Tax Working Group Public Submissions Information Release

Release Document

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Certain information in this document has been withheld under one or more of the following sections of the Official Information Act, as applicable:

[1] 9(2)(a) - to protect the privacy of natural persons, including deceased people;

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In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) of the Official Information Act.

FINANCIAL SERVICES FEDERATION

27 April 2018

The Chair
Tax Working Group

Via email to: submissions@taxworkinggroup.govt.nz

Dear Sir Michael,

Submission on the tax treatment of interest income

The Financial Services Federation ("FSF") is grateful for the opportunity to make a submission to the Tax Working Group.

The FSF is the industry body representing New Zealand's responsible and ethical finance and leasing providers of New Zealand. We have nearly sixty members and associates providing financing, leasing, and credit-related insurance products to more than 2 million New Zealanders and some of our members are licensed Non-Bank Deposit Takers ("NBDTs"). Our affiliate members include internationally recognised legal and consulting partners. A list of our members is attached as Appendix A.

Our work includes setting industry standards for responsible lending, compliance, consumer awareness and working with Government towards fair and enforced legislation.

The following submission speaks mainly on behalf of the FSF's NBDT members and their clients.

Current tax treatment of interest income

The Tax Working Group's paper highlights the issue of the influence of tax settings on the rate and composition of saving in New Zealand.[1]

It further notes that, as New Zealand taxes nominal income (i.e. in the context of interest, the real interest rate plus inflation), a 33% headline tax rate on the nominal return on deposits is a materially higher tax on the real return. The Tax Working Group's Background Paper sets out that the effective marginal tax rate on interest as approximately 55.7% (a figure that is broadly

[1] Tax Working Group, Future of Tax: Submissions Background Paper, 2018, p. 39.

similar to comparable studies). This is the highest of all savings types and is significantly higher than the top personal tax rate of 33%.

This effective marginal tax rate is due to the effect of inflation on interest income. We set out a simplified example to illustrate the issue:

> *Consider a situation where the nominal interest rate is 5%, the real interest rate is 3% (i.e. the rate of inflation is 2%), and the marginal tax rate is 33%. If you deposit $100 into a bank account, after one year you will have derived interest income of $5 and have tax deducted from this of $1.65. This will leave you with a bank balance before tax of $105 and after tax of $103.35. However, in that same time, inflation has meant that the purchasing power of money in your bank account has gone down and that $100 in year 1 is the equivalent of $102 in year 2. This means that the real return on the bank deposit is only $3. As tax of $1.65 is paid on the real return of $3, the effective tax rate on bank account interest is 55%.*

While New Zealand has experienced low inflation in recent years, it is has begun trending up again (and is forecast to be 2% by 2021 according to the Reserve Bank's forecasts) and the average inflation rate since 2000 has been 2.7%. Even low inflation rates are significant when nominal interest rates are low (as they have been over the past decade).

The tax treatment outlined above discourages savings and investment outside of residential housing, inflation on which is not taxed to the extent that gains are not caught by the new residential property "bright line" tests or otherwise taxed on revenue account. Under a broad base, low rate tax system, effective marginal tax rates should not vary between different investment types. We support policy options to encourage saving away from housing and towards more productive and diversified investment.

Policy solutions

We outline below some policy options which we consider would assist with this objective:

— Excluding the inflation component of interest income from tax by indexing for inflation. We acknowledge that there is likely to be complexity in terms of implementation. In addition, the flipside of not taxing the inflation component of interest income is that the inflation component of interest expense is non-deductible.

  However, we consider the proposal should be explored in more detail as it is likely to be more efficient economically than current settings. Indexation of interest income and expenses at a rate that reflects the inflation rate (e.g. 2%) was supported by the Savings Working Group (their report also noted that the 1989 Government Consultative Document on the Taxation of Income from Capital concluded that indexation was not infeasible).[2]

[2] Savings Working Group, Final Report, 2011, pp. 14 and 83.

— An alternative to indexation might be to tax only 60% of interest income or to reduce tax rates on interest income. We note that partial taxation of 60% of interest income was recommended in Australia's 2001 Henry Review final report as providing a more consistent tax treatment across income from bank deposits and bonds, shares and rental property.[3] However, we acknowledge that consideration would need to be given to anti-avoidance provisions to mitigate arbitrage opportunities arising from having partially taxable interest income but fully deductible interest expense.

— Consideration should also be given to reducing tax rates on income from capital more generally (e.g. deposits and dividend/interest-bearing investments and PIEs) as a further measure, i.e. moving to a Nordic-style tax treatment where capital is taxed more lightly on economic efficiency grounds. One option to achieve this could be to apply the 28% top tax rate that applies to investors in PIEs to interest and other investment income. This option was also supported by the Savings Working Group.[4]

Finally, the FSF is a member of the Affiliated Industries Group of Business New Zealand and as such has had the opportunity to read their more comprehensive submission to you. The FSF fully supports all the excellent points made in that submission.

Thank you again for the opportunity to submit. Please contact me on [1] if you would like any further information.

Yours sincerely

[1]

Lyn McMorran
EXECUTIVE DIRECTOR

[3] Australia's Future Tax System: Final Report, 2010, Part 2, volume 1, pp. 70-76.
[4] Savings Working Group, p. 14.

Appendix A
FSF Membership List as at 1 April 2018

Debenture Issuers - (NBDT) Non-Bank Deposit Takers	Vehicle Lenders	Finance Company Diversified Lenders	Credit Reporting Other	Insurance	Affiliate Members
Rated Asset Finance (B) Non-Rated Mutual Credit Finance Gold Band Finance ➢ Loan Co	BMW Financial Services ➢ Mini ➢ Alphera Financial Services Branded Financial Services Community Financial Services European Financial Services Go Car Finance Ltd Honda Financial Services Mercedes-Benz Financial Motor Trade Finance Nissan Financial Services NZ Ltd ➢ Mitsubishi Motors Financial Services ➢ Skyline Car Finance Onyx Finance Limited Toyota Finance NZ Yamaha Motor Finance Leasing Providers Custom Fleet Fleet Partners NZ Ltd ORIX NZ SG Fleet Lease Plan	L & F Ltd ➢ Speirs Finance ➢ YooGo Avanti Finance Caterpillar Financial Services NZ Ltd CentraCorp Finance 2000 Finance Now ➢ The Warehouse Financial Services Flexi Cards Future Finance Geneva Finance Home Direct Instant Finance ➢ Fair City ➢ My Finance John Deere Financial Latitude Financial Pioneer Finance ➢ Personal Finance South Pacific Loans Thorn Group Financial Services Ltd Turners Automotive Group	Equifax (prev Veda) Centrix Debt Collection Agencies Baycorp (NZ) Dun & Bradstreet (NZ) Limited	Autosure Protecta Insurance Provident Insurance Corporation Ltd Southsure Assurance	American Express International (NZ) Ltd AML Solutions Buddle Findlay Chapman Tripp EY Finzsoft KPMG Paul Davies Law Ltd PWC Simpson Western FinTech NZ HPD Software Ltd Total : 56 members