Tax Working Group Public Submissions Information Release

Release Document

February 2019

taxworkingroup.govt.nz/key-documents

Key to sections of the Official Information Act 1982 under which information has been withheld.

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;

[2] 9(2)(k) - to prevent the disclosure of official information for improper gain or improper advantage.

Where information has been withheld, a numbered reference to the applicable section of the Official Information Act has been made, as listed above. For example, a [1] appearing where information has been withheld in a release document refers to section 9(2)(a).

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

2 November 2018

Attention: Tax Working Group
c/- Tax Working Group Secretariat
PO Box 3724
Wellington, 6140
New Zealand

Email: submissions@taxworkinggroup.govt.nz

Dear Madam/Sir,

Joint submission from Securities Industry Association and NZX on Tax Working Group's Future of Tax: Interim Report (20 September 2018)

I attach the submission jointly prepared by the Securities Industry Association (SIA) and NZX in respect of the *Future of Tax: Interim Report (20 September 2018).*

The SIA represents the New Zealand sharebroking and wealth management industry, including leading NZX firms:

- ANZ Securities Ltd.
- ASB Securities Ltd.
- Craigs Investment Partners Ltd.
- First New Zealand Capital Securities Ltd.
- Forsyth Barr Ltd.
- Goldman Sachs NZ Ltd.
- JBWere (NZ) Pty Ltd.
- Macquarie Securities (NZ) Ltd.
- OM Financial Ltd.
- Somerset Smith Partners
- UBS New Zealand Ltd.

No part of this this submission is required to be kept confidential.

If there are further questions or areas of the submission where you would appreciate further input or clarification, in the first instance, please contact:

Bridget MacDonald Executive Director, Securities Industry Association
[1]
or
Hamish Macdonald General Counsel and Head of Policy, NZX
[1]

Yours faithfully

[1]

[1]

Nick Hegan
Chair, SIA & Head of Legal & Compliance, Forsyth Barr Ltd
[1]

Mark Peterson
Chief Executive Officer, NZX Limited
[1]

Joint SIA and NZX submission to the Tax Working Group in response to the FUTURE OF TAX: Interim Report

INTRODUCTION AND EXECUTIVE SUMMARY

Our capital markets play a critical role in the productivity and prosperity of New Zealand's economy – they provide investment opportunities for savers to plan for a stable financial future and a vital source of capital for companies to innovate, grow and create jobs.

Direct investment by retail investors benefits our capital markets, improving price discovery and liquidity as well as increasing competition in our markets and ensuring that there is a diversity of investment views in the market. Direct retail investment also represents an important savings and investment channel for hundreds of thousands of New Zealanders, enhancing financial literacy and allowing investors to build diversified portfolios.

We are concerned that extending capital income taxation to investments in New Zealand shares, i.e. introducing a Capital Gains Tax (**CGT**), has the capacity to discourage direct investment and damage our capital markets. To the extent that indirect investment via Portfolio Investment Entities (**PIEs**) is subject to more favourable CGT rules, direct investments will be switched to indirect investments in PIEs that invest in capital markets, or even away from the capital markets entirely. The administrative burden of a CGT will also tend to favour indirect investment in PIEs. Reducing direct investment would harm both our retail investors and our capital markets.

As a result, we ask the Tax Working Group to carefully consider the various options available to it. Ideally, the status quo would remain, and there would be no CGT on direct investment in New Zealand shares. This would also avoid making international shares relatively more attractive from a tax perspective. At the very least, there should be a level playing field as between direct investment in shares and indirect investment via PIEs, both in terms of the CGT rate and the administrative burden on the investor.

We expand on these points below.

1. Our capital markets are important to our country

Our capital markets are critical to our country's future. In response to the interim findings of the Tax Working Group, a letter from Hon. Grant Robertson, Minister of Finance to Hon. Sir Michael Cullen, Chair of the Tax Working Group (20 September 2018) explicitly notes that "*the Government requests the Group considers measures that will promote a more balanced savings culture and deeper capital markets*."

RBNZ Governor Adrian Orr recently spoke on the need for deep capital markets to ensure the best allocation of capital to productive areas of the economy:[1]

> "***Our listed equity market remains small relative to the economy, banks remain dominant in intermediation, and it is difficult to invest outside of the listed market in any scale with access limited. We still concentrate most of our investment in housing equity - rather than productive equity - relying on leverage from offshore borrowing. This is not a formula that will create 'capital deepening' in our economic efforts. … A vibrant and healthy financial ecosystem requires deep capital markets, with a long-term horizon, to best allocate capital in Aotearoa. We have much to work on to remain sustainably prosperous, but we are committed and long-term focused***."

[1] Financial Services Council, *Shaping Futures National Conference*, Auckland, 7 September 2018.

Similarly, Treasury Secretary and Chief Executive Gabriel Makhlouf has commented on the importance of well-functioning capital markets to productivity and innovation:[2]

> *"**Well functioning capital markets are essential for our productivity as they help firms to raise funds to grow and, by helping individuals to save or borrow, allow funds to be allocated to their best uses. They may also encourage firms to remain in or to relocate to New Zealand. And while New Zealand capital markets may adequately support more mature companies, we need to ensure that some young, innovative or fast-growing companies are also able to raise sufficient early-stage capital. … We certainly want to avoid a situation where the tax system inadvertently encourages investment into non-productive uses**."*

A recent report by the New Zealand Institute of Economic Research[3] (**NZIER**) confirmed the vital contribution New Zealand's public market makes to the broader economy, and the active role that NZX plays in supporting market health and participation. The report highlighted that the economic and employment footprint of the public market was significant, with the combined revenue of S&P/NZX 50 companies totalling more than $61 billion. These companies generated $24.6 billion of Gross Domestic Product – some 10% of the entire New Zealand economy – and produced $2.5 billion in tax annually, in turn used to fund Government initiatives.

Companies in the S&P/NZX 50 span most sectors of the economy including energy, tourism, infrastructure, banking, telecommunications, construction, healthcare, retail and dairy. They employ close to 100,000 New Zealanders and also create over 38,000 jobs in the closely related financial sector for people such as financial advisers, brokers, wealth managers, accountants, lawyers and media.

NZIER analysis and market feedback also found that the New Zealand economy benefits considerably from the market's presence. In addition to the fundamental role it plays in helping companies to raise capital, it plays a vital role in supporting growth in GDP, employment, household spending, investment and productivity.

Capital markets also provide a readily accessible means for New Zealanders to invest. Markets allow for savers to become investors in companies that are seeking to raise long-term capital. This investment is fundamental to the growth and success of companies in New Zealand. Capital markets also sustain the growth of investment funds, which are critical to supporting the future retirement needs of all New Zealanders.

One of the Government's key objectives is for a tax system that "promotes the long-term sustainability and productivity of the economy".[4] Capital markets provide an opportunity for listed companies to raise capital. The markets also direct capital flows to productive areas of the economy. The investment of capital enables companies to grow and expand their business, gain access to export markets, purchase technology and develop infrastructure to improve productivity, invest in talent and create jobs. Companies, employees and their suppliers all pay tax that supports New Zealand's economy – the capital markets should be nurtured and strengthened to maximise this contribution.

2. Direct retail investment benefits both our capital markets and our investors

Retail direct investment is a significant and positive feature of New Zealand's capital markets, and benefits both the investors themselves and the market as a whole.

---

[2] Speech by Treasury Secretary and Chief Executive Gabriel Makhlouf, *Improving Living Standards: We Need to Talk About Productivity*, Catalyst Trust, Queenstown, 4 September 2018

[3] NZIER, The economic contribution of NZX: New Zealand's exchange and its role in supporting the New Zealand economy, February 2018

[4] *Terms of Reference*: Tax Working Group

Market benefits
NZX trade data shows the significance of retail direct investment activity:[5]

- 26% of all trades and 41% of price-setting trades by number
- 13% of all trades and 23% of price-setting trades by value

SIA member data also shows the significance of retail investment to our capital market. The combined businesses of SIA's members work with over 300,000 New Zealand retail investors. The total investment assets of those investors exceeds $80 billion, including $40 billion held in custodial accounts.

The significant number of retail direct investors is emphasised by share registry data, which shows holdings for over 480,000 (Link) and 260,000 (Computershare) investors respectively, with holdings in aggregate valued at $50,000 or less representing 80% or more of each registry.

Without these investors, the secondary market would be in the hands of a relatively small number of fund managers, many of whom are passive investors. It is clear from the activity data above that this would result in significantly reduced on-market activity, price discovery and liquidity. In turn, this would affect the attractiveness of NZX's markets to offshore investors.

In addition, concentrated ownership of competing companies can have adverse effects on competition in the markets where those companies compete,[6] which would be negative for the economy as a whole.

Capital raisings would also be affected: the combination of weakened secondary markets and the concentrated nature of the investor market would likely result in increased costs of capital for New Zealand companies. The capital markets provide a pathway for small and medium enterprises (**SMEs**) to raise capital for growth. SMEs with the ambition and intention to grow and become a listed company need access to significant capital. However, without retail direct investment, both SMEs and larger companies would have no need to list on NZX and would likely look to list offshore in search of much-needed investment – perhaps even being encouraged to move head office or operations offshore. It would also become logical for New Zealanders with innovative business ideas to consider establishing their start-up business in Australia so that they can more easily list there. This in turn would result in a decrease in the number of New Zealand-owned companies and an increased amount of foreign ownership in New Zealand.

The success of the State Owned Enterprise asset sales programme would have been challenged without the participation of retail investors. The Government, retail investors and investment funds have all experienced a very positive outcome from both capital appreciation and dividend income, with the latter being reinvested into portfolio savings.

Investor benefits
There are also many positive educational and social outcomes for people who are active participants in New Zealand's markets – from promoting financial and investment literacy, to encouraging people to save and invest in their future.

Many aspects of direct investment have a positive social influence. Direct participation in capital markets encourages New Zealanders to consider their short and long-term financial goals, seek professional financial advice, and make informed decisions suited to their needs, goals and risk

[5] Data for period January 2017 to September 2018.
[6] see Azar, J., Schmalz, M. C. and Tecu, I. (2017) *Anti-Competitive Effects of Common Ownership*, Ross School of Business Paper No. 1235.

appetite. At its most basic level, it provides a channel for people to develop an interest in their future financial well-being, a focus on financial independence, and promotes financial literacy and engagement on important financial issues such as planning for retirement. With an ageing population and more people becoming focused on financial independence, we want to encourage people to save, take responsibility for their financial future and become investors.

In general, direct retail investment can be a lower cost option compared to managed funds where there may be application and ongoing management fees. A direct investment portfolio also means that investors know exactly how and where their money is invested and offers flexibility for investors to make buy and sell decisions. This allows retail investors to achieve investment solutions that are tailored to meet their individual needs and aspirations, including investing in companies with environmental, social and governance factors that align with their personal values.

Direct investment also contributes to the capital markets' social licence: "*By enabling broadbased wealth creation through financial inclusion, the exchange achieves a potentially higher degree of public legitimacy and relevance*".[7]

Without retail direct investment, these benefits would be lost.

3. CGT could discourage retail direct investment and damage our capital markets

It follows from the above that policies that have the effect of discouraging retail direct investment will have a negative impact on our capital markets and our economy as a whole.

The introduction of a CGT could discourage retail direct investment in New Zealand shares in two ways.

First, and as a broad point, any increase in taxation of returns from New Zealand shares will tend to encourage switching to investments where the tax on returns does not experience the same increase. For example, international shares would become relatively more attractive if their taxation did not change.

More particularly, it appears from the Tax Working Group's interim report that a different CGT treatment is contemplated for Australasian shares held by investors directly, compared to those to held through PIEs. It is mentioned in the report that, given the practical difficulties that arise in applying a CGT to PIEs, one option is for Australasian shares to remain CGT-free for PIEs. Alternatively, various other options are proposed, all differing from the realisation basis that appears to be envisaged for retail direct investors.

To the extent that indirect investment via PIEs is subject to more favourable CGT rules, direct investment will decline and the funds switched to indirect investments in PIEs that invest in capital markets. Funds could also be switched away from the capital markets entirely and into non-productive assets.

Secondly, the administrative burden of a CGT will also tend to favour indirect investment in PIEs. If a CGT applies to New Zealand shares, many hundreds of thousands of New Zealand investors are likely to have to file tax returns each year and manage the cashflow uncertainty that arises from any CGT that becomes payable. It will clearly be attractive to many such investors to hold New Zealand shares through a PIE and let someone else manage the CGT position.

[7] World Federation of Exchanges, *Enhancing retail participation in emerging markets*, August 2017.

4. *Solutions for ensuring a CGT does not discourage retail direct investment*

To address the concerns outlined above, we suggest the following:

Status quo for New Zealand shares

A straightforward solution is to preserve the current position where capital gains on shares in New Zealand companies are effectively untaxed for retail investors. This ensures a level playing field in terms of CGT payable between direct and indirect investment, and eliminates the administrative burden on retail investors referred to above. It would also avoid making investments in international shares relatively more attractive from a tax perspective (assuming, as we understand is likely, that the FDR regime would remain for investments in non-Australasian shares), thereby incentivising New Zealand investors to sell their New Zealand shares and invest offshore.

This approach would be consistent with the tax system supporting the productive economy as opposed to the speculative economy. We understand the Government's interest in a CGT stems in part from currently untaxed gains from property speculation and the consequent effect on the efficient allocation of capital. Targeting a CGT on property investment and excluding New Zealand shares from CGT allows this root concern to be addressed, without damaging our capital markets and our economy.

This approach would also reduce the potential impact of a CGT on KiwiSaver and other retirement savings referred to in the Tax Working Group's interim report.

Another positive feature of this approach is that it would resolve many of the double taxation issues highlighted in the Interim Report (assuming that the companies invested in would themselves be subject to CGT on their capital gains).

This approach would also significantly reduce the number of individuals required to file tax returns if a CGT was introduced, a major administrative benefit and cost saving for both investors and the IRD itself.

This exclusion of New Zealand shares can be rationalised on the basis that any capital gain simply represents the value of the entity plus the present value of the future income stream, which in any case has or will be subject to New Zealand tax. In itself, taxing such gains therefore involves an element of double taxation, which would act as disincentive to investment in this asset class.

Maintain a level playing field between direct and indirect investment

If the above is not accepted, we suggest that at the very least there should be a level playing field between owning New Zealand shares directly and owning them indirectly via PIEs. The playing field should be level both in terms of the CGT rate and the administrative burden on the retail investor. For example, if PIEs are to be taxed on Australasian shares using a FDR (or similar) method, then the same option should be available to retail investors who own shares directly.

Without parity of treatment for direct and indirect investment, there is a risk that we see a return to the tax-driven structures and behaviours of yesteryear that, through sensible policy choices, have now largely disappeared. For example, a tax preference for investing through PIEs could lead to the establishment of listed PIEs each investing in single stocks – hardly an optimum outcome and not one that IRD might view as within the intent of the PIE rules. More generally, any distortion in tax settings could result in unintended consequences that could damage our capital markets and result in an evolution of practices constructed to address or arbitrage any distinction – none of which serves any economic or productive purpose.

In practice, to ensure the administrative and cashflow burden on retail investors is minimised, retail investors should also be given the option of paying any CGT on a realisation basis (in a similar way to the comparative value method is currently available to direct investors in international shares). To avoid discouraging retail investment, it would be helpful for retail investors to have some optionality around how CGT applies to their share investments.

CONCLUSION

Extending capital income taxation to investments in New Zealand shares could create an unlevel playing field between direct investment in shares and indirect investments through PIEs. That would disadvantage New Zealanders choosing to invest directly in New Zealand companies, or worse, discourage direct investment entirely.

Further, depending on how such a tax is imposed it may also result in New Zealand shares being more heavily taxed than foreign shares which will decrease the attractiveness of investing in New Zealand shares and lead to a decrease of investment in the productive sector of the New Zealand economy.

Capital markets provide a lever to stimulate and support the growth, innovation and long-term success and sustainability of New Zealand's businesses and infrastructure. An equitable and fair tax policy design would encourage New Zealanders to save and invest into New Zealand's most productive and emerging sectors, and ensure they continue to have choices that allow them to do so.