STRATEGIC TAX MANAGEMENT
STRATEGY, STRUCTURE AND RISK MANAGEMENT

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Deputy Commissioner, Policy and Regulatory Stewardship
Inland Revenue
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5 May 2022

By email: policymaster@ird.govt.nz

Re: Submission on Selected Areas of the LTIB

Dear Sir/Madam

1.0 Introduction and overview

1.1 We refer to the draft long term insights briefing (LTIB) dated February 2022 for which submissions were required by 14 April 2022. We wish to make a submission in general terms referencing specific aspects of the LTIB but also drawing upon subsequent policy announcements regarding Tax Principles and the topic of a Wealth tax.

1.2 The focus of the LTIB is how to attract foreign direct investment (FDI) and postulates various initiatives to attract further investment, most notably a reduction in the company tax rate and depreciation allowances or specific industry-based incentives.

1.3 This approach is diametrically opposed to the comments made in the context of developing a Tax Principles Act which talks about consistent treatment across taxpayers with the same economic income, and seeks to establish a progressive tax rates scale as economic income increases.

1.4 As an initial observation, there are some fundamental contradictions between these two approaches.

1.5 Firstly, based upon the information provided in the LTIB New Zealand requires further capital to feed economic growth from which tax revenue will be derived.

1.6 Secondly, the proposal to attract foreign capital presupposes concessions in tax rate either by a reduction in corporate rate across the board, an increase in depreciation allowances or specific industry incentives or a combination of all three. Economic value created by foreign direct investment will be owned by the foreign owners, not New Zealand tax residents. As a consequence, with the mobility of capital, if a more preferred or tax efficient destination for that foreign capital is identified then it is possible that the capital will leave New Zealand to find that lower taxed higher return destination.

1.7 One of the major distortions in the New Zealand tax system and investment options is the extent of domestic investment in housing stock both for personal occupation and for investment purposes. We have seen that this emphasis has played a part in an allocation of a very high proportion of investment capital to housing stock, but also providing incentives for investment due to the returns achieved which have been self-fulfilling given the economic settings that have prevailed in recent years (low interest rate, finite housing stock and high levels of demand).

1.8 The LTIB ignores outward direct investment (ODI) on the basis that recent tax changes to our international tax regime finalised in 2009 which were intended to be concessionary have not resulted in an increase in ODI of any magnitude. We see the taxation of ODI is more complicated than this. If we are to attract and retain the owners of investment capital in New Zealand then we need to ensure that the portion of the investment capital allocated to offshore investments is taxed efficiently. At the moment, ODI is discouraged by several tax settings and interpretations adopted.

1.9 The philosophy of our approach to ODI should be that it facilitates investment capital, or the owners of investment capital, residing in New Zealand and investing globally from New Zealand.

1.10 For example, if foreign tax credits cannot be claimed against New Zealand income tax in the year in which they arise they are forfeited. Because New Zealand measures taxable income differently to other jurisdictions it may be that there is foreign tax credit leakage as a result of that which could be due to timing issues for example. The taxation of foreign exchange, the timing of the recognition of economic interest under our financial arrangements regime can give rise to timing differences, as can depreciation rates. The compliance cost of managing ODI through all of its various structural options, combined with the inability to carry forward or match foreign tax credits to the New Zealand liability to which they relate provides an impediment to ODI.

1.11 Further, our interpretation of double tax treaties with respect to the availability of foreign tax credits is a further impediment, and is potentially contrary to international law principles. Double tax treaties are intended to do just that – remove double taxation. However, when determining the quantum of the credit to be allowed in New Zealand we have interpreted the words of the treaty to be that a credit is only available proportionate to the income to which it relates. Unlike other tax credits such as imputation credits which can offset any other form of income, a credit for foreign withholding tax is limited to the proportion of income that the tax bears. For example, if 10% is withheld from interest income then the recipient of that interest income can only claim a maximum 10% credit. If through managing ODI via trust arrangements, a taxable distribution of interest is made together with the entire foreign tax credit the recipient will only be able to claim 10% as opposed to the entire credit. This dramatically reduces the flexibility of managing the tax on foreign sourced income derived via ODI, contrary to principles applied to the rest of the tax system. Clearly the tax credit for non-resident withholding tax is severable from the income to which it relates. It can be dealt with separately at trust law. But our interpretation of the double tax treaty preserves the right to view that eligibility very narrowly with the result that a credit is denied in situations where it should reasonably be made available. We make it hard for the tax on ODI to be managed effectively. As mentioned above, the most clear example is the inability to carry forward foreign tax credits notwithstanding that the timing and measurement of income and expenditure between two jurisdictions will naturally be different. As a consequence the effective tax rate and the compliance cost to manage ODI increases providing a significant disincentive.

1.12 We would like to see a review of these rules to try and encourage foreign capital to come to New Zealand and invest via New Zealand by providing more flexible foreign tax credit rules to reduce the effective tax rate of ODI and reduce compliance costs.

1.13 Our tax system also provides disincentives for large organisations to headquarter in New Zealand, or remain headquartered in New Zealand. Previously, section DB 55 provided a deduction for all head office costs in relation to the stewardship of overseas investment entities. With its repeal, albeit belatedly, an international organisation with a headquarters based in New Zealand will be denied a deduction for expenditure incurred on stewardship functions which cannot be attributed to the provision of services to its subsidiaries offshore and validly claimed as a deduction in that offshore jurisdictions. This introduces significant disincentive for successful New Zealand organisations to remain headquartered in New Zealand, and for foreign entities to come to New Zealand and establish headquarters here. We think that there should be a review of the economics of providing a deduction for those stewardship costs as section DB 55 used to do, and more broadly a review of the impediments to entities with international operations basing themselves in New Zealand.

1.14 A significant segment of successful businesses with overseas operations are involved in information technology, communication and related intellectual property services. As the proportion of New Zealand's income from exporting these skills and intellectual property assets greater focus will fall on how tax effective the New Zealand tax system is for those companies. We have mentioned above the inflexibility around the management of foreign tax credits. With respect to ODI by New Zealand businesses in the intellectual property and services sector, greater compliance costs are imposed through the controlled foreign company regime treating any intellectual property with the remotest connection to New Zealand as requiring a full attribution and compliance under New Zealand law to its New Zealand shareholders or owners. That is, where a New Zealand business derives income offshore from intellectual property which has or had a connection with New Zealand it must file a tax return returning the income of that foreign entity calculated under New Zealand rules, including foreign exchange and other timing differences, as part of it's New Zealand tax obligations. If there is any difference between the New Zealand tax rate on that net income calculated according to our rules, and the amount of tax paid offshore, then a further payment will be required in New Zealand. As you can imagine, where businesses have multiple offshore jurisdictions this adds significantly to compliance costs in New Zealand and provides further encouragement for those businesses to relocate offshore.

1.15 We understand the underlying principle that royalty income and licence revenue is viewed as passive income which is mobile. That said, intellectual property will find its offshore market and be taxed accordingly. We propose that the treatment of offshore or foreign sourced revenues from intellectual property based businesses be reviewed to ensure that our tax system is not creating an impediment or disincentive for those businesses to continue to be based in New Zealand and execute their international growth strategies.

1.16 We do wonder whether the normal pattern of a sale of the intellectual property in toto to an offshore owner is significantly affected by the way in which we tax international organisations headquartered in New Zealand. We think further research needs to be undertaken to establish whether there is in fact a disincentive, and what type of changes might need to be made to remove those impediments or disincentives, let alone providing any incentive compared with bricks and mortar businesses. With an increasing mobility of skills, and the ability to work remotely, it is important to review the settings applied to these businesses so that New Zealand can retain both its skills and revenues from intellectual property. If our rules provided some incentive (or remove current disincentives) for IP-based companies to headquarter in New Zealand then that could increase the level of investment capital and skills capital New Zealand has in what is a very competitive international market.

1.17 Finally, there has been much discussion regarding the fairness of our tax system and the levels of tax applied to high-net-worth individuals when considering their economic income. There is a natural segue from the preceding comments to this issue. Any form of wealth tax imposed upon high-net-worth individuals will take capital out of the productive sector and reallocate it to the public sector. From our review of budget numbers, given the growth in the economy currently and in recent times being experienced, there is sufficient tax revenues from today's tax settings in order to fund the government expenditure. This is a complex and interrelated issue. Working for families tax credits reallocate income currently such that the bulk of tax cash flows are in fact funded by the highest income earners. There are inequities between the taxation of capital and income. However, we believe the real inequity is the rate of tax that income has born which funds consumption. By consumption we mean living expenses, which for a high-net-worth individual includes luxury houses, travel, motor cars et cetera. If we had a measure to ensure that no matter how funded, an individual pays tax based upon the amount of their consumption per annum then there would be an equity reached, combined with a progressive tax rate scale. If a high-net-worth individual consumes the same amount as an average wage earner, and chooses to invest and continue to compound their investment capital, as opposed to consume it, then they should not be taxed differentially for doing so. As observed in the LTIB the key issue is a lack of investment capital. Taxing that investment capital on an unrealised or realised basis transfers resources from the private sector investment capital pool to the public sector social spending pool. If that transfer is not required then taking this approach reduces the investment capital available to the economy to fund future growth, which includes jobs and tax revenues which can then fund social services as the government of the day determines. Taking this approach, there is equity as between individuals if they are both taxed at marginal rates on the total consumption. We acknowledge this presents measurement issues which we have undertaken some consideration of which would tax distributions from trusts in particular having regard to the use to which the funds are applied. This approach would effectively abandon the ability to live from capital - living costs would be treated as income regardless of how they are funded, whether it be from tax paid trust income or capital gains. There would need to be credit given for underlying tax paid so that the uplift related to the additional tax paid at the natural person level depending on their marginal tax rate. The framework provided by our imputation credit regime could equally be applied to trusts to facilitate the passing through of underlying credits.

1.18 Adopting a different approach to impose a wealth tax provides a disincentive for that capital to remain in New Zealand rather than an incentive to allocate that capital to productive sources as opposed to consumption. This will exacerbate our deficit of investment capital and provide further influence to government spending with potential attendant inflation risks. The fundamental question is that capital collected via the wealth tax that is imposed due to a redistribution philosophy better invested by government or better invested productively by the private sector with consequential benefits in terms of economic growth, jobs et cetera? We think the latter approach produces a far superior economic outcome when the effect of retaining capital, and ideally attracting or encouraging the allocation of capital to productive sectors and the tax revenue that flows from that as well as employment is taken into account. Providing further capital to the government to allocate or reallocate will produce an inferior economic outcome, particularly where the government can fund all necessary social services under the current model/balance sheet.

1.19 Introducing a wealth or redistribution tax will be regressive. The current approach to provide support to lower income families through working for families is supported as an effective mechanism to ameliorate the effect of the percentage of income consumed, and which bears GST, and serves to redistribute a level of wealth via the tax take.

1.20 The palatability of proposed initiatives to impose another layer of tax which will increase the effective tax rate in New Zealand and make us less attractive as an investment destination needs to be factored into the determination of tax principles.

1.21 Why not provide a fair system to tax consumption and provide incentives to allocate capital to productive investment. That would provide an opportunity to deal with the bias towards property investment in New Zealand.

1.22 At a principle level, why should we tax the unrealised wealth of New Zealanders and take capital from the economy and allocate it to government, when the best place for that capital is to remain in its productive role. It is acceptable for individuals to be wealthy and to have created wealth as long as they are taxed fairly against their fellow man (or woman). A person who is a high consumer will pay for that whereas a person who is more frugal and focused on investment will benefit from investing in the productive sector which will benefit our economy.

We would welcome further discussion on the principles that we have raised. Clearly, we do not have the resources to model the effect of taxing consumption for income tax purposes but believe it to be feasible and would result in removing much of the concern around the ability of high-net-worth individuals to reduce their marginal tax rate through tax planning and the source of funding for their consumption. Our approach does require an acceptance that no matter who owns investment capital it should be taxed in accordance with the entity which derives it, as opposed to being attributed to natural person shareholders. If the investment capital is invested productively then we should let it do its job, rather than impose economic costs and distortions by seeking to attract foreign investment capital. Adopting this approach would encourage all persons to consider investing as opposed to consuming, where possible.

Yours sincerely,

Brett Whyte
Principal