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14 April 2022

Deputy Commissioner, Policy and Regulatory Stewardship
Inland Revenue
PO Box 2198
Wellington

By email: policy.webmaster@ird.govt.nz

Dear David

Draft long-term insights briefing

Thank you for the opportunity to comment on Inland Revenue's draft long-term insights briefing titled Tax, foreign investment and productivity (the draft briefing paper).

At the outset we welcome Inland Revenue undertaking this work. Foreign Direct Investment (FDI) is critical to the New Zealand economy and we support work to determine whether our tax rules are deterring overseas investment. We appreciate that the objective of the work is to provide medium-term and long-term trends, risks and opportunities and impartial analysis on possible policy responses.

In summary, the long-term insights briefing raises some very important questions, but we are concerned at both the narrow focus and the lack of evidence connecting increasing FDI and our corporate tax settings.

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Summary table

Overall comments

The analysis should consider whether and how tax settings affect FDI, and it does not appear to do this.

The analysis should take account of the work undertaken for the New Zealand Treasury LTIB.

The work should be used to develop a forward-looking policy framework, and should be broader and consistent with the Government's policy developed in the Living Standards Framework.

General comments

The analysis does not take into account transfer pricing arrangements, which might have a material effect on the tax raised by FDI.

The comparison with other economies does not consider differences in situation, nor is it up to date.

More work should be done to determine how to quantify costs not quantified to date.

Specific measures

None of the specific measures proposed seem viable, with the exception of the Nordic tax system.

However, as this would involve introducing an effective capital gains tax, we do not believe this is viable in either the short or medium term.

Our more detailed comments are below.

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Overall comments

Foreign direct investment

The aim of the long-term insights briefing (LTIB) was to examine how New Zealand's tax settings are likely to affect decisions for overseas firms to invest into New Zealand. This draft has also benchmarked New Zealand's tax settings against those in other countries.

It is our understanding that this work forms part of Inland Revenue's role as steward of the tax system, to ensure the long-term health of the system.

FDI is vital to the New Zealand economy. We have high infrastructure needs and will continue to have in the coming years. We also have an aging population and will arguably need to increase productivity if we are to fund increasing government superannuation and related health costs. The draft briefing paper notes in paragraph 1.7 that "New Zealand's investment demand exceeds the pool of domestic savings of domestic residents, so we rely to a considerable extend on imported capital to fund domestic investments." That is, we need FDI. What do we need to do as a country to access further FDI/make it more attractive for foreign investors to want to invest here?

It is not clear to us whether this draft briefing paper achieves its aims. There is no analysis of the effect that tax settings have on FDI, nor evidence provided that there is a connection on the two factors. The draft outlines how each of the different options would affect Effective Marginal Tax Rates (EMTRs) but provides little analysis as to whether any of the options would improve FDI. There is no consideration as to how much FDI will be needed and to what extent the various options may affect it. This is fundamental.

It seems from the draft briefing paper that there is not a lot of data about whether or how tax settings affect FDI. In that case, it may have been preferable to limit the scope to discovering if or how tax settings affect FDI before undertaking further analysis.

We understand that the purpose of the report is to present options rather than recommendations or conclusions. However, the briefing paper does not provide any real insight as to what the suggestions would or could do for FDI in New Zealand. Without this step, the research has limited utility.

While the briefing paper provides a good summary of the factors considered it is relatively narrow in scope. New Zealand's inability to improve productivity over an extended period is a fundamental issue. This is acknowledged yet the paper does not consider the taxation of individuals. It is primarily focused on efficiency and hence can be criticised because it departs from mainstream government policy which would consider overall well-being in accordance with the Living Standards Framework. We believe that all four capitals should be considered in a long-term insights briefing, not just financial and physical capital.[1]

Work undertaken by the New Zealand Treasury

The draft briefing paper refers to the complementary Treasury project undertaken in 2021. At paragraph 5.5 it notes that the Treasury LTIB[2] raised the importance of the sustainability of the tax system given future fiscal pressures such as an aging population, rising healthcare demand and the wider costs of Covid-19.

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[1] https://www.treasury.govt.nz/publications/tp/living-standards-framework-2021-html
[2] Briefing and Long-Term Fiscal Position He Tirohanga Mokopuna 2021, the New Zealand Treasury

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Despite this reference, the work in the draft LTIB seems to have been undertaken in isolation from the earlier Treasury work. In our view, the Treasury findings should be used as a reference point in the Inland Revenue analysis. The Treasury insights consider issues that will impact New Zealand and its citizens. Inland Revenue should consider broadening the scope of its briefing paper to be more relevant.

Given the Treasury findings, it may have made sense to assume the tax system was needed to increase revenue (or at least maintain current levels) when considering how best to attract FDI.

Once the level of revenue needed has been determined, the next step should be to determine whether non-residents are being taxed appropriately. Are non-residents paying sufficient tax relative to New Zealand residents? If not, how could they be taxed more or less? The draft LTIB considers options for reform in isolation. In our view this work should form part of a larger project across IR and Treasury to determine whether non-residents are paying the right amount of tax and/or the impact that tax settings have on attracting the required level of FDI into New Zealand.

Outcome of the work

In our submission on the scope, we recommended that the work done as part of the LTIB be used to develop a framework to evaluate policy decisions going forward.

It would have been useful if the draft LTIB had considered the direction of tax reform more generally. For example - does New Zealand need more FDI? Is there a link between tax settings and FDI? Are current tax settings for non-residents appropriate? If not, what types of changes would be useful? Which are likely to affect FDI?

From there, a framework could be developed to inform tax policy decisions going forward. Instead, the draft LTIB has generated specific and isolated reform options that may be either implemented or not. We recommend that the analysis in the draft LTIB be extended to consider any overall policy trends or frameworks that should be pursued in future international tax policy development.

General comments

Overlay of transfer pricing requirements

The analysis also fails to take into account transfer pricing rules. The transfer pricing rules mean that non-residents do not always calculate and return tax in the same way as domestic residents.

Overseas entities operating in New Zealand often transact with related parties. This is particularly true of internationally recognised brands. Product manufacture and development (whether goods or services) is done centrally to ensure quality and consistency. International firms set up entities in market countries to market and distribute their product.

As you are aware, transfer pricing is a set of rules that requires cross-border associated party transactions to be conducted on an arm's length basis. The aim of the rules is to ensure that the multinational enterprise is returning sufficient profit in New Zealand relative to the economic activity performed here. Overseas entities are required to have robust transfer pricing documentation. This involves documenting (and often agreeing with Inland Revenue) the method used to determine their New Zealand profit.

There are two general categories of transfer pricing methods. The first is transaction methods, which look at the price paid for the goods or services. The second category is profit methods, which look at the profit made on transactions here.

Many overseas firms use a profit method, usually one agreed with Inland Revenue. For example, a large soft drink manufacturer might investigate and agree to return profit based on a percentage of sales; and to pay tax on that profit. That is, non-residents do not always calculate and return tax in the same way as a domestic resident.

Where a profit method is used, which is common, most of the measures outlined in the draft LTIB will be irrelevant. An overseas firm's decision to invest in New Zealand will not be influenced by depreciation rates, indexation, incentives for specific businesses or an allowance for corporate equity if their taxable income is a percentage of sales. Thin capitalisation may still be relevant.

Comparison with other economies

The draft briefing uses OECD comparative analysis to determine the merits or otherwise of the New Zealand tax system

Some of the information used in the comparisons is out of date. For example, the tax rates for companies in other jurisdictions. This is discussed further in the Appendix under our comments on Chapter 6 of the draft briefing paper (Reducing the company tax rate).

Another limit on the OECD comparative analysis is the lack of consideration of capital gains tax. As the draft LTIB notes at 3.21, New Zealand is unusual in that regard. Thus, although table 3.1 (page 28) shows that buildings are highly taxed by international standards, this ignores that we do not tax on exit (other than by way of tax depreciation recovery capped at cost).

The work underpinning the draft briefing also relies heavily on comparisons with other small, open economies (see in particular figure 3.1 on page 31). While this is useful, we note that the other economies considered (for example Norway, Sweden, Belgium and the Netherlands) generally have contiguous land borders with other large economies; or are situated very close to a larger market (for example, Ireland, which is part of the EU).

New Zealand faces some unique challenges. Foreign investors may choose not to put their money here for many reasons. Distance, size and a lack of familiarity with the country or culture mean that overseas investors are less likely to place their money here. Australia is more likely to attract foreign capital than New Zealand because it is larger, has (arguably) a more attractive climate, and is better known on the international stage. These merits are nothing to do with its tax system. This is discussed further under "Unquantified costs", below.

Unquantified costs

In our submission on the scope of the LTIB, we noted factors that do not concern the rate of tax but may affect a business's decision to invest here. Examples of these are:

- Distance from markets
- Compliance costs
- Market size
- Familiarity with market
- Climate
- Ease of doing business

We realise these will not be easy to quantify; however, we recommend more work is done to determine how they may be taken into account.

As well as our general comments, we have commented on each of the individual measures considered in the Appendix, under the chapter headings used in the draft briefing paper.

We would be happy to discuss our submission with you. Please contact Jolayne Trim.

Yours faithfully

John Cuthbertson FCA

CA ANZ NZ Tax and Financial Services Leader

Scott Mason FCA

NZ Tax Advisory Group Chair

Appendix: Specific measures

Chapter 6: Reducing the company tax rate

We have looked at the economic analysis in chapter six of the draft LTIB. In summary, the chapter considers whether a reduction in the company tax rate would decrease EMTRs.

While the analysis is extensive, we do not believe it gives sufficient justification for reducing the company tax rate.

The trend analysis for corporate tax rates ends at 2019. However, the world has changed in the past three years. In 2019. In the spring budget of 2021, the United Kingdom announced an increase in their corporate tax rate (for those companies earning more than £250,000) from 19% to 25%. We understand that the US has also signalled interest in increasing its corporate tax rate in order to pay for the cost of the pandemic, although legislation has yet to be introduced. This global trend to higher corporate taxation is one material factor which deserves consideration and reflection.

Moreover, the OECD work on Base Erosion and Profit Shifting (BEPS) is well advanced. As you are aware, BEPS looks to impose a standard set of tax rules on some of the world's largest multi-national entities to ensure that they are paying sufficient tax overall. At a high level, it would involve coordination between countries to enact similar tax rules in each country. This points towards greater global cooperation in some respects, rather than the global competition which sits as a fundamental part of this analysis.

The current misalignment of tax rates – in particular, the 11% differential between the top personal tax rate and the corporate rate – has resulted in Inland Revenue having to undertake additional anti-avoidance activity and Government suggesting further integrity measures. The integrity measures will add significant complexity to the system and have the potential to blur the lines of our current tax policy framework – including the distinction between income and capital gains.

There is also limited reconciliation to previous advice provided by Inland Revenue. For example, the recommendation of the Secretariat to the Tax Working Group in 2018 advised against a reduction in corporate income tax, saying:[3]

> "All of this leads us to conclude that, on balance, in the judgement of the Secretariat it would not be in New Zealand's best interests to lower the company tax rate."

In addition, the company tax rate should not be reduced without considering the other factors we refer to in our overall and general comments at the start of the submission.

Overall, we do not believe it would be appropriate to reduce New Zealand's company tax rate.

[3] Paragraph 40 of the report, Appendix 2: Company tax rate issues Background Paper for Sessions 6 and 7 of the Tax Working Group (2018), available at https://taxworkinggroup.govt.nz/sites/default/files/2018-09/twg-bg-appendix-2--company-tax-rate-issues.pdf

Reducing the company tax rate: Key questions to consider		
6.1	If New Zealand wished to reduce EMTRs, should reducing the company tax rate be an option to be considered?	No
	If governments wanted to reduce costs of capital and EMTRs without reducing the progressivity of the tax system, what accompanying tax changes would you suggest?	Not considered
6.3	Would the case for or against company tax rate cuts depend materially on what happens to company tax rates in other countries?	In part, as the current global trends tend towards cooperation
6.4	If there were a cut in the company tax rate, should there be changes to other tax rates at the same time?	If the company tax rate is to be cut, government should consider cutting other rates at the same time to address issues caused by rate misalignment

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Chapter 7: Accelerated depreciation

The analysis considers whether allowing additional depreciation deductions would improve EMTRs.

Broadly speaking, accelerated depreciation is a means to give businesses additional deductions for capital costs. The draft briefing paper considers two main methods:

- Depreciation loading; and
- Partial expensing

Undertaking this type of change would go to the heart of our tax policy system, which is a "broad base low rate" structure. This proposal seems similar to initiatives undertaken towards the end of the 20th century where the tax system was used by some governments as a tool to incentivise particular businesses or industries. As it runs against the overall philosophy of our tax system, it should not be undertaken without wider consultation on the structure of the system as a whole. As we have noted in our general comments, this work is not explored in the draft LTIB.

Our preference would be to move to a more simplified system of depreciation rates rather than reintroduce loadings, which will bring in further complexity. We would support consideration of partial expensing, particularly for items that are currently black hole expenditure

Accelerated depreciation: Key questions to consider		
7.1	If New Zealand wished to reduce EMTRs, should accelerated depreciation be considered as an option?	No
7.2	If accelerated depreciation measures are considered, should these be restricted to new investments, or available for both new and existing investments?	New investments only
7.3	If accelerated depreciation measures, or other measures that increase the value of depreciation deductions, are considered, are there reasons to prefer depreciation loading, partial expensing or some other scheme?	Partial expensing should be preferred if it results in a simpler regime

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Chapter 8: Indexation

This chapter considers whether our income tax system should be indexed for inflation.

Broadly speaking, the concept is premised on the basis that a component of the income received by individuals and businesses is compensation for inflation. This is particularly true of interest income, which is partly compensation for the time value of money and partly compensation for the value of the money reducing in real terms over the time it is held by the borrower.

This chapter of the draft LTIB explains that, in theory, the two could be split out and only actual income taxed.

In reality indexation is likely to lead to further complexity, it would permeate through or need to be considered for all income sources and could potentially result in a significant reduction in Government revenue. The draft LTIB notes that no other country has adopted this approach.

Indexation: Key questions to consider		
8.1	Might comprehensive indexation of the tax base, including indexation of interest, depreciation and trading stock, be worth considering further and does the answer depend on future inflation and interest rates?	Not under current settings
8.2	Might partial indexation of the tax base, including indexation of depreciation deductions or indexation of both depreciation deductions and trading stock, be worth considering further and does the answer depend on future inflation and interest rates?	Not under current settings
8.3	How do these measures compare with other ways of reducing higher EMTRs and reducing current tax distortions?	Overly complex and no evidence that either measure would attract FDI to New Zealand

Chapter 9: Thin capitalisation

The draft briefing also considers New Zealand's thin capitalisation rules.

Broadly speaking, "thin capitalisation" refers to a set of rules that govern interest deductibility for foreign owners. The aim of the rules is to prevent foreign companies that do business here from sheltering their New Zealand profits against interest deductions so that they pay little or no New Zealand tax. The rules work by limiting the amount of deductible interest over a certain debt threshold.

While increasing the debt threshold may improve EMTRs, this option should not be considered in isolation. As we have mentioned earlier in our submission, an overall policy decision needs to be made as to whether non-residents pay the right amount of tax currently before making changes to the thin capitalisation rules.

Moreover, taxation of non-residents is often borne ultimately by New Zealand residents through lower wages or rental income. If the measure was implemented, it could increase New Zealand's productivity through higher wages or rental incomes earned from non-residents. However, it is also possible that the increased return received by the non-resident through paying less tax could be simply retained by the non-resident as additional profit. It is not clear whether either of the potential changes in tax settings would attract additional FDI, or merely benefit existing foreign investors.

Thin capitalisation: Key questions to consider		
9.1	Would it be sensible for the tax rules to be as neutral as possible between foreign direct investment and foreign portfolio investment or are there good grounds to promote one form of investment over another? If so what should be promoted and why?	Not considered
9.2	Is the current 60% thin capitalisation safe harbour broadly reasonable? If not, should it be increased or decreased?	Yes broadly reasonable

Chapter 10: Allowance for corporate equity

Broadly speaking, an allowance for corporate equity (ACE) would allow a company a deduction for the cost of its equity finance. The draft briefing paper notes that:

- In theory this would add more neutrality to the tax system; and
- It would be practically impossible to implement unless changes were made to the personal income tax system.

We agree with both these points. However, our overall comment is that implementing an ACE would be too complex, particularly given the changes needed to the personal tax system.

We note that a separate issues paper has been released which proposes, among other things, a change to the rules regarding share sales[4]. If this change is to be made (which we disagree with), it should be evaluated on its own merits and not be implemented as a stepping-stone to an allowance for corporate equity.

[4] Dividend integrity and personal services income attribution: A Government discussion document, 16 March 2022 https://taxpolicy.ird.govt.nz/-/media/project/ir/tp/publications/2022/2022-dd-dividend-integrity-psa/2022-dd-dividend-integrity-psa-pdf.pdf?modified=20220315155634&modified=20220315155634

Allowance for corporate equity: Key questions to consider		
10.1	If problems of integration with personal taxes could be resolved, would an ACE be a viable tax reform option if governments wish to reduce EMTRs and make investment decisions more neutral?	Not under current policy settings
10.2	Are there ways of integrating an ACE with personal taxes and, if so, what are they?	Not considered
10.3	If an ACE system were to be introduced, would it be viable to levy a tax on firms with negative equity? If not, would the neutrality properties of the tax be sufficiently compromised for this to be an unattractive option?	Not considered

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Chapter 11: Incentives for specific businesses

This chapter of the draft briefing considers whether New Zealand should provide tax incentives for specific businesses or industries to encourage them to invest here.

Undertaking this type of change would go to the heart of our tax policy design, which is to retain a "broad base low rate" structure as much as possible. Departing from this structure would be a significant policy decision which should be undertaken only after a broader examination of New Zealand's tax policy frameworks.

Incentives for specific businesses: Key questions to consider		
11.1	Are there specific businesses or industries where spillovers are large enough to justify lower tax rates?	No
11.2	Are there specific businesses or industries where economic rents are large enough to justify higher tax rates to fund lower general business tax rates?	No
11.3	Are there any other arguments for specific incentives?	No

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Chapter 12: Dual income tax system

The final option considered in the draft paper is the introduction of a dual, or "Nordic", income tax system. Broadly speaking, a Nordic tax system is one where high, progressive tax rates are applied to labour income and lower rates to capital income.

While the paper does not provide any recommendations it would seem that, of all the options considered, this would be the most attractive. We agree. While there is no data to suggest that it would increase FDI, it is the most coherent suggestion, would effectively reduce EMTRs and would alleviate some of the other issues currently facing the tax system such as the incredible level of complexity in the new bright-line test rules, denying interest deductions on residential property and the taxation of share sales.

However, this option would, in essence, involve introducing a capital gains tax. This is unlikely to be politically palatable in the short or medium term. Moreover, as we have previously mentioned, the current tax rate differentials have created additional complexity in the tax system which is not desirable. For these reasons, we do not believe this is a realistic option.

Dual income tax system: Key questions to consider		
12.1	Is a dual income tax worth considering as a way of allowing costs of capital and EMTRs to be reduced?	Yes
12.2	Would a dual income tax be worth considering as a way of reducing distortions in the way that different forms of savings are taxed?	Not considered
12.3	Is a dual income tax only worth considering in the future if it becomes harder to tax capital income at high marginal rates?	No

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