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LTIB First Draft
c/-Deputy Commissioner
Inland Revenue Department
By email:policy.webmaster@ird.govt.nz

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Dear Sir,

LTIB First Draft ('the Draft")

Thank you for the opportunity to respond to the LTIB First draft.

There is much in the Draft to consider. My response remains a work in progress. However, I find it useful to record my reactions to the Draft for me and hopefully the team at IR.

The project has two aims – to determine a cost of capital and to suggest policy responses that may be considered. The two are intertwined.

How much to tax FDI

I start with "what is the right tax for FDI?"

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If the objective is to ensure tax has no impact on marginal FDI, the obvious answer is that no tax should be imposed on FDI. The LTIB Draft does not go that far. However, it would be useful to establish and state a target acceptable impact of tax on FDI. This will make it easier to assess the impact of tax on certain scenarios and also to consider policy solutions.

The model – convert to financial statement format

Despite a former Minister of Finance's response to a complaint regarding the use of formulae, "you should be able to understand it", I consider the model used is not readily accessible. The work to solve the equations and understand what they are doing to test the assumptions and conclusion is considerable. Economists and some others are used to doing this work. More readily accessible language is that of financial statements – balance sheets, profit and loss (with attendant tax calculations) and cashflows. The model should be converted to this format and be made available for consideration.

I appreciate this may not be simple to do. IR should therefore take a collaborative approach to developing this version of the model. It does not have to produce a definitive version, simply a version which can be tested and considered and improved where necessary. Clearly stating this as its approach should enable a ready response to any reaction which says the model is wrong (when first published).

(Some of) the model's assumptions

The model has assumptions (as it must). Some are simplifying, others are derived from observation. I comment on a few:

- The level of gearing is based on observed levels of debt in the economy. However, the modelled scenario, as I understand it, is not one represented in the observed levels. The model assumes a declining level of revenue over the expected life of the investment to match the declining value of the investment. In that scenario, I would expect the investment to be geared to the allowable thin capitalization level at the start of the investment and for debt to be repaid in step with the declining value of the investment (to maintain the maximum level of debt allowed). I would expect the tax impact on cost of capital to be lower than produced by the assumption made. I would also expect that to be more realistic. (I have separate comments on the observed levels of debt and the impact of inflation.)
- The draft notes that it is not possible to determine the effect of the restricted transfer pricing (RTP) rules. That is a gap that should be remedied. IR has completed international questionnaires on the impact of the RTP rules (amongst others). There is also practical experience of the application of those rules which I suggest would show something in the order of 66% of an arms-length rate is allowed under the RTP

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rules. As the RTP rules do not allow an arms-length rate of interest for related party borrowing, they must in principle increase the cost of capital.

- The model appears to assume that AIL is deductible while NRWT is not. For an NZ taxpayer subject to the financial arrangement rules, both would be deducted as a matter of course. In either case, whether or not there is a gross up clause, AIL and NRWT would be included in the cashflows from the loan financial arrangement and would be treated as interest expense. (The thin capitalisation rules and RTP may of course limit the allowable deductible but that does not seem to be the assumption being made.). The reasons for this assumption should be made clear or corrected.

Observed level of debt

Unlike the modelled scenario (with declining revenues), the observed levels of debt will be for businesses which expect to grow. Further, the initial investment will likely be historical. The observed level of debt and therefore the cost of capital calculated is an ex post and not an ex ante calculation. This can be justified as a cost of capital if the growth is seen to be financed by additional capital investment through retained earnings (i.e. each year a decision is made to reinvest profits). This means the observed levels of debt and the resulting cost of capital will be the result of multiple marginal investments made.

Of interest therefore should be whether the tax system or other factors mean that the additional investment is made as an equity and not a geared investment.

As above, the observed level of debt, is unlikely to be what would be done in practice for a known declining level of investment. A more realistic scenario should therefore be included in the modelled calculations of the cost of capital.

Impact of inflation

The model results show inflation as having the most impact on the cost of capital. As a policy response to address the impact of inflation would be substantial and technical, testing this impact is critical. Some comments:

- An accounting model version of the model would show the assumptions made more readily. These can be more widely tested.
- If prices are assumed to rise with inflation (as many contracts would allow a CPI adjustment), an investor can be expected to still have a cost of CPI x CIT. It is not clear that this is the only reason the model is showing a higher cost of capital for inflation (i.e. does the revenue decline reduce for inflation to reflect a CPI adjusted increase) . Note that I assume this is the tax cost of inflation as the deduction for the

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original investment does not change under current tax settings. Accordingly, any CPI adjusted revenue would be fully taxable.

- Further, given reported increased business profits in the current inflation environment, businesses may be able to mitigate the impact of tax by other measures (including raising prices at a rate greater than inflation.). This alternative, to a tax policy response, should be considered and researched (i.e. is a tax policy response required at all because other mitigations will reduce the tax impact).

Dual income systems

I have not focused on this possible policy response. However, I note there are proposals to further integrate company and personal tax through the taxation of sale of shares. The comments in that discussion document imply further integration rather than less. This is likely to be at odds with a dual income system.

Observed investment

The message from the Draft is that New Zealand's cost of capital is higher than other countries. Despite that there is FDI.

Does this mean that any effort to reduce the cost of capital is unnecessary? It may be unnecessary because there are no additional investments to be made?

These questions should be addressed before considering policy responses.

The impact of the home investor's tax and OECD measures

My reading of the Draft is the focus is on New Zealand's tax system and its impact on cost of capital. As the Draft rightly notes, the availability of credits and exemptions affects the total cost of capital for an FDI investor. Credits and exemptions may be available at different levels of the investment chain.

For example, a credit for NRWT may be available for interest income derived by the FDI investor who makes a loan. It is however rarely available to the ultimate portfolio investor in the FDI investor (i.e. a shareholder in an FDI investor company will be taxed on profits distributed as dividends without any credit for NRWT on the components of the profit distributed.). Further, an exemption (full or partial) may be available through the FDI investor using particular features of a tax regime (e.g. using a share buyback to distribute excess cash rather than paying a dividend).

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These effects have historically meant that a lower effective tax rate in New Zealand (and elsewhere) are optimal for an FDI investor.

It is worth modelling the home country effects of New Zealand FDI for the ultimate FDI investor. This should inform the possible policy responses.

However, we note the Pillar 1 and 2 responses proposed for the Inclusive Framework countries by the OECD. These proposals will not affect all FDI investors – they will not all be covered by one or both of the proposals. However, a minimum tax may alter behaviour. This should also be modelled.

Economic equivalence and capital gains

Broadly, the differences to an expected tax cost of capital are due to tax applying to a different result than the economic one. (For example, the effect of debt reduces the cost of capital because an equity investment is treated as a debt investment. The effect of inflation is due to nominal and not real returns being taxed.)

I take from this that the “standard” is the measure of tax against the real economic return. As the Draft acknowledges, the model does not account for capital gains,

It is not clear why the OECD model, from which the Draft’s is derived, does not account for capital gains taxes. The expectation is that taking into account capital gains taxes would show a lower cost of capital for New Zealand than other countries. If so, not modelling capital gains may miss an opportunity to show that New Zealand’s tax regime is competitive. However, it may also be the case that the effect of participation and non-resident exemptions mean that capital gains taxes do not apply to FDI into other countries. (For example, using Australia, a non-resident selling shares is generally exempt from Australia’s capital gains tax unless the shares constitute Taxable Australian Real Property (“TARP”). Equally, exemptions may apply when an Australian sells a foreign investment.

This issue should be addressed as the LTIB project is progressed as the tax effect of capital gains should be an important part of the FDI decision.

General comment

The above implies on-going analysis and discussion. I encourage IR to continue its work through formal and informal consultation before it finalizes its LTIB.

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My response has benefited from the IFA session and some informal correspondence. Errors of understanding of what the model does and its implications remain mine.

I am happy to discuss my comments and questions should that be helpful.

Yours sincerely

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