recommendations to be revenue neutral. What should this look like?
- The current tax system design is based on less interaction to lower compliance and administration costs. Is that the right lens?
- The taxation of saving was "unfinished business" for the previous Government. Previous attempts at getting this right, including the PIE tax regime, have required compromises. A silver bullet has thus far proved elusive. That is unlikely to change.
- NZ company tax is a half-way house between integration (i.e. taxing profits at shareholders' marginal rates) and the "final tax" model in other countries. Is BT a potential enabler for full integration and might that solve some of the fairness and balance considerations?
- The politics of tax reform (i.e. is it "sellable") will not be able to be ignored. This is likely to guide its considerations.

2017 TWG proposed timeline

Dec 17 – TWG established

Feb 18 – First TWG meeting / call for submissions

Sep 18 – Interim report / request for feedback

Feb 19 – Final report with recommendations

Apr 19 – Cabinet decisions

Apr to Aug 19 – Public consultation

Sep 19 – Tax Bill introduced

Sep 19 to Jul 20 – Parliamentary process

Jul 20 – Legislation enacted

Sep to Nov 20 – General election

Apr 21 – Changes apply

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Detailed analysis

For those wanting a bit more context, read on…

Looking back to look forward

The Victoria University Tax Working Group's ("2010 VUTWG's") **final report** was published in January 2010. Some of its recommendations were implemented in Budget 2010. We highlight some of the key themes to contrast the 2010 VUTWG's considerations with the task facing the 2017 TWG.

Why was there a 2010 review?

Briefly, the 2010 VUTWG considered New Zealand's tax policy settings against the background of a challenging economic and fiscal environment, the effects of the 2008 GFC. That put pressure on Governments globally, including New Zealand's, to efficiently collect revenue. Such an environment meant different taxes and their effects were considered.

Process

The 2010 VUTWG was able to carry out a thorough review of tax policy settings which (largely) carried people with it. Even if one did not agree with the conclusions, there was a process to debate the issues, including at a symposium prior to the 2010 VUTWG's release of its final report.

It also had a review framework which added system coherence and sustainability to the assessment of tax policy. Coherence covers the way that all policies fit together so that the system moves in the same broad direction. Sustainability signals that successful tax policy needs to be politically sustainable in the long term. These remain important to the assessment of any tax policy or overall set of policies.

Recommendations

The 2010 VUTWG considered new tax bases (including a land tax, quickly ruled out by the then Government), changes to taxing property (by removing building tax depreciation), and rebalancing (by better aligning the company and top personal tax rates) and reweighting of taxes ("switching" between income tax and GST with compensation for those adversely impacted). Budget 2010 implemented the recommendations accepted by the then Government.

What was missing?

Although broad in scope, the 2010 VUTWG omitted or did not reach clear views on:

Inland Revenue's administration

The 2010 review did not cover Inland Revenue's administration of the tax system. (Some may recall Sir Ivor Richardson's organisational review of Inland Revenue, which reported in 1994, as the last significant purely tax administration focussed review).

Since 2010, Inland Revenue has commenced its Business Transformation ("BT") programme which has largely filled that gap. (A Tax Administration conference was held in 2014. This considered a wide variety of tax administration issues which have influenced the BT changes).

BT is outside the terms of reference of the 2017 TWG. However, one objective of BT is to allow more flexibility in the development of future tax policy and its implementation. BT will therefore be an important enabler for the 2017 TWG when considering different tax reform options.

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Social policy interaction

Both the 2001 and 2010 tax reviews highlighted the high effective marginal tax rates ("EMTRs") which apply when the tax and transfers systems interact. The transfers system includes *Working for Families*. In some cases, the EMTR can exceed 100%, meaning for every dollar of additional income earned, more than $1 is lost in social assistance and tax.

Solving this problem is difficult. The 2010 VUTWG did not make any recommendations on this interaction or how best to address the issue of high EMTRs. The 2017 TWG has also had consideration of the transfers system scoped out. That will be addressed by a separate review of *Working for Families*. It remains to be seen whether this is the best approach.

Capital gains and land tax

The 2010 VUTWG considered a capital gains tax ("CGT") and a broad-based land tax.

A majority of the 2010 review members considered the practical difficulties of implementing a CGT outweighed its benefits. This, they considered, did not justify its introduction.

A land tax, which is more economically efficient, was more widely supported but ultimately ruled out on political grounds. In part, the expected exemptions required to make it politically sustainable meant that it was not worth the effort.

In both cases, the political and practical realities in 2010 did not support introduction.

Except for the family home and land under it, neither a CGT nor a land tax have been ruled out of scope for the 2017 TWG. Indeed, a CGT is expected to be a key focus.

A tax system that treats all assets in a fair and balanced manner, having special regard to housing affordability, and promotes the right balance between the productive and speculative economy is an explicit objective of the 2017 review.

What has changed?

A lot has changed since the 2010. We see three key themes.

Fairness

It is fair to say that the 2010 VUTWG's main focus was on greater tax system efficiency. Its focus was on the revenue raised versus the costs imposed from the different tax bases as well as on overall economic efficiency. Its recommendations therefore focused on limited tax "switches", from income taxes to GST, and removing some of the tax "advantages" to property investment by denying depreciation on buildings.

The ability for foreign multinationals to arbitrage different tax regimes around the world, to minimise total taxes payable, had little public focus. Growing budget deficits around the world, arising out of the GFC, meant Governments were having to raise taxes or cut spending ("austerity") to remain solvent. This, and concerns around income inequality, gave the OECD the political support for the BEPS project.

Questions about who pays tax and on what tax should be paid are prominent. In short, a real focus on paying a "fair share" has framed the tax debate and is a major change since 2010.

The 2017 TWG's terms of reference focus squarely on "fairness" and "balance" in the tax system. This raises expectations that fairness, rather than system efficiency, will be given greater weight.

That is likely to lead to questions of whether capital, including foreign direct investment and investment in the housing market, is appropriately taxed compared

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to labour. As an aside, what is "fair" remains largely undefined and will be in the eye of the beholder.

Tax competition

As well as raising questions of fairness, BEPS also raises questions of global tax competition. As a capital importing country, New Zealand's framework has been to ensure that tax does not distort or raise the cost of foreign capital for New Zealand business.

The BEPS project has seen a fundamental shift in how Governments view the taxation of capital. The expectation is that adopting a consistent global approach to international tax policy design will mean that tax is not an issue in attracting investment. The foreign capital will flow in any case.

That proposition needs to be tested. This is particularly so as countries reduce their corporate tax rates and a global consensus on what is a "fair tax" for cross border transactions remains elusive.

The OECD recognises that BEPS will place general downward pressure on corporate tax rates. A generous view is that BEPS will simply bring tax competition into the sunlight, rather than allowing it to be hidden in opaque tax system design.

The global trend is likely to see the NZ company tax rate and the coherence of the domestic tax system (including imputation) come under pressure.

Role of experts in a "post-truth" world

The 2010 VUTWG was described as a committee of tax experts. Perhaps less so in New Zealand, but there has been a global shift to distrust the view of the expert. "Post-truth" – *it feels right so it is right* – has found increasing favour.

The indications are that the 2017 TWG will have fewer tax experts, with a greater focus on those with business and societal experience. That is not necessarily a bad thing. The diversity of views is important as there are many different stakeholders in the system. Often their voices can be missed. They need to be heard and their concerns reflected.

Recall that tax economists generally favour a tax on wealth accretion – an annual tax on unrealised gains. As far as we are aware, no one has yet successfully implemented such a "pure" model. This goes to the political economy of tax reform.

As the 2010 VUTWG recognised, sustainability (aka acceptance by the voting public) is a key ingredient for successful tax policy reform. It is important that the reforms are "sellable". It is not a bad thing for the experts to be required to advocate clearly for their solutions.

Some thorny issues for the 2017 TWG to consider

Reform almost always requires trade-offs. Perfect solutions are few and far between.

Tax switch – what offsets any tax increases?

The 2010 VUTWG recommended a shift to GST as a more efficient taxing method. This was achieved through a higher GST rate, accompanied by reductions to income tax and increases to transfer payments as an offset.

Assuming the tax system already raises the 30% of NZ GDP required for Government spending and that, for example, a CGT would raise revenue, a CGT should mean that other taxes are lowered. Is that best done by lowering:

- the company tax rate;

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- the tax rate on lower incomes (bearing in mind that this will also flow through to a tax cut for higher rate taxpayers as well);
- the GST rate; or
- some combination of the above?

The terms of reference exclude increasing tax rates but not lowering them. The new Minister of Finance has noted that the 2017 TWG can consider a revenue neutral package.

Taxing different types of income differently (aka taxing savings)

Generally, New Zealand taxes all types of income at the same rate. There is an exception for income earned through Portfolio Investment Entities ("PIEs"). The maximum PIE tax rate (28%) is capped below the top marginal tax rate (33%).

Although the PIE regime was introduced by the last Labour Government to support KiwiSaver, capping the top rate has been an issue for the Labour party. Further, the current taxation of savings was said to be "unfinished business" by the previous Minister of Finance and an area of concern for NZ First, Labour's coalition partner.

The balance between taxing savings and other income will be a significant question for the 2017 TWG.

What you want and what you need – who engages with the system?

The tax system's current design is based on as many as possible not being aware of its operation.

An employee that has PAYE deducted at source generally has no tax return filing obligation and pays GST over the counter as a matter of course. This reduces compliance and administration costs. It reduces stress as contact with Inland Revenue is generally expected to be about bad news. BT continues this approach, with emphasis on collection of third-party held information to build a person's tax profile.

However, this means that many are not aware of the tax that they pay or of their tax obligations. Arguably, the former means that many are uninformed when faced with the prospect of tax reform or understanding the current system and its trade-offs.

The thorny question is whether a nudge to including more New Zealanders, more formally, in the system is a good thing. This will depend on the lens you apply.

Taxing entities – from half-way house to full integration?

New Zealand's tax system is a little schizophrenic when it comes to companies. For New Zealand shareholders, company tax is a withholding tax – they top up to their marginal tax rate when a dividend is paid. For foreign shareholders, the company tax is a final tax.

Designing a coherent system is difficult. A reduced company tax rate benefits foreign shareholders. (Whether that is an absolute benefit – a windfall gain – depends on the tax rate and system of the shareholder's country of residence).

Further, there is a difference between who legally pays and who bears the economic incidence of company tax. The economic theory is that company tax is ultimately borne by employees (through lower wages), customers (through higher prices) and shareholders (through lower dividends and share price).

The 2010 VUTWG did consider taxing shareholders directly in some cases. The "look-through company" tax regime was the result.

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The more than 10 years' experience with the PIE regime, and subsequent technological advances, means there is the prospect that more extensive integration (e.g. where shareholders and beneficiaries are attributed the taxable income of the company or trust) is possible.

Whether that change would achieve the Government's aims for the tax system is an interesting question.

Back to the future

Each tax review is a reflection of its time. Although it has to be forward looking, as the terms of reference of the 2017 TWG require, implementation of any recommendations will very much depend on the political environment.

As a reminder of that reality, the Fourth Labour Government released the *Consultative Document on the Taxation of Income from Capital* in 1989. The proposal was for a comprehensive tax on capital gains. The key features were:

- all exemptions for capital would be removed;
- realised capital gains and losses would be taxable;
- the cost of capital assets would be inflation indexed;
- some losses would be ring-fenced (to counter the incentive to realise losses); and
- the family home would be included in the tax base. An annual standard allowance of $4,000 or the actual cost of improvements would increase the deductible cost to provide some protection from tax for the family home.

The consultative committee was due to report in December 1990. In October 1990, Labour was replaced by National. The consultative committee's efforts were refocused on general remedial and other tax matters following the change of Government.

A closing comment

The 2017 TWG will demand attention in 2018 and beyond. Its work deserves the focus and engagement of all New Zealanders.

We will continue to play our part and are happy to discuss it.

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