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AUSTRALIA + NEW ZEALAND

6 September 2021

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

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

Dear Sir / Madam

Tax, investment and productivity: Consultation on the scope of Inland Revenue's long-term insights briefing

Thank you for the opportunity to provide feedback on the proposed scope of Inland Revenue's long-term insights briefing (LTIB). Chartered Accountants Australia and New Zealand (CA ANZ) is supportive of this project and related workstreams.

In summary our comments are as follows:

- We agree that the impact of tax on investment and productivity is a worthwhile subject to investigate further.
- Several of the suggested options for consideration have been considered previously and it would be preferable to take a broader approach.

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- We recommend that the work also consider whether an increase in Foreign Direct Investment (FDI) would increase New Zealand's productivity.
- The work should consider the role of the tax system in:
  - Reducing the cost of capital into New Zealand;
  - Addressing New Zealand's infrastructure deficit;
  - Adapting to the changing nature of work; and
  - Attracting "frontier firms" to New Zealand.
- We suggest that the outcomes be used as a framework for future policy work.

General comments

As the consultation document notes, New Zealand's productivity is lower than comparable economies and this remains a concern to the business sector as well as Government.

We are supportive of work undertaken to assist New Zealand's international competitiveness and productivity. We agree that it will be useful to consider whether the tax settings are a contributing factor.

Productivity in New Zealand

New Zealand's productivity has been the subject of much investigation.

In 2017, the Tax Working Group considered New Zealand's productivity as part of its work. The group investigated a number of options for tax reform that could advance productivity and boost investment. In particular, it considered[1]:

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[1] https://taxworkinggroup.govt.nz/resources/future-tax-final-report-vol-i-html.html#child-47, Chapter 6 and Summary at

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- Changes to the loss continuity rules;
- An expansion of black-hole deductions;
- Reinstatement of building depreciation deductions;
- Removal of residential rental loss ring-fencing rules; and
- Tax concessions for nationally significant projects.

The first three of these have been addressed to some extent although further work is needed to extend the scope of deductible feasibility expenditure. We hope that the introduction of the residential property interest denial rules may bring with it a repeal of the residential rental loss ring-fencing rules. To our knowledge, the last measure is the only one that has not been progressed in any form.

It may be too early to tell whether the changes have affected New Zealand's productivity. However, to date, there have not been any headline changes. It is likely that something bolder is needed.

Proposed topics for consideration

The proposed scope suggests the following as possibilities:

- Reductions in the company tax rate;
- Measures which increase the present value of capital write offs for capital expenditure;
- Measures to take account of inflation to reduce overstatements or understatements of capital income;
- Changes to thin-capitalisation rules which might allow multinational firms to claim greater deductions for interest expense;

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- Changes to allow multinational firms or other firms with foreign shareholders a notional interest deduction on their equity;
- Specific incentives for particular types of investment or specific types of business, and
- More fundamental changes in the tax base such as the dual income tax structure adopted in Nordic countries with a relatively low flat marginal tax rate on capital income with higher progressive tax rates on labour income.

All of these would be useful to consider. However, many have been considered already as part of the Tax Working Groups in 2009 and 2017. Again, it is likely that something bolder is needed.

Foreign Direct Investment

A key question is whether an increase in FDI would increase New Zealand's productivity. According to the scope document, New Zealand's FDI is low compared to other countries.

Ultimately a non-resident investor will view the New Zealand tax cost as another cost that will impact return on investment or increase the cost of goods and services it charges to New Zealand customers. The lower the taxes the lower the charges to New Zealand customers and the increased likelihood the investment will occur.

The key issues will be the level of tax, the certainty that these taxes will remain constant and above all the predictability of the direction of tax changes. Recent periods have suggested that non-residents have faced increased NZ tax obligations.

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Cost of capital

We believe the cost of capital will be key to increasing New Zealand's productivity over the medium to long term. New Zealand is going to need an enormous amount of capital to:

- address the infrastructure deficit;
- invest in New Zealand businesses to grow and/or become "frontier firms"; and
- encourage frontier firms to locate themselves here.

It is unlikely that all infrastructure needed can be funded exclusively from the Government balance sheet. The LITB should be considering

- where the additional capital will come from; and
- how the tax system should be designed to allow the desired capital flows.

If the work concludes that the capital will come from overseas, we recommend the LTIB consider how best to attract investment into New Zealand. This will include broader considerations such as:

- cost of capital;
- cost of engagement;
- ease of engagement; and
- ability to link up with the rest of the world;

and the tax system has a role in them all.

The LTIB work should look at what more can be done in the tax system to achieve each of these, including any changes to tax administration through further leveraging the START system. At the time of introduction, the START system was seen as "billion dollar investment" and should be an asset to be leveraged for medium and long term benefit. The return on investment should not be limited to additional tax collected and reducing head count at Inland Revenue. The LTIB should consider how the START system can contribute to ease of doing business in New Zealand.

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Another important component will be how non-residents are taxed compared to New Zealand residents under our current system, whether the differences remain appropriate and what changes could be made to the tax settings to attract foreign capital into New Zealand. At that point, it would be appropriate to consider measures such as thin capitalisation or notional interest deductions, but we recommend that a broader enquiry is undertaken first.

A foreign investor will have a choice of entities and structures to use as it looks to put capital into New Zealand. The tax system includes specific regimes for many different tax entities and it is often difficult to see the reasons for the differences. It would be easier for a foreign investor to invest into New Zealand if the structures could be chosen for commercial reasons, with tax being neutral across all equivalent structures. A key part of the work should be to articulate the reasons for the differences or establish tax neutrality across all structures.

New Zealand infrastructure

Concerns have been raised regarding New Zealand's infrastructure and the difficulty faced by Government in delivering large scale infrastructure projects; for example, Transmission Gully and Kiwibuild.

There is a growing need for additional infrastructure in New Zealand including:

- housing;
- roading (including bridges and tunnels);
- public transport;
- water infrastructure (the Three Waters project).

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The work should also consider whether an increase in FDI or a change in tax settings could assist to address New Zealand's infrastructure deficit.

Many foreign investors and investment consortiums incur large up-front costs, including due diligence, scoping and tendering for significant infrastructure projects. These costs are not recoverable nor are they tax deductible in the event that the bid is unsuccessful.

It is important that foreign investors have certainty of tax outcome from investigation of viability, financing and construction if successful and potentially operation. Costs can be reduced if tax outcomes are neutral as between similar investment structures. At present there is a heavy reliance on private rulings to provide tax certainty. Changes in factual position or key assumptions add to these costs as often a new ruling is required.

The future of work

As you are aware, the nature of work is changing. Covid-19 has demonstrated that business can be conducted from home and individual employees can work from home. Many now have more than one income source. Technology continues to improve. This has implications for where people are likely to locate in future and therefore our infrastructure need. This should be considered in prioritising infrastructure projects and developing the tax settings needed to achieve them.

The changing nature of work also has implications for the way people structure their business affairs. It would be useful to look at the way businesses are taxed and whether the settings are appropriate. A person in New Zealand may choose to go into business as a sole trader, or through a partnership, a company or an LTC. Should tax settings be neutral across all structures? If not, why should the treatments be different? Articulating the reasons for the differences will be key in deciding which policy settings to retain or change going forward.

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The study should also consider personal tax rates. Businesses operating as a sole trader or through a partnership or LTC will equally be affected by personal tax rates. This includes those in the "gig economy". For SME companies that are predominantly New Zealand owned, the personal tax rate may influence investment decisions.

The interaction between the tax and social policy systems is important. The Welfare Expert Advisory Group (WEAG) made a range of recommendations in 2019, many of which have not been adopted. Work undertaken on how to increase New Zealand's productivity should additionally take into account care required for the most vulnerable members of society and how they can transition to generating income/further income if and when appropriate.

The WEAG's report highlighted that the rules for benefit abatement could lead to extremely high effective marginal tax rates for people moving into work. It recommended increases to the level at which Working for Families credits were abated, and a reduction in the rate at which they were removed. There are currently well-publicised labour shortages, which is having a significant effect on New Zealand's productivity. The LTIB should consider whether the interaction between tax and social policy systems has a role to play.

Frontier firms

The consultation document states that the LTIB work will be done in conjunction with the Treasury and other Government agencies. We note the importance placed on "frontier firms"[2] in the Productivity

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[2] https://www.productivity.govt.nz/assets/Documents/Final-report-Frontier-firms.pdf

Commission's report. If frontier firms are the best pathway to growth, then it would be worthwhile to explore which tax settings would attract frontier firms to New Zealand, including any changes as appropriate to our R&D regime.

Outcome of the LTIB

The scope document is silent on how the outputs from the study will be used.

In the event that the tax system is shown to impact productivity, we believe that as a minimum the output should be used as a foundation for a policy framework or terms of reference against which to evaluate all future policy work.

Ideally more detailed policy work should then be undertaken to develop a suite of tax changes that may be adopted by Government to increase productivity. The work should be done in conjunction with other areas of Government to play a part in a whole-of-Government response to leverage productivity in New Zealand.

Page 36 of the consultation document notes that possible measures which might lower costs of capital are likely to include:

- changes to allow multinational firms or other firms with foreign shareholders a notional interest deduction on their equity;
- specific incentives for particular types of investment or specific types of business ...

Recent policy projects in the short term have moved to restrict multinationals interest deductions, rather than ensure they are allowed (for example restricted transfer pricing/changes to thin capitalisation and the work on hybrids). While we are not against New Zealand being broadly in step with other comparable countries to do business, the cost of belonging needs to be evaluated against the long term good of New Zealand's economy and it may be that a more muted response is appropriate.

Other projects have added to the tax cost of inbound investment such as the work on thin capitalisation and changes to AIL and NRWT. If tax cost of FDI is a barrier to productivity, Government should take that into consideration in deciding whether to progress future policy projects.

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

Yours faithfully

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Reponses to specific questions

- Is tax and its impact on investment and productivity a worthwhile subject to investigate further through an LTIB?
  Yes

- Are there other global tax trends that are critical to this study which should be considered?
  Yes - the tax settings they have used to attract frontier firms and foreign capital

- Are these sensible policy options to consider?
  Yes

- Are there other reforms which should also be considered?

We recommend that the work also consider whether an increase in FDI would increase New Zealand's productivity.

The work should also consider the role of the tax system in:

- Reducing the cost of capital into New Zealand;
- Addressing New Zealand's infrastructure deficit;
- Adapting to the changing nature of work; and
- Attracting "frontier firms" to New Zealand.