EXECUTIVE SUMMARY

This summary should not be read as replacing or modifying the full original report.

Introduction

The structure of the tax system has changed dramatically in the last 35 years in response to a growing view that in an open modern society, broad-based low-rate systems are the fairest and most efficient revenue-raising strategies.

Much of the impetus for change came from earlier rigorous, independent reviews. The important reforms were often controversial at their original launch. Consensus developed only over time.

This Review, like its predecessors, has to grapple with inescapable trade-offs among competing goals. We have tried, as previous reviews did, to let the evidence speak for itself where it raises inferences that test inherited conventions.

The report draws on public submissions. We look forward to testing it rigorously against further submissions, before presenting final recommendations.

Tax Bases

Income Tax

New Zealand's income tax base is more comprehensive than most other countries, but falls short of being fully comprehensive.

Capital gains

The income tax base already captures a wide range of changes in the value of assets and liabilities. The issue is whether to tax capital gains more comprehensively, and if that is considered desirable, whether to do so by:

- Including more of them in the income tax base,
- Or introducing a separate capital gains tax

The argument is theoretically sound that including capital gains in taxable income as they accrue makes the system fairer, more efficient, raises more revenue, permits other rates to be lowered, and stops conversion of taxable income into non-taxable capital gains.

But the capital gains taxes used overseas tax those gains when realised. They are, in fact, a transactional tax on the disposal of assets. They encourage people to hold or sell ownership to avoid tax, and tie assets up unproductively. They require costly and complex rules that often add to that problem of lock-in.

Because these are serious problems, our current thinking is that capital gains should not be taxed comprehensively on a realisation basis. Options are:

Option I

New Zealand's approach for many years has been to include capital gains in the income tax base as and when specific problems arose that required such an action.

That approach could be extended into areas where the absence of capital gains taxation may currently be creating problems. They include:

- Inconsistent treatment of different savings vehicles
- Offshore investment
- Investment in housing

Option II

Alternatively, fundamental reform could be undertaken by redefining the tax base for some or all investment income as:

- The amount the same sum would have earned invested in a 'risk-free' government bond, minus the part of that return that merely compensated for inflation.

Application of this Risk Free Return Method (RFRM) would in most cases be straightforward:

Net asset value at the start of the year
x
Inflation-adjusted rate of return on a one-year Government bond
x
The investor's tax rate.

The system is capable of application wherever an objective estimate is available of an asset's value at the start of the year. Taxpayers with the same wealth and tax rate at the start of the year would face identical taxes.

Arguments about whether sale proceeds are taxable income or capital gains would be eliminated. Investment choices would no longer be tax-driven. An annex to the Review report describes RFRM in more detail.

Owner occupied housing

People with savings have to make choices about how they will invest their money. If they put it into shares or a bank account, they will be taxed on the interest or dividends which they earn. If, on the other hand, they buy a house, they can replace those taxable benefits with the benefit of occupancy—an alternative return that is tax-free.

This tax concession for returns on savings that are taken in the form of owner occupancy alters the behaviour of New Zealand savers in favour of home ownership. In this country, housing accounts for more than 70% of total household savings, compared with less than 50% of the average of all OECD countries. Money goes into home ownership which might otherwise have been invested in assets that improve economic growth and lift the incomes of all New Zealanders.

The present concessionary treatment of home ownership is a tradition that is deeply embedded in the psyche of all New Zealanders. Quite clearly, any proposal to change it will be highly controversial.

But the distortions induced in the behaviour of savers have very important consequences. It is past time they were more widely understood and debated by the public.

The OECD last year recommended that New Zealand should tax both capital gains and the value of occupancy (imputed rental) for owner-occupied homes, with deductions for mortgage interest, depreciation, repairs and maintenance.

Economic efficiency would, however, suffer if people facing a tax bill on the sale of their home would be discouraged from taking up better jobs in other centres. Those who had to move to find work would be disadvantaged over those who could find it locally.

Most regimes overseas that tax income from owner-occupied homes are therefore forced to make major concessions and exemptions. Where imputed rental income is taxed, rates are kept at very low levels.

Since interest is deductible, the outcome is often a greater tax benefit on housing than owner-occupiers enjoy here.

The Review does not therefore favour a tax on imputed rental income or capital gains for houses. The Risk-Free Return Methodology however provides a potential way of taxing owner-occupied and rental houses.

Property valuations for rating could be used, net of all debt secured on the property, so interest would not need to be deductible. Depreciation and repairs and maintenance could be built into an expected net rate of return reflecting such expense, instead of being separately deductible, to achieve a much simpler approach.

An example is given: David and Ruth own a $200,000 house with a $100,000 mortgage. His marginal tax rate is 39%, hers 21%, and the IRD's risk-free return is 4%. Taxable 'income' from their owner-occupied house is therefore $4000, split equally between them. His extra tax is $780 and hers is $420.

The market values of owner-occupied houses would fall as buyers took account of the extra tax cost they would face.

The decline would be less where buyers relied on high mortgages, and more where they needed low mortgages, ranging from perhaps 2% for a buyer using 90% borrowed money to 15% for people buying without mortgage.

The report estimates that, at an average tax rate of 25%, the tax would generate $750m in revenue. This should be used to reduce income tax.

The Review suggests targeted transitional relief with partial or full tax exemption for some households, or deferral of the tax until the house was sold.

Wealth taxes

Wealth acquired by re-investing after-tax income is already taxed. Inherited wealth, generally accumulated from income subject to tax, is then used to derive taxable income.

There is no need for a general wealth tax. Estate duty is not required to fill any gap in the income tax base. The Review is not convinced New Zealand could operate an effective estate duty even if it was desirable. Elderly New Zealanders would avoid the tax if they redomiciled in Australia, for example, which has no estate duty.

Cash-flow tax

The proposal to replace income tax with a cash-flow tax (CFT) has received widespread academic endorsement. So far no country has implemented it.

The CFT tax base is simply cash inflows minus cash outflows. No complicated rules are needed to deal with timing, valuation or the interface between a company and investors. It does not distort investment decisions, improves the return on savings, and probably induces higher investment.

On the other hand, several billion dollars of revenue would be lost annually in the transition from income tax to CFT. The value of some firms would fall markedly at introduction. Pioneering design problems would be considerable.

The review does not see a practicable case for CFT in New Zealand in the foreseeable future, but recommends a close watch on any developed country introducing this type of taxation.

Expenditure, Transactions Taxes

Expenditure and transaction taxes include GST, excises, customs duty, road user charges, motor vehicle fees, stamp and cheque duties and energy resource levies. They comprised 35% of total tax revenue and 11.7% of GDP in the 2000/01 year.

Goods and Services Tax

GST is a broad-based, low-rate, fair and efficient tax.

It has three important exemptions—financial services, rental accommodation, and housing. Traders in those areas cannot claim back GST on supplies used in trading. Their GST burden is believed to be close to what they would pay if GST applied.

GST is roughly proportional to income for more than 80% of households. Using multiple rates or exemptions to remedy concerns about regressivity would create other costs and anomalies likely to have worse impacts.

The Review does not propose any significant change.

Gift Duty

Gift duty raises only $1.6m a year, but involves significant compliance costs. Its rationale has been eroded by other tax changes in the past 20 years. Where it does still in minor degree protect the tax base, other less expensive options are available. Gift duty should be abolished.

Welfare issues such as geriatric care can be managed by bringing into welfare asset tests any assets transferred over the last half-dozen years. The transfer of assets otherwise taxable at 39c into trusts taxable at 33c should be addressed by re-examining the tax scale.

Stamp and Cheque Duties

Cheque duty is easy to avoid by using cash, electronic payments, credit cards, debit cards or direct payment authorisations, which do not carry any such duty. It raises only $11.5m. It is inefficient and should be abolished.

Financial Transactions Tax

A financial transactions tax, levied on withdrawals from financial institutions, has been promoted as a less regressive alternative to GST.

The impact of the tax falls not ultimately on the withdrawal transactions, but on goods or services purchased with those funds.

But no credits are allowed on inputs along the production chain. So a cascade occurs where tax is levied at each stage on the tax which has already been levied at previous stages. The tax levied on products of equal value ends up varying greatly, dependent on the number of stages in the production chain.

Prices of some goods will be artificially inflated, distorting production and purchasing decisions. In addition, the amount of tax likely to be raised by any given rate is very hard to estimate.

Tobin tax

Tobin tax is a low-rate tax on all foreign exchange transactions aimed at dampening currency speculation and stabilising exchange rates.

Long-run exchange rate movements are a vital means by which New Zealand adjusts to economic changes here and around the world.

No means exists to identify transactions aimed primarily at speculation. Every buyer buys in hope. There is a speculative element in every transaction.

Buyers anxious to minimise risk hedge against it via transactions with sellers who are happy to accept higher levels of risk, but a Tobin tax would reduce the amount of risk speculators are willing to accept.

It would therefore limit the ability of exporters and importers to hedge their own risk by trading it with speculators happy to manage a higher level of exchange rate risk.

A tax intended to improve exchange rate stability therefore ends up exposing importers and exporters to increased exchange risk.

The tax mix

In general, it is desirable to spread tax reasonably evenly across a number of bases to minimise avoidance. Overall revenue flows would tend to be more stable.

The income tax base is less comprehensive than the GST base. Income tax offers more scope for base broadening to raise revenue and reduce incentives to activities that are less profitable to the nation as a whole.

Economic decisions are likely to be distorted less by the GST base than by a comprehensive income tax, and GST's compliance costs are also somewhat lower than those of income tax. The total costs imposed by tax on the economy would be reduced somewhat if relatively more reliance were placed on GST.

We therefore think that, if the government needs to increase taxes in the future, it should turn first to GST. If it is able to reduce them, it should turn first to income tax.

Excises and Duties

Excises on tobacco, alcohol and petrol, and duties on gaming are in marked contrast to GST, which applies at one rate across the board, independently of how people choose to spend their money.

They are of particular interest because they raise about $2.8 billion, and directly challenge the broad-based low-rate rationale that underpins the rest of the New Zealand tax system.

Excise tax revenue

Excise receipts based on the 1999-2000 year—inclusive of excise on local production, customs duty on imports, the additional GST induced by the inclusion of those taxes in the price of the goods, and adjusted for the most recent tobacco tax changes, implicit regulatory taxes on gaming and road user charges on petrol—comprise $583m on alcohol, $1063m on tobacco, $507m on gaming, and $630m on petrol. They total $2783m.

The total rate of indirect taxation in New Zealand expressed on a 'GST-equivalent' basis is of the order of 16.6%.

Many of these taxes appear likely to have high deadweight costs per dollar of additional revenue raised relative to broadly based forms of taxation. It appears difficult to justify current levels of excises and duties on 'efficient taxation' grounds.

The Review does not believe revenue raising provides a sustainable rationale for narrowly based indirect taxes in an environment where GST is available.

Impact on price paid by consumers

Alcohol excise adds $3.56 to a dozen cans of beer, $1.70 to a bottle of wine and $17.09 to a bottle of spirits. Tobacco duty adds about $5.56 to the price of a packet of cigarettes.

Gaming duties average 15 cents per dollar of gambling expenditure, but they vary by operator and product. GST-adjusted rates range from 4.4 cents per dollar of consumer spending in casinos, 14c for lotteries, and 19c for racing and sports, to 22.5c for non-casino machines.

These figures ignore statutory monopoly profits and mandatory charitable contributions that push the total 'tax' take to 66% for the Lotteries Commission and 60% for non-casino gaming machines.

Adverse impact on social equity

Tobacco tax accounts for 38% of total excise revenue. It is paid by only 25% of the adult population. A person smoking one packet a day pays over $2000 a year in GST adjusted tobacco tax.

Although 87% of New Zealanders consume alcohol, 50% of those drinkers pay 90% of the excise, at an average rate of $400 a year each. The top 10% of drinkers (260,000 people) pay half the alcohol excise, at an average $1100 a year each.

Similarly 86% of us gamble, spending an average $490 a year each. But more than half of those gamblers spend less than $240 a year. The top 10.5% of adults who are regular continuous gamblers spend an average $1800 a year. At an average tax rate of 40c, those 300,000 New Zealanders would pay an average $700 each in gaming taxes.

In short, many New Zealanders of modest means pay as much or more through taxes on alcohol, tobacco and gaming than they pay in GST on all of their other spending.

The impact is disproportionately severe on the minority of individuals and their families who experience drinking or gambling problems. To the extent that alcohol and gaming abuse is a symptom of a deeper problem, this large transfer of funds away from such families must worsen the problems it was intended to counter.

Tobacco tax, in particular, falls dramatically more heavily on disadvantaged people. Smoking prevalence is 37% among the most deprived New

Zealanders, falling to only 16% for the least deprived.

Smoking prevalence among Maori is about twice that of the general population. Among sole parents with dependent children, a notably low-income group, it is also very high at 42%. No feasible change in other forms of taxation can address these large vertical and horizontal inequities.

Because excises fare so poorly on normal criteria of fairness and efficiency in raising revenue, such taxes require a strong alternative justification.

Public spending externalities

Some submissions sought 'regular and substantial increases in tobacco excise' to modify lifestyles in pursuit of improved health outcomes to meet health system targets.

Where smokers and drinkers incur additional medical expenses paid for by the individuals themselves, those costs will be factored into their decisions about smoking and drinking. That will not be true where public health care is provided free.

We are not convinced that those concerns provide a robust basis for tax policy. It is not easy to justify singling out smokers and drinkers. The same public health rationale applies to other lifestyle choices that impose extra costs on the health system.

Road transport externalities

We have reviewed recent estimates of generalised environmental road transport externalities, and regard these as too speculative to provide a rational basis for the 21c/litre general revenue excise on petrol, or to suggest that diesel should be brought into the excise regime.

Gaming taxation

The Government is undertaking a comprehensive 'first principles' review of the gaming sector. This review is managed in the Department of Internal Affairs.

Submissions to the Gaming Review on the tax treatment of gaming have been forwarded to us for consideration. Chapter 2 contains our initial observations on some aspects on this topic.

Eco-Taxes

The Review considers that an eco-tax is appropriate only when the following three conditions are broadly satisfied:

- The environmental damage of each unit of emissions is the same across the geographic area to which the tax applies;
- The volume of emissions is measurable; and
- The marginal net damage of emissions is measurable.

At a national level, we consider only greenhouse gases satisfy these conditions.

Prospects for a broader range of eco-charges may, however, be more promising at a local level. For example, each tonne of organic waste going to a landfill can be presumed to have much the same impact as any other tonne.

Carbon Tax

We note that under the Kyoto Protocol New Zealand's gross emissions in the first commitment period from 2008 are expected to exceed by about nine percent the levels required under the Kyoto Protocol.

However, accounting for forests planted after 1990, which are recognised as carbon sinks under the Kyoto Protocol, New Zealand's net emissions in 2010 will be less than 75% of targeted levels.

A carbon charge satisfies the conditions for effective eco-taxation at a national level.

New Zealand has an unusual greenhouse gas emission profile, heavily weighted towards methane (48.5%) and nitrous oxide (15.9%) relative to carbon dioxide (35%).

The Review has not seen with any analysis of the impacts of methane taxes and we have been unable to find any explanation for why ruminant methane should be excluded from a New Zealand carbon tax regime.

We seek further consultation on the feasibility of this form of taxation, on its efficiency in providing incentives for greenhouse gas emissions abatement in New Zealand and on the risks under Kyoto of excluding ruminant stock numbers from a carbon charge.

We would not favour the introduction of a carbon charge prior to ratification of the Kyoto Protocol by New Zealand, because of our inability to take meaningful unilateral action to affect global climate change.

Following ratification, imposition of a charge prior to the first commitment period may be desirable but only after international carbon markets begin to give clearer indications of the likely price of carbon (emissions abatement).

It would be desirable for meaningful debate over the feasible, fair and efficient coverage of a national carbon charge, consistent with the government's Kyoto commitments, to begin immediately.

Tax Rates

Personal Tax Rates

Personal income tax is used to generate revenue for government, and reduce income inequality. The number of personal rates has been reduced from 33 ranging from 15-60% in 1967 to four now, ranging from 15-39%. At the same time the tax base has been broadened. The top rate has halved but proportion of tax collected from the top bracket remains roughly the same.

There is a wide gap between our present 21% middle rate and the top rates of 33% and 39%. This creates a large incentive for higher income people to split income with a lower tax-rate partner.

Family trusts, with minors as beneficiaries, are one common means. Measures implemented so far to block the gap are only partly successful. The top personal rate is now 6 percentage points higher than the company rate, creating incentives for individuals with income above $60,000 to earn it through companies.

Preventive measures so far miss some companies, and may unfairly penalise others.

The new rate structure has led to a growing number of business decisions based on tax avoidance, not efficiency. The ability of many individuals to avoid the new top rate undermines the credibility of the tax system.

Effects on Inequality

In New Zealand, most redistribution occurs through government spending. The distribution of taxpayers does not permit large amounts of redistribution through additional rate scale progression.

Only 200,000 taxpayers earn more than $60,000, compared with 1.65 million on less than $30,000. It takes eight dollars in tax from each person in the high group to provide one dollar for each person in the low-income group.

The top income group does almost the entire nation’s saving. The country is not well served if they reduce their saving, focus more effort on avoidance, raise their fees to recoup extra tax, or emigrate.

People sometimes suggest helping low-income earners by not taxing income below $9500. That would give people on $20,000 a gain of $17.31 weekly, but the other rates would have to move to 26%, 39% and 49% to fund that tax threshold.

The real driver of redistribution is that both the proportional and progressive systems collect more tax at the top, and governments spend it with a bias towards low-income groups.

If an increase in progressivity is desired, it is best achieved through an increase in targeted spending, not an increase in the progressivity of tax rates.

Implications for tax scale design

The tax scale has limited ability to help low-income earners through progressivity, and in doing so creates expensive inefficiencies.

The Review considers that a proportional scale offers substantial benefits over a progressive one in terms of efficiency, administration costs and avoidance.

However, a proportional scale would result in income losses to low-income earners. Also, many New Zealanders value the progressivity delivered through the tax system.

The Review’s analysis points towards a two-rate scale that retains some progressivity while reducing its cost, and simultaneously, minimises the loss that low-income earners would suffer if the system moved to a simple proportionate scale.

The following table gives examples of two-rate combinations which, based on a rate step at $29,500 and a corporate rate aligned with the top personal rate shown in the table, are approximately revenue neutral as compared with the present four-rate system:

Low Rate	*High Rate*
17%	34%
18%	33%
19%	32%
20%	31%

Taxable Unit

Tax in New Zealand is based on individual income, while the benefit system operates on a basis of household income. Some suggest using household income for both systems to overcome anomalies created by a progressive rate structure.

Currently, for example, a household with two $25,000 incomes pays $9,360 in tax, while a household with one earner on $50,000 and a non-working partner pays $11,370. Why not let that earner split the income with the spouse for tax purposes?

That would create as many anomalies as it solves. Traditional 'empty-nest families' with a single earner on a high income would make quite large gains, for example, while sole working parents with dependent children made none. Concerns focused on households are addressed best through decisions on spending, not tax.

Taxation and the Benefit System

The welfare system targets cash payments (income) to beneficiaries. As they move into work and their income rises, they pay tax and they also lose part of their benefit.

Their effective marginal tax rate comprises both payments, and may reach high percentages. High marginal rates affect people's decisions. They may, for example, decide the residual gain is not enough to warrant working full-time.

Family support abatement for example pushes effective marginal tax rates for a one-child family to rates between 39% and 51% at incomes from $20,000-32,000. At the same time, the problem should not be exaggerated. As they gain experience, are promoted and change jobs, their income in many cases rises, the benefit abates fully, and they move back on to normal tax rates. This is the price of targeted assistance.

Targeting Vs Universality

Universal benefits are payments made at the same rate to everyone, regardless of income. They do not change effective marginal tax rates as income rises. But they are so costly that only limited assistance is provided to low-income groups, while an equal gain is passed to middle and high-income people.

Increased Targeting

More targeting means more people facing high effective marginal tax rates as they try to move out of benefit dependency. Less targeting means a lower level of assistance to needy people. There are no perfect answers.

Universal Basic Income

Some submissions recommend paying a universal basic income to every New Zealander, based on age and residence. Unfortunately such a payment, set at $17,000, around the level of the highest present benefit, would require raising the tax rate to 67.5% on *every taxpayer*, and tolerating major inefficiencies.

With a universal basic income of $10,000 per person, a family of four would have an income of $40,000 without working. If they did work, they would face a tax rate of 41%.

Universality usually has little impact on the underlying objective of policy. Paying benefits to middle and upper income families does not reduce child or family poverty.

Conclusion

There is no way to eliminate high marginal tax rates without making beneficiaries better off than working people, or incurring large costs by paying benefits to middle and upper income people. It may be possible to make significant gains, however, if the benefit system, with its many different rates, benefits, abatements and eligibility rules can be simplified.

Collapsing the present 15% and 21% rates into one rate in the 17-22% range would also provide some reduction in marginal tax rates for most beneficiaries and low-income earners.

Corporate Tax Rate

For domestic shareholders, company tax acts as a withholding tax on their company income, like PAYE on wages and salaries. Through the imputation system, it is taxed ultimately at the personal rate of the shareholder. Company tax also discourages people from sheltering labour income in companies to avoid personal income tax. For non-resident shareholders, it is a final tax on company income as it accrues.

The statutory rate is not a complete guide to the impact of company tax because taxable income is not fully aligned with economic income. However, the evidence is that the effective tax rates imposed on investment in New Zealand are lower and less disparate than in most other countries. It also suggests our effective marginal rates are broadly consistent across most types of business asset.

Impact on domestic shareholders

For domestic shareholders, the focus should be on aligning the company rate with the top personal tax rate to reinforce its withholding tax role, and to remove any opportunity to shelter any income in companies.

Impact on avoidance

Other countries do not always take this approach. Some are relatively tolerant of individuals

sheltering income in entities. Some have given up on enforcing the boundary, and accepted split rates. Others use distortionary efforts to block tax base leakage. New Zealand should not follow any of those examples.

Impact on foreign investment

Company tax on non-resident shareholders is one of the factors affecting our ability to attract foreign investment. The rate appropriate to domestic investors is not necessarily the same as the rate appropriate to non-resident investors.

Impact on competitiveness

While many factors affect our ability to attract foreign capital, the statutory company tax rate is a headline indicator of receptiveness to international capital flows.

Conclusions

Setting the company rate is complex, because the tax plays different roles. In general, it should be aligned with the top personal rate, if that rate is not out of step with international norms.

Taxable Entities

Where entities are interposed between individuals and their income, rules are needed to deal with transactions between the entity and the beneficial owner. Companies, partnerships and trusts are the most common entities.

The existence of such entities can create opportunities and incentives for people to 'shop around' among entities. Outcomes include search costs, sub-optimal entity choice, and leakage from the tax base. The goal of policy is to minimise those and compliance costs.

The number of different entity-specific regimes should be as low as possible. Core rules applied to all such entities should be as wide as possible. Boundaries between such regimes should be clean.

Different forms of substitutable investment should be treated as uniformly as possible. Marginal rates at individual and entity level should be aligned where possible.

Do existing rules measure up?

New Zealand has different entity-specific regimes for qualifying companies, controlled foreign companies, foreign investment funds, co-operatives, producer boards, Maori authorities, unit trusts, group investment funds, life insurance companies, superannuation funds and close companies.

The substance of all those varying rules falls into three main groupings:

- Partnerships, ignored entirely for most tax purposes. Income is attributable directly to partners.
- Companies, taxed on their income with imputation credits to shareholders. The income they derive is taxed, overall, at the correct rate for the individual.
- Trusts, where distributions of current-year income are treated as if directly derived by the beneficiary (not the trustee), but income retained by the trustee is subject to final tax in the hands of the trustee.

The Review suggests reducing the number of entity-specific regimes to a minimum by mixing and matching to bring all entities within these three groups.

We also distinguish between widely held entities (many owners with an arm's-length relationship) and closely held entities (a few closely related owners).

Widely held entities & their owners

Default rules for widely-held entities

In substance, the owners of widely held entities are simply providers of finance. The management team is a distinct and separate group. The company tax regime is an appropriate set of default rules, modified as necessary to accommodate unique features of other business forms.

Under that regime, dividends are not tax deductible, but double taxation is prevented by the attachment of imputation credits. All dividends, however funded, are taxable.

At present, other widely held entities are treated differently. Distributions from current-year income are, in effect, deductible while distributions from retained income are exempt.

In examining how to integrate widely held entities into a single tax regime, the Review examines three alternatives to imputation. It concludes that imputation should be the default approach, despite design challenges in areas such as discretionary trusts.

Pass through of preferences

Shareholders receive returns in two forms—dividends and capital appreciation. If it were not for tax differences, they would be indifferent to the source of the dividend.

The Review endorses the view of the 1990 Valabh Committee that dividends, like interest on debt, should be taxed whether or not it derives from a source that is tax-free within the company.

Current trust and partnership rules do however allow the flow-through of entity-level preferences other than losses to beneficiaries.

This would prove costly if trusts could be substituted for companies. Widely held trusts compete with widely held entities taxed as companies, including unit trusts and life insurance funds.

The same general rules should, in principle, apply to both. Current rules already treat trusts as companies where the rights and entitlements of contributors are sufficiently well defined.

The Review, after examining the issues involved, concludes that imputation without pass-through can—with modifications if necessary—be applied to widely held discretionary trusts, much as it is applied currently to unit trusts.

Widely held partnerships also tend to have relatively clearly defined property rights based on contract. Under an imputation regime, a widely held partnership would be defined as a widely-held company, pay tax on all partnership income, and distributions would carry imputation credits.

The Review wishes to explore these options further, and invites submissions on the application of the company regime to widely held partnerships and trusts.

Taxation of closely-held entities

A closely held entity regime has to recognise the close economic connection between the owner, entity and its underlying assets. It should minimise the extent to which taxpayer choices are influenced by differences in tax treatment among entities.

The Review envisages that closely held *companies* would be subject to the qualifying company regime, closely held *partnerships* would be subject to the present partnership rules, and closely held *trusts* would come under the present trusts regime.

Wide/close held entity boundaries

The key priorities in defining the boundary between widely and closely held entities are to:

- Reduce the ability of widely-held entities to seek tax advantages by recharacterising themselves as closely held; and
- Ensure the rules avoid undue complexity.

Charities

These recent Government *Tax and Charities* discussion document proposes a number of changes, and also defines three options for amending the definition of ‘charitable purpose’:

- The status quo safeguarded by registration and a possible government veto
- The same safeguards plus a new definition based on guidelines and applied by an independent body
- A narrowing of the definition to the relief of poverty, which is included for discussion purposes only.

The Review will follow with interest the outcome of this document and its proposals.

International Tax

Introduction

Taxation of inbound investment (income earned in New Zealand by non-residents) and outbound investment (income earned offshore by New Zealanders) have been controversial policy areas for 15 years. They are complex.

They impact on mobile corporates and high-worth individuals who are very responsive to tax, so the stakes are high.

Globalisation is challenging the ability of governments to tax such income, but the time has not yet come for New Zealand to move away from taxing income from capital.

Theoretical Framework

The three income tax bases involved are: residents’ New Zealand income, and their offshore income; and non-residents’ New Zealand income. The offshore income of non-residents is generally beyond our reach.

Which bases should be taxed, how, and by how much, to achieve outcomes that are ‘best for New Zealand’? The Review begins by analysing simplified economic models, to arrive at insights not otherwise available.

Theory: Taxing of non-residents

New Zealand depends on capital inflows for its development. It helps performance by introducing new technology, management, expertise and access to world markets. Direct foreign investment totalled $63.8 billion at 31 March 2000.

Tariffs on imported capital, like tariffs on imported goods, raise revenue at a high price, and make New Zealand a less attractive place for non-residents to invest.

They have plenty of other options. They will bring funds here only if their return after New Zealand tax at least equals their return elsewhere. They require international levels of post-tax interest and yield.

If our tax on them is high, it merely boosts the interest rate or yield they require to come here. So the tax burden does not fall on them. It passes to New Zealanders through higher costs of capital, less investment and depressed share prices. On that basis, it is best for New Zealand not to tax them at all. But there are two important qualifications to that conclusion:

1. Economic rents

First, foreign direct investment by multinationals to earn income that is specific to New Zealand may give them access to economic 'rents' or economic rents.

In that case, the tax may not deter them, and may not damage New Zealand. Reducing it may merely raise their after-tax profit without enhancing this country's national welfare.

2. Foreign tax credits

Many countries reduce the tax liabilities of their residents in their home country by the amount of any tax paid elsewhere. In that case, tax in New Zealand, if it is not higher than their rate at home, affects where tax is paid, but does not change the amount they pay.

In theory, those non-residents should be taxed by New Zealand up to the level of the foreign tax credits available to them in their own country.

Practical difficulties arise because the tax credit schemes vary by rate, timing and the restrictions placed on them, complicating the question of optimal design.

Theory: NZ residents' offshore income

The system presently used to tax income earned by New Zealanders offshore is a compromise that does not arise from the strict application of any policy framework. The Review has therefore thought carefully about policy framework design.

Taxes paid to the New Zealand government contribute to national wellbeing. Taxes paid to foreign governments do not. It will be in the national interest for New Zealanders to invest offshore only when the return after foreign tax is higher than the pre-tax return of a similar investment in this country.

Residence principle

The idea that New Zealanders should be taxed at the same rate on the income they earn, here and abroad, subject only to a deduction of foreign taxes, is known as the *residence principle.*

On that principle, non-residents would not be taxed on the income they derive here. Most economists think a pure residence basis gives the best outcome for New Zealand. World welfare is, by contrast, maximised when investors choose the best investment available globally, regardless of tax.

New Zealand's obligations under double tax agreements reflect that world welfare view. New Zealand is therefore constrained in its ability to adopt the pure residence approach.

The 'see-saw' model

The right level, in theory, for tax rates on offshore investment, approximates the following equation:

Average net NZ rate on NZer's foreign sourced income
=
Tax rate on New Zealand sourced income
minus
Net effective NZ tax rate on income sourced by non-residents from NZ.

This implies that when either of these two rates is high, the other rate should be low. In line with that 'see-saw' principle, New Zealand will gain by:

- Allowing a deduction, not a credit, for foreign taxes paid by New Zealanders earning offshore income.
- Imposing uniform tax rate on all offshore income as it accrues, regardless of source. (Differences in treatment will distort residents' offshore investment decisions.)
- Taxing New Zealanders' offshore income at a lower rate than domestic income, to the extent that the cost of capital to New Zealand is raised by taxes on non-residents earning New Zealand sourced income.

Where tax on non-resident income earned in New Zealand raises their required pre-tax return in New Zealand, the burden of that tax is not carried by the non-resident. It passes to New Zealanders in the form of higher interest rates, higher costs of capital, lower levels of investment and lower national welfare.

Reducing the present level of New Zealand tax on non-residents' New Zealand income will, as a general principle, help to increase investment and improve economic growth.

Finally, tax policies, trends and rates elsewhere impact on our inbound investment. New Zealand should keep the tax rates of other countries in mind when setting its own rates.

Non-resident income earned in NZ

The sensitivity of inbound investment to New Zealand tax varies.

Debt finance, portfolio investment and direct foreign investment in goods and services intended for export are highly sensitive because substitutable investments are available in other jurisdictions.

Direct foreign investment targeting the local market is less sensitive because the non-resident cannot be a player in the market without investing here. Moreover, some of that investment is likely to be made in order to earn economic rents by exploiting the market.

Current rules compared with framework

At present, New Zealand imposes somewhat disparate effective tax rates on non-resident investors.

Equity is currently taxed significantly higher than debt, distorting their relative costs to New Zealand firms.

The Review concludes that it would be highly desirable to narrow the gap by reducing effective tax rates on investment in equity instruments for both direct and portfolio foreign investment.

Options for non-resident regime

Direct Investment

The review does not recommend any across-the-board reduction in company tax rates significantly below the top personal marginal rate. It is costly, and not well targeted to a reduced burden on non-resident investors. It sees advantage in:

- Somewhat reducing the effective rate on foreign direct investment
- And reducing the effective rate on equity to narrow the present debt/equity gap.

The Review seeks submissions on the size of the reduction. It would like New Zealand's regime to 'stand out from the crowd'.

The Review outlines options to pursue those objectives:

1. A reduction in company tax rate for non-residents.

   An Annex to the report outlines and seeks submissions on a proposal to impose 33% on companies which are entirely New Zealand owned, 15% on companies entirely owned by non-residents, and set intermediate rates for mixed ownerships.

   A 1% change in the non-resident rate reduces government revenue by $45-50m. The fiscal cost is estimated at $380m for a 25% rate rising to $855m for a 15% rate.

2. If it proves that significant economic rents exist, the reduction could apply only to foreign equity investment in new productive activities, or for example new productive activity in export industries, or new productive activities in selected industries or regional development zones.

The review notes that limiting the concession to new activities alone may have unintended consequences.

Interest

The Review advises against any material increase in tax rates on interest paid to non-residents, but sees possible merit in a small AIL increase to 3% (2% after tax).

Portfolio Equity

Two options targeting separate effective tax rate components warrant further consideration, with a case for implementing both of them:

1. A choice for companies paying 'supplementary dividends' between Non-resident withholding tax (NWRT) and an approved issuer levy (AIL) at the level applied to debt.

2. An increase in the present Foreign Investor Tax Credit (FITC).

Taxing NZers' offshore income

New Zealand's current international regime does not satisfactorily reflect the insights either of economic theory or the business community. The current compromise in the taxation of New Zealanders' offshore income is unsound. It needs change.

Key design issues

Key design issues include the timing of income inclusion, the availability of foreign tax credits, and the taxation of capital gains in offshore equity investments in non-grey-list countries.

Approach of Review to design

Our double-tax treaties require us to allow tax credits. Differences in the approach of other jurisdictions to tax credits mean that foreign investors do not face a single uniform 'net' rate of New Zealand tax on New Zealand sourced income. The Review is considering two possible approaches:

- Allow tax credits across the board for tax-treaty and non-tax treaty countries.
- Or use the 'Risk-free return method' outlined in the Report to introduce a fundamentally different approach to taxing equity investments. Evaluation of this option will require careful consideration of the incentives likely to be created by this option, and the likely reaction of treaty partners.

Repeal of grey list

The present grey-list framework creates incentives for New Zealanders to invest in high-tax grey-list countries. This does not maximise national welfare. The Review recommends repealing the grey list, providing repeal occurred as part of a satisfactorily revised regime for offshore investment.

Policy options for offshore investment

The review outlines two broad options to consider the context of grey-list repeal:

1. A *modified CFC approach* with an active/passive distinction for taxing foreign direct investment by New Zealand residents outside a designated list of low tax/tax haven countries.
2. An *RFRM approach,* involving either foreign investments only, or both foreign and domestic investments.

   The RFRM approach would increase the relative New Zealand tax burden of grey list investments compared with foreign investments elsewhere, and create some helpful movement of investment flows towards lower tax countries.

The analysis of the costs and benefits of these options is set out in the full report.

Australian and triangular issues

The Review awaits the outcome of bilateral talks between the Australia and New Zealand governments. When they are completed, the Review will consider whether any unilateral steps would be desirable.

Foreign trust rules

The review has not yet considered the foreign trust rules.

Attracting high net worth immigrants

In general, residents are taxed on their worldwide income, but non-residents are taxed only on their New Zealand sourced income. The prospect of facing New Zealand tax on their world income may deter individuals of high skill and net worth from taking up residence in New Zealand.

Because that does not enhance national well being, the Review is considering a domicile rule similar to the United Kingdom's, where residents not domiciled in New Zealand would be exempt, perhaps for 6-8 years, from FIF and CFC rules.

Capping an individual's maximum tax liability at $1 million a year could also be considered as a means to reduce the perceived disadvantage of New Zealand tax residence.

The issue of capping the amount of income tax paid by any individual arose in discussions with submitters. An amount of $1m was raised as a possibility. It is the amount of income tax that would be paid by a person earning $2.6m a year. Under this idea, people earning $2.6m a year or more would simply pay $1m in income tax.

The proposal was directed at countering the increasing mobility of high-income individuals and encouraging such people from overseas to make New Zealand their economic base. It would have fiscal costs if applied to any existing New Zealanders, offset to the extent that residents in this category were encouraged to stay instead of leaving, and people overseas were attracted.

The proposal would also have to be judged against accepted notions of vertical equality. The Review has reached no conclusion but welcomes additional submissions on this issue.

Conclusion

The most appropriate direction for reforming tax of non-residents may be to refine the current regimes so that New Zealand taxes them only where the economic incidence of the tax is not shifted to New Zealanders.

Successive governments have found it difficult to develop an appropriate sustainable framework for taxing the foreign sourced income of residents.

The Review sees merit in trying to design a suite of regimes with a core based on 'risk-free rate of return' methodology, and will further examine the feasibility of this course.

Savings

'Saving' refers to all additions to a person's net worth, including financial assets, housing and small businesses. Tax is just one of a large number of factors that impinge on their motivation to save, ability to save, and the form in which they save.

Policy since 1988 has been to treat income from savings identically to other forms of income. We have a TTE regime—savings are funded from taxed income, the income earned by the savings is taxed, but withdrawals of savings are tax-free.

Aggregate savings by households, business and government are currently estimated at 2% of GDP. A 'true' measure would include e.g. investments in education and consumer durables, and would probably be more than 20% of GDP.

The more we save as a nation, the better off the nation will be in the future. But the average rate of return on our savings is equally important. Our lacklustre economic growth in the last 20-30 years owes more to poor returns than low investment. It is very important to ensure that the tax system does not induce investment in poorer performing assets.

If a savings problem does exist here, it is because national savings, not private savings, are too low. The Review is not convinced that tax concessions would benefit national saving, and therefore favours retaining the present TTE regime.

However, people's choices on how they will save are very sensitive to tax considerations. Concessions on housing, for example, encourage widespread investment in housing, which has lower financial returns than returns on financial assets.

Using the Risk-Free Return Method of taxing some forms of capital could benefit savers by reducing the impact of inflation on tax. It offers a more neutral treatment of different forms of saving, and promotes investment in the highest yielding uses.

If that approach is not possible, no tax concessions should apply to savings, but disparities in the tax treatment of returns on saving could be addressed. They include:

- Owner-occupied housing
- The non-deductibility of mortgage interest, which encourages paying off the mortgage ahead of other forms of saving.
- Disparities in the treatment of closely substitutable savings vehicles, e.g. unit trusts and superannuation funds.

If, despite our conclusions, governments want to introduce savings concessions, the present regime can be rearranged in a variety of says, but it is difficult to design 'good' savings incentives. The transition to new concessions may also involve considerable fiscal costs for uncertain gains.

One of the less costly approaches would be to apply a reduced rate to earnings on savings—the middle T in TTE—to create what might be called a TtE regime. The Review surveys the design difficulties involved in policing the boundaries of the concession, and outlines options for doing so.