Business Tax Review

A discussion document

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FOREWORD

The Business Tax Review is a policy priority for the government and a key condition of the Confidence and Supply Agreements with United Future and New Zealand First.

This discussion document is a first step in a dialogue on a range of possible business tax initiatives that will help transform the New Zealand economy.

The initiatives are designed to enhance productivity and boost New Zealand's international competitiveness. Company tax reductions would assist all profitable companies and increase our competitiveness with Australia. Productivity gains could also be promoted by supporting innovation, expanding our export base and building a more skilled workforce. Reducing the cost of investing in assets which increase productivity also has a part to play.

The amount of tax businesses pay is not the whole story. We can also direct our efforts to reducing compliance costs for small businesses, since compliance costs are a burden borne disproportionately by small businesses – and New Zealand has many small businesses. That would free up time for business owners to concentrate their attention on innovation and growth.

We need you, the public, to tell us which measures you believe will best boost New Zealand's productivity in the future and their relative importance. We also need to hear any other ideas you have that should be explored.

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Chapter 1

INTRODUCTION

1.1 The government is committed to fostering an environment that enables New Zealand businesses to grow and compete in a global economy. Continued transformation towards an economy that has higher levels of productivity, business investment, innovation and skills is central to the government's economic policy. Tax policy has an important role to play in support of these objectives. The tax policy initiatives discussed in this document are examples of measures that may further boost New Zealand's strong economic growth, which has been consistently ahead of the OECD average over the last six years.

1.2 This discussion document is a first step towards engaging with the public on tax reforms that will help transform the New Zealand economy. Its purpose is not only to obtain the public's views on the initiatives described here, and their relative priorities, but also to elicit suggestions on other initiatives that should be explored.

Increasing productivity and competitiveness

1.3 The objective of the Business Tax Review is to provide better incentives for productivity gains and improved competitiveness with Australia. This is a policy priority for the government and a key condition of the Confidence and Supply Agreements with United Future and New Zealand First.

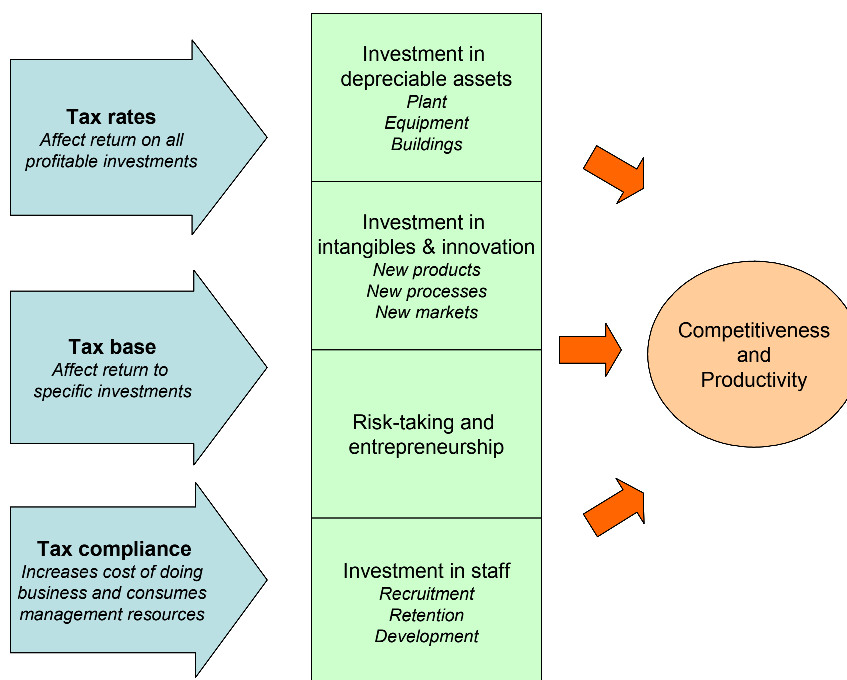
1.4 Support for business can be delivered through tax rate reductions, changes to the tax base or compliance cost reduction measures. In recent years the government has focused on changes to the tax base and compliance cost reduction, introducing changes to depreciation, provisional tax and other simplification measures. The Review suggests a reduction in the company tax rate and a range of possible tax base changes and compliance cost reduction initiatives designed to increase competitiveness, productivity and the potential for growth.

1.5 Figure 1 illustrates how business tax affects productivity and competitiveness. Central to this concept is the wide range of ways that businesses can invest in expanding and improving their performance – including investment in depreciable assets, investment in intangibles and innovation, risk-taking and entrepreneurship, and investment in staff. Tax rates influence investment in all these areas, by affecting the return to investments.

1.6 The design of the tax base can also affect all these investments, but is usually focused on particular investments. For example, changes to depreciation affect investment in depreciable assets and changes to the tax treatment of R&D primarily affect innovation. Tax compliance affects all investments directly by increasing the costs of doing business and indirectly by consuming scarce management resources. In turn, these investments all influence labour productivity and competitiveness.

1.7 Business investment in plant and equipment will make labour more productive and enable workers to earn higher wages. It is also important to highlight the role of human capital: tax policy changes that increase skills will also add to labour productivity and growth.

Figure 1. Tax linkages to productivity and competitiveness



What can be spent?

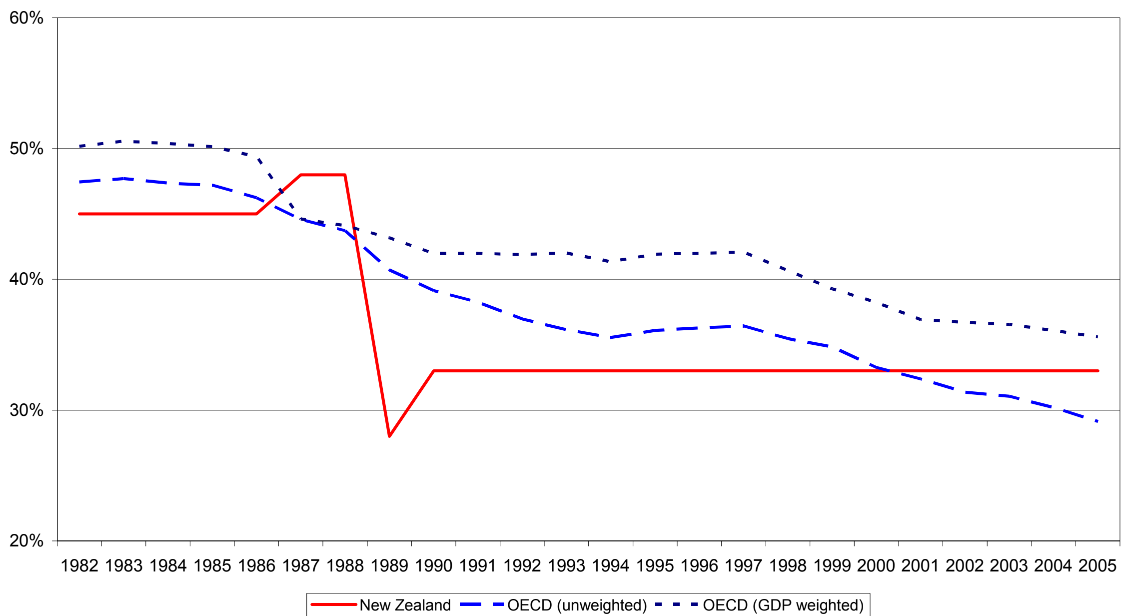
1.8 The government's fiscal strategy has delivered prudent fiscal management over the past six years. Its revenue strategy contributes to this by seeking to maintain the tax to gross domestic product ratio at around current levels. As indicated in the recent Budget, the government faces very tight fiscal constraints over the next few years. Nevertheless, there may be some fiscal headroom for tax changes proposed in the Review.

1.9 The government will give consideration to how income tax is levied to meet its equity and spending objectives at lowest economic cost. Priorities must be established and choices made to ensure that any measures advanced represent the best value in light of the objectives of the Review. The government seeks feedback on the relative merits of the initiatives presented in this document in relation to those objectives. Not all the initiatives can be progressed, and informed trade-offs will have to be made.

Pressures on New Zealand's tax system

1.10 New Zealand's tax system currently faces a number of pressures. As figure 2 illustrates, over the last 20 years there has been a downward trend in statutory company tax rates in OECD countries. The same downward trend is also evident in other countries.

Figure 2. NZ and OECD average corporate tax rates[1]



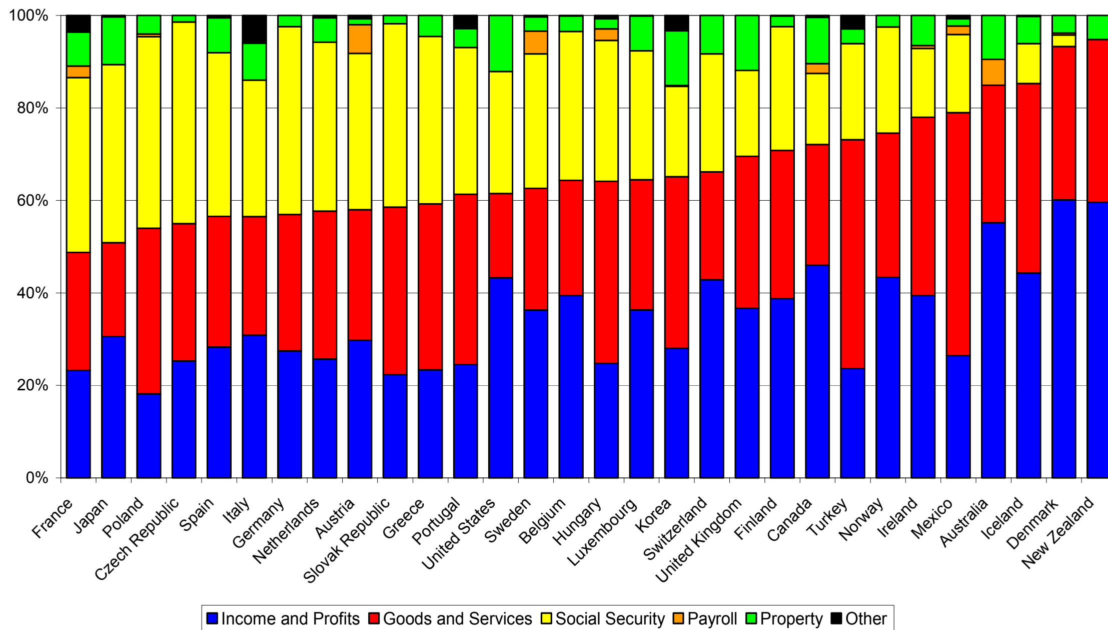
1.11 A company tax rate higher than those of our trading and investment partners puts pressure on the New Zealand tax system because it creates incentives to stream profits to countries that have lower tax rates. In particular, maintaining a competitive tax rate is important in relation to Australia, which has a 30 percent company tax rate, since almost half of foreign direct investment into New Zealand is Australian.

1.12 Other economic costs arise from a higher company tax rate. Higher company taxes in New Zealand create an incentive for New Zealand companies to relocate or be established elsewhere. They also discourage internationally mobile firms from locating their businesses in New Zealand.

[1] Source: OECD and Institute of Fiscal Studies.

1.13 Statutory corporate rates are not the whole story, however. Many countries have other taxes that can impinge on productivity and competitiveness. New Zealand could afford a lower statutory company rate if some of these other taxes were adopted, but this need not benefit New Zealand. For example, Australia has a comprehensive capital gains tax, state payroll taxes and a number of stamp duties. The last include duties on property sales, mortgage registration and transfer of securities. Moreover, New Zealand, like Australia, has a full imputation scheme. Many other countries impose higher taxes on dividend payments than New Zealand does. Figure 3 illustrates the contribution other taxes make to tax revenues around the world.

Figure 3. Sources of tax revenue worldwide, 2003[2]



The importance of making choices

1.14 Although the main constraint is fiscal, there are also government, private sector and Parliamentary resource constraints on the tax policy process that make it necessary to choose among the initiatives outlined in the discussion document.

[2] Source: OECD.

1.15 In prioritising measures, it is also important to have regard to the principles of good tax policy design.

- **Fairness**. The government is committed to a fair distribution of the tax burden, reflecting the ability to pay of different individuals.
- **Efficiency**. The tax system should not distort private decision-making. Under an efficient tax system, resources flow to the most productive areas, which will enhance productivity and growth. Exemptions and concessions should be considered in the context of the full range of policy options and accepted only when the benefits for New Zealand can be shown to outweigh the costs.
- **Simplicity**. Measures with low compliance and administrative costs are to be preferred as long as they are consistent with other objectives.
- **Integrity**. The government supports a robust tax system in which people pay their intended rates of tax and appropriate tax revenues can be obtained to fund government programmes.

Deep company tax cuts

1.16 The Review has also considered deep company tax cuts. However, total tax revenues raised need to be sufficient to support high quality government services. That means that deep rate cuts are not an option by themselves. Some other countries have a significantly lower company rate but they will also typically have other taxes. A payroll tax has been considered as a possible replacement revenue source. After careful analysis, the government is not convinced that this would be an effective means of achieving its objectives, and the option has not been developed further. The difficulties with this approach are discussed in chapter 4.

Summary of possible initiatives

1.17 A summary of the possible initiatives presented in the discussion document, together with an indicative fiscal cost when it is available, is provided below. As is standard practice, all fiscal costs are reported on a static basis so that any behavioural changes are ignored. To the extent that these measures enhance growth, static costings will tend to overstate costs. Any revenue raised as a result of the possible initiatives would be available to fund other productivity-enhancing measures.

POSSIBLE INITIATIVES

Para Ref	*Description*	*Cost per year ($m)*
Tax rate measures		
2.7	Reduction in the company tax rate to 30% (from 33%)	540
Tax base measures		
3.8 – 3.26	Targeted tax credits for • R&D activities, • export market development activities, and • skills improvement	 45 to 350 Uncosted Uncosted
3.27 – 3.28	Deferral of losses from significant upfront expenditure (extension to Budget 2005 R&D measures) to allow losses to carry through a shareholder change	Uncosted
3.29 – 3.35	Deduction for other "blackhole" expenditure, such as losses on buildings	150 to 300
3.37 – 3.40	Increased depreciation loading on new assets to: • 30% • 40%	 120* 230*
3.41 – 3.42	Reduced depreciation loading on new assets to: • 10% • 0%	 (120)* (250)*
3.43	Aligning depreciation loading at 20 percent on new and second-hand assets	90*
Tax compliance measures		
3.46 – 3.47	Increasing low value asset write-off threshold (figures given for increase from $500 to $1,000)	170*
3.48 – 3.50	Reducing compliance costs for assets that reach a low depreciated value (say, $100)	Uncertain
3.51	Increasing the threshold for taxpayers allowed to submit an annual FBT return	0**

* These are average costs over the first five years. The cost of depreciation changes is a matter of timing, and no allowance is made for reduced depreciation outside the five-year period.

** While there should be no difference in aggregate tax collections in any fiscal year, there will be a time-value of money cost.

When will the changes take place?

1.18 If any of the measures were to be enacted, the application date would be from the 2008/09 year, subject to this being administratively and fiscally feasible.

How to make a submission

1.19 The government invites submissions on the relative merits of the initiatives presented, having regard to the revenue and resource constraints and tax policy principles discussed earlier. The government also welcomes submissions on any similar measures that meet the objectives of the Review. Those who make submissions are asked to prioritise between these initiatives.

1.20 Submissions should be made by 8 September 2006 and be addressed to:

Business Tax Review
C/- Deputy Commissioner
Policy Advice Division
Inland Revenue Department
PO Box 2198
WELLINGTON

Or email: policy.webmaster@ird.govt.nz with "Business Tax Review" in the subject line.

1.21 There is a very tight reporting timeframe and extensions to the 8 September deadline are not feasible. Late submissions cannot be considered.

1.22 Submissions should include a brief summary of major points and recommendations. They should also indicate whether it would be acceptable for officials from Inland Revenue and the Treasury to contact those making submissions and to discuss their submission, if required.

1.23 Submissions may be the subject of a request under the Official Information Act 1982, which may result in their publication. The withholding of particular submissions on the grounds of privacy, or for any other reason, will be determined in accordance with that Act. Those making a submission who feel there is any part of it that should be properly withheld under the Act should indicate this clearly.

Chapter 2

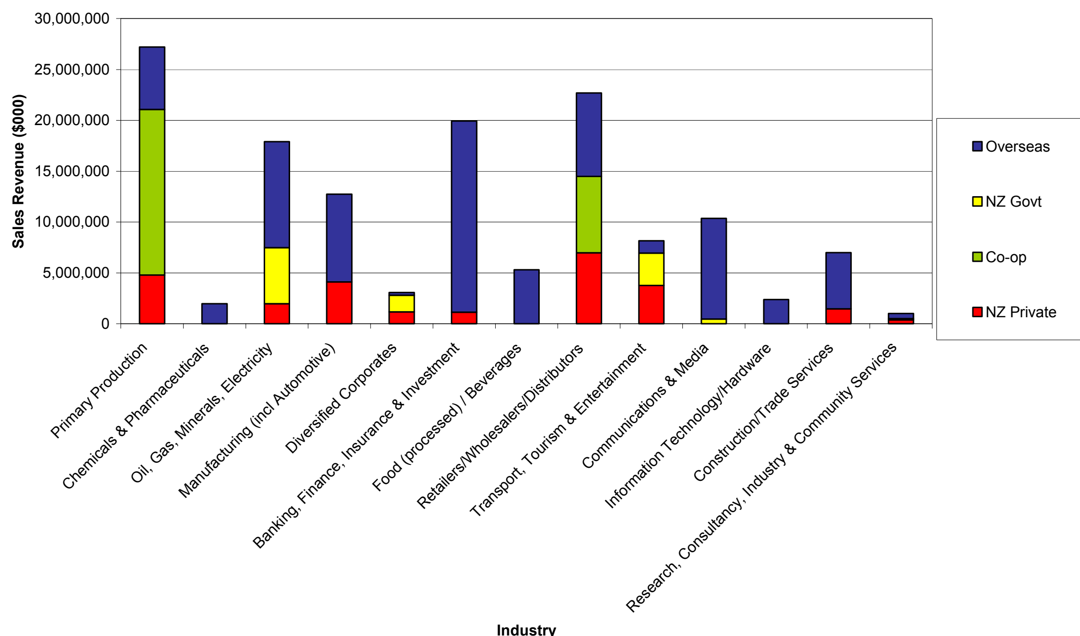
COMPANY TAX RATE REDUCTION

2.1 This chapter discusses the advantages and disadvantages of a reduction in the company tax rate to 30 percent, which would align our company tax rate with that of Australia.

2.2 An important consideration for the government is how New Zealand-owned businesses would benefit from a tax rate reduction. The changes considered in the next two chapters would affect different businesses differently. For example, reducing the company rate alone would benefit only profitable businesses that choose to operate as companies, while the tax base and compliance cost measures would benefit both companies and unincorporated enterprises.

2.3 An important question is how best to promote productivity and competitiveness. The extent to which businesses become more dynamic and innovative as a result of the possible initiatives may be influenced by other factors such as their profitability, ownership and size. Some sectors of the economy – for example, finance and insurance, mining and electricity, gas and water – are relatively more profitable than others, and would benefit more from company rate reductions. Thus the impact of company rate reductions on productivity will depend on how companies in these sectors respond: for example, whether they choose to innovate and invest more in New Zealand.

Figure 4. Top 200 firms ownership by industry, 2005



Source: Management New Zealand Database of the top 200 New Zealand Firms: Courtesy of MED.

2.4 Figure 4 shows the ownership structure of New Zealand industry. It highlights that the largest businesses in many industries are majority foreign-owned, while co-operatives and government-owned businesses are also important in some industries. This may be important, if ownership affects the ways that businesses respond to changes in the company tax rate, and other business tax changes.

2.5 The tax base and compliance measures would be likely to benefit different sectors and different types of businesses. An R&D tax credit, for example, would favour entities with increasing levels of R&D and innovative businesses that make losses in their early years.

2.6 Compliance cost measures may often benefit smaller firms which have limited scope to absorb such costs. Although New Zealand is itself a small country, the proportion of small firms (those with less than 20 employees) is within the OECD average, so compliance cost measures should not be given special consideration on this ground alone.

Reducing the company tax rate

2.7 To reduce New Zealand's company tax rate to 30 percent, and so align it with the Australian company rate, would have a cost of $540 million a year.

2.8 Reductions in the company tax rate would improve New Zealand's productivity and growth in a number of ways.

2.9 Most business activity in New Zealand is undertaken by companies. Reducing New Zealand's company tax rate would boost the competitiveness of New Zealand-based companies. It would encourage increased inbound investment by firms that have decided to locate in New Zealand. As a result, it would tend to increase New Zealand's stock of plant, equipment and buildings which would, in turn, boost labour productivity and wage rates.

2.10 It is not possible to measure and tax economic income perfectly, so income taxes will inevitably distort investment decisions and impede corporate capital from flowing to its most productive uses. A reduced company tax rate would boost capital productivity by reducing these distortions.

2.11 Reducing New Zealand's company rate would also reduce incentives for firms to stream profits away from New Zealand. Profits can be diverted from New Zealand by way of artificially low sales prices or excessive interest deductions, for example.

2.12 Reducing the company tax rate also has a number of disadvantages. There is growing evidence that the gap between the company and top personal tax rates causes pressures on the integrity of the personal tax system. At present, both companies and trusts are taxed at a rate of 33 percent, while the top personal marginal rate is 39 percent. This gap provides incentives for companies and trusts to be used to shelter income from higher rates of personal tax, so reducing the company tax rate would increase these incentives even further.

2.13 For companies, the tax-sheltering benefits are generally a matter of timing only because the imputation system ensures that profits are taxed at the marginal tax rates of shareholders when they are ultimately distributed as dividends. Thus substantial benefits are available only if funds are sheltered in the company for a long period of time.

2.14 For trusts, the tax-sheltering benefits are permanent because income that is taxed as trustee income at a final rate of tax of 33 percent can be distributed to beneficiaries in the future without any further personal tax. There appears to have been growth in tax sheltering between 1998/99 and 2003/04.[3]

2.15 Many countries have larger differences between the company tax rate and the top personal marginal rate than New Zealand has. At first glance, it might seem that a moderate reduction in the company rate to 30 percent should not create greater problems for New Zealand than those faced in many other countries. However, other countries also have features in their tax systems which help to protect them from exploitation of the difference between tax rates.

2.16 Another disadvantage of a company rate cut is that, by itself, it would not ensure that the benefits of the cut were passed through to New Zealand-resident shareholders. The incentive to invest in domestic companies is increased only to the extent that income is retained in the company.

2.17 Finally, cutting the company tax rate would be of benefit only to businesses operating as companies, and many businesses are not incorporated. For example, some businesses may efficiently operate as unincorporated sole proprietorships or as partnerships of individuals.

Other tax rate initiatives pursued outside the business tax review

2.18 The government acknowledges that company tax rate changes may have implications for the design of the wider income tax system. For example, briefing papers to the Minister of Revenue discussed proposals which would combine a reduction in the company tax rate to 30 percent, with a corresponding reduction of the top personal marginal tax rate to 36 per cent and an increase in the trustee rate to 36 percent.

2.19 Changes to the system of personal income taxation or to the taxation of trusts, however, are outside the scope of the Business Tax Review. Any changes in those areas will need to be considered within the context of the overall personal tax regime and have regard to the revenue constraints and tax policy principles discussed in chapter 1.

[3] For example, tax paid by trusts grew by 105 percent, tax paid by companies grew by 71 percent, and tax paid by individuals other than salary and wage-earners grew by 16 percent over this time. Over the same period trustee income (taxed at a 33 percent rate) grew by 256 percent, whereas beneficiaries' income (taxed at the rate of beneficiaries) grew by only 28 percent. Changes to the minor beneficiaries rule may account for a little of this large growth in trustee income.

The consequences for savings vehicles

2.20 Individuals can save directly or they can save through a number of savings vehicles. If there were to be a reduction in the company tax rate, the consequences for savings vehicles would need to be considered. Savings vehicles include the proposed portfolio investment entities (PIEs); superannuation funds; unit trusts and group investment funds; investment companies; and life insurance companies.

2.21 The tax treatment of these entities is as follows:

- Under the rules proposed in the taxation bill currently before Parliament, income from portfolio investment entities will be taxed on a flow-through basis at investors' marginal rates, capped at 33 percent.
- Superannuation funds are taxed at the trustee rate of 33 percent.
- Unit trusts and certain group investment funds are taxed as companies at a rate of 33 percent. If a unit trust distributes its profits, full imputation operates, and the income ends up being taxed at the marginal tax rates of resident shareholders. However, many unit trusts do not distribute profits, instead accumulating earnings within the trust, and members who want to leave the fund can sell their interests to the fund manager. When that happens, the company tax rate on the unit trust will generally be a final tax provided units are held on capital account.
- Investment companies are taxed as companies, dividend payouts are subject to the imputation system, and sales of shares on the open market are often treated as capital gains.
- The policyholder base of life insurance companies is taxed at a rate of 33 percent.

2.22 If the company tax rate were reduced, the government would need to consider how best to tax these different savings vehicles. In principle, it would be desirable for income to flow through and be taxed at the marginal rates of the ultimate beneficiaries of the income, although that would not always be feasible. For example, in the case of investment companies with multiple classes of shares or with both shares and options, it would not be clear who the ultimate beneficiaries were. It would also appear to be inconsistent with the proposed tax treatment of PIEs.

2.23 Investing through a savings vehicle has both costs and benefits. Costs include management fees, while benefits include the ability to diversify risks. As much as possible, it is desirable that taxes do not bias decisions on how to invest or on which type of savings vehicle to invest through.

2.24 If the company tax rate were to be reduced, there would appear to be two viable options for the taxation of savings vehicles:

- taxing all savings vehicles at the new company tax rate; or
- continuing to tax all (or most) savings vehicles at a 33 percent tax rate.

2.25 Although a lower rate on savings vehicles appears attractive, there is an obvious concern with taxing all savings vehicles at the new company tax rate. Reducing the company rate only would increase the bias against direct investment for individuals on the top marginal tax rate, and it would similarly distort the decisions for individuals on the 33 percent marginal rate.

2.26 Moreover, over the longer term, if international pressures were to lead to further reductions in company tax rates, there would be a growing divergence between the tax rates applying to similar types of personal income, depending upon how the underlying assets were held.

2.27 Continuing to tax all (or most) savings vehicles at the 33 percent rate would mean that superannuation funds, group investment funds and unit trusts would no longer be taxed at the same rate as companies. This would not increase the bias in favour of such vehicles for taxpayers on the top marginal rate. Arguably, it would increase fairness because top marginal rate taxpayers investing through PIEs would bear a closer tax burden to that of direct investors. However, it would reduce the attractiveness of KiwiSaver relative to direct investment for taxpayers on the top personal marginal rate.

The transition

2.28 Any change in company tax rates would give rise to a number of transitional and consequential issues, although the preference is not to take any measures in this area unless there is a good case to do so. In particular, any company rate changes would require consideration of consequential changes to the areas of provisional tax, imputation, resident withholding tax and a number of the international tax rules.

Submission points

Submissions are sought on the following matters in particular:

Tax rate changes

- The desirability and priority of a reduction in the company tax rate to 30 percent.

Savings vehicles

- The most appropriate tax treatment of savings vehicles if there were to be a reduction in the company rate.

- Whether there are viable ways of including investment companies in the set of savings vehicles if the company tax rate were to be reduced and the treatment of savings vehicles remained unchanged.

Chapter 3

TAX BASE AND COMPLIANCE COST MEASURES

3.1 Productivity and competitiveness may also be fostered by changes in the company tax base and by reducing compliance costs, building on the achievements of Budget 2005's business tax package. Some of these changes are likely to come at a fiscal cost, which would have to be taken into account when prioritising their importance relative to each other and to tax rate changes. Other changes may raise revenue that could be used to provide scope for reductions in tax rates or other tax base or compliance cost initiatives.

3.2 With company rate cuts, much of the benefit may flow to highly profitable, foreign-owned firms, without necessarily doing much to boost competitiveness and productivity. Some of the tax base initiatives discussed in this chapter may be better targeted at doing that.

3.3 The tax base and compliance cost initiatives discussed in this chapter would benefit both companies and unincorporated enterprises. Compliance cost measures may often benefit smaller firms, for which these costs may be high relative to income.

3.4 Tax base changes would tend to benefit specific types of firms. For example, increasing depreciation rates would most benefit capital-intensive firms or an incentive for export market development would benefit firms breaking into new export markets.

3.5 The examples of tax base and compliance cost initiatives described in this chapter are not intended to be an exhaustive list of possible measures. The public and tax professionals are invited to suggest similar base and compliance initiatives that promote productivity and competitiveness.

3.6 The examples discussed in this chapter are grouped under two themes:

- improving productivity, business investment, innovation and competitiveness through tax base initiatives; and
- improving productivity by reducing compliance burdens.

Tax base initiatives

3.7 A number of tax base initiatives could improve productivity, business investment, innovation and competitiveness. Several examples are described here.

Targeted tax credits

3.8 Although it is generally undesirable to favour some business activities over others, tax concessions for a particular activity may be justified when:

- there is under-investment by business in an activity because the investing firm does not capture all of the benefits of the investment – the investment results in wider benefits to New Zealand; and
- the government can intervene effectively, with the benefits of the intervention outweighing the costs; and
- delivery of assistance through the tax system is the most efficient mechanism to provide that support.

3.9 The government considers that there are wider benefits to New Zealand when businesses invest in R&D, export market development and enhancing skills in the workforce. It therefore currently provides support by way of various grant programmes to encourage business investment in those areas.

3.10 These activities could be further supported by way of tax concessions, and, in relation to R&D at least, there is evidence that tax credits can be a more effective way of supporting these activities than discretionary assistance. In relation to R&D, this would bring New Zealand into line with other OECD countries, three-quarters of which provide non-discretionary support for R&D through the tax system. (Support through the tax system for export market development and skills development is less common.)

3.11 A government objective in designing the concessions is to reduce to a minimum the bureaucracy that can accompany such measures. There are several key design issues: the definition of "eligible expenditure"; approval of expenditure; whether the support is incremental or volume-based; the level of assistance; and the delivery mechanism.

Definition of "eligible expenditure"

3.12 A clear and objective definition of the relevant expenditure is critical for the workability and integrity of a tax credit mechanism. The challenge is to have definitions that are sufficiently broad to capture expenditure that generates wider benefits, but are sufficiently precise to be clear and workable. These definitions would need to cover businesses' own expenditure and their expenditure on activities delivered by external providers.

3.13 For R&D, there are numerous precedents in New Zealand and overseas which could be used. The definitions currently used in the Income Tax Act are based on accounting standards set out in Financial Reporting Standard 13. The system of discretionary grants administered by the Foundation for Research, Science and Technology uses a definition which summarises the Frascati manual (an OECD manual written to assist in the collection and issue of R&D data).

3.14 In relation to enhancing skills, there is less guidance. A range of definitions is possible, from the narrow – for example, foundation numeracy, literacy and language skills – through to broader definitions that include, for example, trade and technical skills that are not firm-specific.[4] There could also be an overriding requirement that courses be externally provided, NZQA-approved and provided to employees who are New Zealand citizens or permanent residents.

3.15 The current discretionary grant programme for assisting export market development has a definition of "eligible expenditure" that includes market visits, in-market representation, advertising and promotion, marketing materials, market research, and trade fairs. At its broadest, the initiative could target the same expenditure. Alternatively, it could apply to a more limited range of this activity. There could also be overriding requirements that businesses receiving the tax credits are below a certain size (e.g. a turnover of less than $50 million), that the market development is not business as usual (e.g. involves taking new products to new markets), and that the businesses can only receive a limited amount of tax credit in any one year or in total (e.g. $100,000 in one year and $500,000 as a lifetime total).

Approval of expenditure

3.16 In some jurisdictions, such as Australia, those wishing to take advantage of tax concessions must first register or apply to a board for approval of their expenditure. This would be an option in New Zealand, although the government would prefer to minimise the bureaucracy this involves while still adequately monitoring the type of expenditure to which the concessions apply.

3.17 The preference, therefore, would be for selective audit of the expenditure (by an expert body, perhaps in conjunction with Inland Revenue) after it has been incurred. If this approach were adopted, it might also be possible for people to seek pre-approval from the expert body to increase certainty that the expenditure was eligible.

Incremental vs volume-based subsidy

3.18 The tax credit could be designed using an incremental or a volume-based approach. A volume-based credit provides tax relief in proportion to the total volume of eligible expenditure in each year. An incremental credit provides tax relief in proportion to the increase in the volume of eligible expenditure above a base.

3.19 There are advantages and disadvantages with both schemes. A volume-based scheme is less complex to design and administer – tax relief can be calculated at the level of individual companies, rather than groups, and is neutral as to when the expenditure is incurred.

[4] The evidence suggests there is under-investment in the development of generic skills that are easily transferred from one employer to another. Firm-specific training - in skills that are not transferable - does not suffer from the same problems.

3.20 An incremental scheme targets relief on new investment in R&D, market development and enhancing skills, and offers the same rate of relief for a lower cost. It seeks to avoid subsidising activity that would have occurred in the absence of the tax credit. However, it is more complex and more prone to tax planning. Ascertaining base year expenditure may also at times be difficult.

3.21 The government preference would be for an incremental approach, from a base year of 2004/05.

Level of support

3.22 International evidence around the level of assistance for R&D indicates that the effectiveness of government support for business R&D declines at levels beyond 14 percent of the R&D, though the optimal rate of support will vary across countries depending on their particular characteristics – such as size and industrial composition of businesses.

3.23 The government proposes a tax credit of between 7 to 15 percent for expenditure on all three types of activity – that is, each $100 of expenditure could generate a refundable tax credit or cash refund of $7 to $15. Based on a 33 percent tax rate, this is equivalent to allowing a deduction for 121 percent to 145 percent of eligible expenditure. These rates of support are consistent with those provided by R&D tax credits in most OECD countries. It would be reasonable to assume that a similar level of support should apply to market development and skills enhancement.

3.24 The preliminary estimated fiscal cost for this level of support to R&D is:

- for 7 percent to 15 percent support on an incremental basis, $45 to $90 million a year rising to $140 to $230 million a year after four years;
- for 7 percent to 15 percent support for a volume-based credit from $100 to $210 million a year rising to $200 to $350 million a year after four years.

3.25 It is not possible to cost reliably such support for export market development and skills training – this will depend to a greater extent on the detailed design and scope of eligible expenditure.

Delivery mechanism

3.26 Ideally, the delivery mechanism would ensure that the tax credits are available to entities in a loss position and to those exempt from tax. The credits should also retain their value for non-resident owners of New Zealand businesses and not be clawed back by other parts of the tax system – that is, should not lower the imputation credits available when dividends are paid. The government is considering whether a refundable tax credit will achieve this.

Deferral of losses from significant and upfront expenditure

3.27 Encouraging productive investment in the economy is a priority for the government. This was highlighted in the Budget 2005 measure allowing firms to defer claiming deductions for expenditure on R&D. Previously, firms found that tax deductions for R&D could effectively be lost. That happened when there was a breach of loss continuity as a result of bringing in substantial amounts of capital from new shareholders to commercialise and exploit their successful R&D activities.

3.28 It would be possible to extend this measure to a wider set of expenses to encourage productive investment. Doing so would ensure that early deductions which might normally be expected to promote investment did not inhibit a growing business from taking advantage of those deductions. Similar expenditure might include petroleum exploration and development or forestry. In examining possible areas for the extension of this treatment, the underlying policy intent of the continuity of ownership rules – to prevent the trading of losses – must be kept in mind.

Deductions for "blackhole" expenditure

3.29 "Blackhole" expenditure is expenditure that proves worthless, or leads to an asset which falls in value over time, and is neither immediately deductible nor amortisable. The government is looking at the problem on a case-by-case basis and has recently provided for the deductibility of patent and Resource Management Act application expenses. A number of taxpayers have raised concerns around specific examples of blackhole expenditure.

3.30 Dealing with these concerns would give taxpayers certainty that particular expenditure incurred for their businesses would benefit from tax deductions or amortisation. It would also ensure neutrality in the tax system and would not discourage taxpayers from undertaking certain types of expenditure and investment solely because of their tax treatment.

3.31 An example of blackhole expenditure is the lack of deduction for losses on the sale or demolition of a building. A loss incurred on the involuntary destruction of a building is now deductible, but the more general problem has been deferred for more careful consideration.

3.32 There can be a concern with allowing deductions for losses on assets, such as buildings, that combine price volatility with slow depreciation. Allowing a deduction for a loss in value when a gain would not generally be assessable appears anomalous in these circumstances.

3.33 A further concern is the potential for abuse. Taxpayers acquiring property with a view to demolishing and replacing an existing building may seek to attribute much of the value of the property to the building rather than the land. While this may be limited by professional valuations, there is considerable variability and uncertainty in the valuation process.

3.34 If allowing a deduction for losses on buildings were to lead to .5 to 1 percent of the depreciated value of the building stock being written off in any year, it would have a fiscal cost of $150 million to $300 million a year.

3.35 Another example of blackhole expenditure is the cost of certain feasibility studies. Allowing such expenditure to be deducted or amortised would clearly have a fiscal cost, though it is not possible to estimate it with any accuracy.

Adjusting depreciation loading for new assets

3.36 There are two possible directions for adjustments to depreciation loadings:

- increasing the loading from 20 percent to 30 percent or 40 percent; or
- reducing the loading to 10 percent or to 0 percent, with the revenue gained to be used to fund other measures.

Increasing depreciation loadings

3.37 Inflation produces a tax bias that favours investment in longer-lived assets relative to shorter-lived assets. Allowing depreciation loading is a relatively simple way of reducing this bias.

3.38 Accelerated depreciation reduces the cost of capital goods for taxation purposes and promotes investment. By itself, such a policy is likely to lead to capital deepening and add to labour productivity, which in turn is likely to increase GDP growth. New Zealand currently allows a loading of 20 percent to be added to the depreciation rate for most new assets. One option is to increase the loading to 30 percent or 40 percent, to reduce further the cost of capital goods and promote investment.

3.39 Increasing the loading, however, would increase the extent to which risk-adjusted returns for some investments fall short of their actual cost. Encouraging investment that is not profitable, in the absence of tax, would tend to reduce national welfare, as the cost of financing the investment more than offsets the increased level of production.

3.40 The fiscal cost of increasing the loading has been estimated (excluding buildings) at:

Year	**1**	**2**	**3**	**4**	**5**
30% depreciation loading (cost)	$50m	$110m	$130m	$140m	$150m
40% depreciation loading (cost)	$90	$220m	$260m	$280m	$280m

Decreasing depreciation loadings

3.41 An alternative option would be to reduce or remove the loading. This would raise revenue that could be made available for funding cuts in tax rates or other tax changes. Australia partly funded its company tax rate cut by removing accelerated depreciation.

3.42 The revenue gained from such a measure has been estimated at:

Year	1	2	3	4	5
0% depreciation loading	$90m	$230m	$290m	$320m	$330m
10% depreciation loading	$50m	$110m	$140m	$150m	$160m

Aligning depreciation loading on new and second-hand assets

3.43 Depreciation loading does not apply to second-hand assets. If the loading is retained for new assets, it can provide a bias against firms acquiring second-hand assets. That can lower productivity by standing in the way of assets being acquired by their best users. The estimated fiscal costs of extending the current 20 percent loading to second-hand assets are set out below.

Year	1	2	3	4	5
	$30m	$90m	$110m	$115m	$110m

Improving productivity by reducing tax compliance burdens

3.44 Tax compliance activities impose burdens on business by consuming funds and time. Reducing these burdens would allow business owners to focus more on business operations than compliance issues, and contribute to the improved productivity and growth potential of their businesses and, consequently, the economy. Over recent years the government has made a commitment to reducing tax compliance costs, and a number of the pressing and soluble compliance problems have already been dealt with.

3.45 Even so, the government is continually looking for ways to improve upon what has already been achieved. The initiatives discussed in the remainder of this chapter are examples of threshold adjustments.

Increasing the low-value asset write-off threshold

3.46 The threshold below which low-value assets can be expensed immediately, rather than being capitalised and depreciated, was raised in Budget 2005 from $200 to $500.

3.47 Further raising this threshold is likely to lower compliance costs even further. The recent rise in the threshold was welcomed by taxpayers and tax professionals alike, although there was some indication that the government should go further. However, to do so would mean that benefits would accrue disproportionately towards firms which have relatively high levels of assets falling below the threshold, and would come at a high fiscal cost. The estimated fiscal costs of raising the threshold to $1,000 are set out below.

Year	**1**	**2**	**3**	**4**	**5**
	$270m	$220m	$170m	$120m	$70m

Assets that reach a low depreciated value

3.48 Another compliance concern that has been raised is the large number of assets on depreciation registers that have been depreciated to a low level. Options to deal with this concern include:

- allowing assets to be written off once they reach a particular tax book value;
- allowing assets to be moved into a simplified pooling system – for example, allowing them to be depreciated in a single pool or a limited number of pools, regardless of their depreciation rate; or
- reducing the technical constraint that such assets must still be in use or available for use while they continue to be depreciated.

3.49 The first two of these measures could provide significant tax savings to firms, while the third may not. It should be noted, however, that to the extent there are costs of removing assets from asset schedules, these first two options may in some instances increase compliance costs.

3.50 Fiscal costs of any changes in this area clearly depend on the option adopted. It is not possible to cost reliably any of these options at this time. However, the first option's costs will be significantly higher in the first year than in subsequent years.

Fringe benefit tax threshold

3.51 At present, employers whose deductions of PAYE (pay-as-you-earn) and specified superannuation contribution withholding tax do not exceed $100,000 can file fringe benefit tax returns annually. One option, for example, would be to raise this threshold to $250,000, which would generally mean that only firms with more than 10 to 20 employees would need to file returns quarterly. This would not be expected to change aggregate tax collections in any fiscal year, but would have a time-value of money cost of approximately $4 million a year.

Other relevant initiatives pursued outside the Business Tax Review

3.52 This discussion document does not deal with two important measures that are currently being worked on. The first relates to the examination of New Zealand's international tax rules and, in particular, the controlled foreign company (CFC) rules. It will involve analysis of whether New Zealand should modify its treatment of CFC income and whether there are measures which could reduce tax compliance costs for CFCs. The work will also consider other parts of the system such as non-resident withholding tax rates, the thin capitalisation rules, foreign dividend withholding payments and the conduit relief rules. A discussion document on these matters will be released later this year.

3.53 Work is also under way on a review of tax penalties aimed at increasing voluntary compliance. A discussion document on this issue will also be released this year.

Submission points

The government invites those making submissions to rank initiatives (including their own), given the likely fiscal costs and effect on productivity and competitiveness. Having more expensive initiatives means that fewer could be implemented – see the summary of initiatives on page 6 for comparative fiscal costs. It would also be useful to know the advantages and disadvantages of the various initiatives from the perspective of those making submissions.

Submissions are specifically sought on:

Targeted tax credits

- the desirability and priority of introducing tax incentives for eligible expenditure on R&D, export market development and skills;
- the definitions of "eligible expenditure";
- whether the tax credits should be volume-based or incremental in design; and
- how the tax credits should be delivered by Inland Revenue, having regard to the criteria set out in paragraph 3.26.

Deferral of losses from significant expenditure

The types of expenditure which should be included in any changes in this area.

"Blackhole" expenditure

The types of blackhole expenditure (apart from losses on buildings and feasibility studies) that should be considered.

Tax compliance

The key compliance concerns that should be considered.

Chapter 4

OTHER INITIATIVES CONSIDERED AND REJECTED

4.1 In the course of the Business Tax Review, more radical options such as deep company rate cuts have been considered. Deep company rate cuts would require a replacement revenue source, for which a payroll tax has been considered. Payroll taxes are levied in many other countries and can raise substantial amounts of revenue. The government is not willing to countenance an increase in the rate of GST as a method of funding a deep cut in the company rate. The simple reason is that high-income households save a greater proportion of disposable income than do low-income households, so an increase in the rate of GST falls disproportionately on the latter.

4.2 After a thorough consideration of these possibilities, the government has decided against deep company rate cuts because of the revenue cost, concerns about the desirability of a payroll tax and the significant integrity problems that would need to be resolved. A payroll tax, while having some attractions in principle, is much less attractive in practice.

Deep company rate cuts

4.3 Deep company rate cuts have attractions as a means of enhancing productivity and competitiveness by allowing firms greater scope for retaining funds for reinvestment.

4.4 On the other hand, deep company rate cuts can be extremely expensive. Without an alternative revenue source, the government could no longer afford to provide the high quality of services that New Zealanders demand.

4.5 Moreover, by themselves, any company rate cuts would increase the gap between the company tax rate and higher rates of personal tax. This would magnify a number of concerns, including tax base integrity pressures, inconsistencies with other parts of the tax system, the impact on savings vehicles and concerns that much of the benefit may flow to large, foreign-owned firms.

4.6 As discussed in chapter 2, there is evidence that the current gap between the top personal marginal rate of 39 percent and the 33 percent company and trustee tax rates is already placing pressure on the integrity of the personal tax system. Deep company rate cuts would add to these pressures.

4.7 Full imputation would give rise to inconsistencies if deep company tax rate cuts were introduced. Deep cuts would provide a permanent benefit to companies owned by non-residents or domestic non-taxpayers but, generally, only a timing benefit to companies owned by domestic taxpayers. For companies owned by non-residents or by domestic non-taxpayers, the company tax is a final tax. For companies owned by domestic taxpayers, however, it is a withholding tax only, with a final wash-up tax when dividends are paid. For companies owned by domestic taxpayers, there is an apparent inconsistency in reducing the company tax rate but clawing it back when dividends are paid.

4.8 By itself, a deep company rate cut would not benefit all businesses. It would benefit only those structured as companies.

4.9 Again, the impact on savings vehicles is a concern. As discussed earlier, in the context of a moderate cut in the company rate to 30 percent, there would be concerns about how best to tax PIEs and other savings vehicles. These concerns would be magnified if deep cuts in company tax rates were introduced.

4.10 If there were to be a deep company rate cut, the question arises as to what, if any, other measures should accompany it. There are three broad options:

- reduce significantly personal tax rates at the same time as a reduction in the company rate;
- move to a model with a low company tax rate aligned with a low rate on capital income more generally, with rules differentiating labour income from capital income, as in Nordic countries; or
- move to a model which has a low company tax rate on business income only, with a number of provisions to ensure investment income is taxed at marginal personal rates, as in Ireland.

4.11 Either of the first two approaches would, at least in principle, be ways of allowing for deep company rate cuts without compounding existing misalignment problems.

4.12 Reducing personal tax rates significantly together with company tax rates would come with a large fiscal cost and require a substantial alternative revenue source. Unless there is a viable revenue source that is more efficient than the current income base, this is unlikely to promote productivity and growth. An alternative, which would also avoid exacerbating misalignment problems, would be to reduce only the top two marginal rates – the 39 and 33 percent marginal rates – in line with the cut in the company rate. This would, however, make the tax system less progressive.

4.13 Pursuing the Nordic or dual rate approach would involve cutting personal rates only on capital income. Although this would be less costly than cutting personal tax rates on all income and would potentially make deeper company rate cuts more viable, it would require systematically differentiating between labour and capital income. That would introduce considerable complexity, and the costs of this approach are likely to outweigh its benefits. Fairness concerns also arise, since investment income is heavily concentrated in the hands of higher income individuals.

4.14 Either of these measures would be comprehensive approaches to resolving the misalignment problem. An alternative approach is to provide deep company tax rates but to put in place specific anti-avoidance measures to help counteract the pressures a deep company rate cut would create. This is essentially the Irish approach.

4.15 On balance, the government does not believe that these measures are likely to lead to an improvement in New Zealand's tax system.

4.16 A final consideration which weighs against any deep company rate cut option is that many large corporate taxpayers are foreign-owned firms with very high levels of profit from their New Zealand operations. Deep cuts in the company rate may be of benefit to foreign shareholders without necessarily doing very much to promote additional investment by these firms. In this case, to the extent that replacement taxes are borne by New Zealand residents, deep company rate cuts may make New Zealand worse off.

4.17 For all these reasons, the government is not convinced that deep company rate cuts would be an effective way for it to achieve its objectives.

Payroll tax

4.18 Many countries rely on payroll taxes to raise revenues. Often payroll taxes are used to fund social security contributions, but in Australia payroll taxes are the principal state tax base. Australia also has a federal superannuation levy which requires employers to make contributions to the superannuation funds of employees. One way of funding deep company rate cuts would be for New Zealand also to introduce a payroll tax.

4.19 There are a number of different possible payroll tax bases. They include payrolls of:

- companies only;
- all employers; or
- all employers plus the labour income of the self-employed.

4.20 In principle, a broad-based payroll tax on all employers plus the labour income of the self-employed along the lines of the current ACC base might appear a relatively neutral way of raising revenue to fund a deep company rate cut. However, it would be more problematic to levy any general payroll tax on this base. In practice, the current ACC base for the self-employed carves out passive investment income such as interest and dividends, which is appropriate if the aim is to tax labour income. However, part of the income of the self-employed may reflect a return on capital assets employed in the business, including plant and equipment (such as cars, trucks and computers), buildings and trading stock. Carving out this further income would be complex.

4.21 Australian payroll taxes are not levied on the labour income of the self-employed. In addition, there are general thresholds, so firms with relatively low payrolls (thresholds for which differ across states/territories) are exempt from payroll tax so as to reduce compliance costs. However, introducing thresholds provides a bias for labour to be employed by firms that are below the threshold rather than by firms that are subject to payroll tax. This is unlikely to promote labour productivity. It also could have large revenue costs.

4.22 Another approach would be to attempt to levy payroll taxes only on companies if the proceeds were being used to fund deep company rate cuts. This was not considered viable as companies would have had incentives to outsource employment to unincorporated entities such as partnerships of individuals or trusts. Again, this would not have promoted labour productivity.

4.23 A further concern in levying a payroll tax to fund deep company rate cuts is that the company rate cuts might be of little benefit to many new and rapidly-expanding or innovative companies, which may be in tax loss or have very low income tax liabilities. On the other hand, any new payroll tax would impose an important new cost on these firms. A payroll tax would also have an uneven impact across the economy, because it would be levied disproportionately on sectors with a high labour cost. It is unclear whether such a switch would promote productivity and growth.

4.24 Thus, even if there were thought to be substantial benefits from a deep company rate cut, there are some important practical concerns about employing payroll taxes as a way of financing such cuts.

Submission point

Submissions on the issue of deep company tax cuts are welcomed but they should make clear how they are to be funded and how misalignment problems should best be addressed.