Tax Working Group
Te Awheawhe Tāke

Tax Working Group Public Submissions Information Release

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27 April 2018

Tax Working Group Secretariat
PO Box 3724
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Submitted by email: submissions@taxworkinggroup.govt.nz

Dear Sir/Madam

Tax Working Group Submission

Please find attached our submission to the Tax Working Group.

Craigs Investment Partners is one of New Zealand's largest investment advisory and management firms, offering personalised investment solutions to private, corporate and institutional clients. We have 17 offices across New Zealand, 140 advisers (all Authorised Financial Advisers, or studying towards this), 440 staff, 50,000 clients and over $14 billion of client funds under management. We are also a KiwiSaver provider.

We have focused our comments on investment and retirement savings.

We would welcome contact by the Tax Working Group and Secretariat to discuss the points raised, if required.

Yours faithfully
Craigs Investment Partners Limited

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Introduction

We commend the TWG Submissions Background Paper. It provides a thought provoking overview of the risks and challenges facing our tax system. In particular, our ageing demographic brings into focus the obvious pressure this will bring to bear on superannuation and healthcare costs. Environmental issues, retirement savings, global equalisation of company tax rates and fairness across the tax base are among the other important issues discussed in the paper.

As investment advisers, not tax experts, we have focused our comments on the areas where we believe we have most to add, namely investment and retirement savings.

As requested on the TWG website, we have kept our submission brief. We outline our major points and provide recommendations under four areas;

1. Financial literacy
2. Tax neutrality across asset classes
3. Consistent taxation methodology across investments
4. Savings incentives

Our submission

1. Financial literacy

We sense two themes underpinning this report, and many other similar reports over recent decades, are the vexed questions of how to lift savings, and how to channel more of these savings into productive assets.

Tax settings are clearly an important factor. Tax undoubtedly influences investor decisions on how much to save, and on what assets to buy.

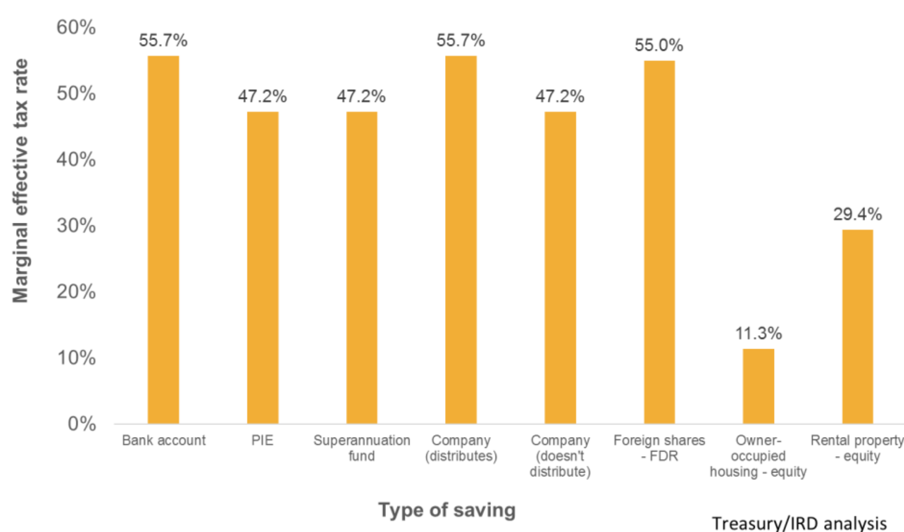
We also believe financial literacy has the potential to play a central role in addressing these issues. People who have a broad appreciation of some key investment concepts such as 'the how and why to save', the power of compounding, and an appreciation of risk and the role of diversification, are likely to make more informed investment decisions.

When people think about saving and investment, these factors should ideally take priority over tax. For this reason, we believe financial literacy should be a component of any government strategy on the taxation of savings.

2. Tax neutrality across asset classes

From an investment perspective, we believe the overriding principle of taxation policy should be to make the tax impost as agnostic as possible across asset classes (cash, bonds, listed property, shares, rental properties and the increasingly long list of alternative investments like cryptocurrencies, gold, art and so on). This neutrality ensures taxation does not drive investment decisions. A person's portfolio should be constructed based on their risk profile and long term financial goals, not tax. Material variability in after-tax returns across asset classes can lead to inefficient asset allocations.

The TWG recognises the importance of minimising the differences in the tax treatment of different investments on page 39 of the Submissions Background Paper. We agree with the TWG that the consistent treatment of different investments should improve both fairness and efficiency. Unfortunately, the current situation in New Zealand is far from neutral across asset classes. This is clearly illustrated by figure 21 on page 40 of the Submissions Background Paper (copied below).



The tax impost on cash deposits is nearly double that on residential rental property. This inequity across asset classes has obvious implications for investment decisions and, from the government's perspective, tax revenue. In 2009, the IRD estimated the value of the residential rental property market for the Tax Working Group at $200 billion[1]. At this time, the Reserve Bank of New Zealand (RBNZ) estimated the total housing stock as being worth $578 billion[2]. Based on the IRD's estimate, rental properties accounted for some 34% of total residential property.

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[1] A Tax System for New Zealand's Future, Report of the VUW Tax Working Group, January 2010
[2] RBNZ housing statistics – Housing M10, rbnz.govt.nz

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Taking the December 2017 RBNZ total housing stock figure of just over $1 trillion, and assuming rentals represent the same proportion of total housing, infers $350 billion is invested in residential rental property in New Zealand. By comparison there is currently $47 billion invested in KiwiSaver[3]. Given the size of the residential rental market and its relative tax impost, aligning this asset's tax profile with other asset classes would clearly lift government revenue.

Recommendations

a. **Better align the tax impost on rental property with other asset classes** – Rental property is the obvious outlier asset class from a taxation perspective. It incurs a significantly lower tax burden than the other investment assets. We note the government is already taking steps to address this with the recent extension to the bright line test for the application of capital gains tax from two years to five years and with the March 2018 proposal to ring-fence losses on rental properties[4]. We suggest these measures should be complemented with a capital gains tax on realised gains for this asset class. Together, these policy settings may better align the tax rate on rental property with other investment assets.

b. **Inflation indexing should be considered** – Nominal returns are taxable. People who invest in cash and bonds tend to be more detrimentally affected by taxation as generally a higher proportion of their total return (interest) is impacted by inflation. The CWG should consider some form of inflation indexing to mitigate the unfair impact of inflation on investors in cash and bonds. This protection is warranted as, in our view, deposits and other low-risk fixed income is often the preferred investment of less sophisticated investors.

c. **Potentially lower the FDR 5% rate** – The FDR rate of 5% per annum was established 10 years ago. Interest rates and global dividend yields have fallen since then and the appropriateness of retaining a 5% rate should be reviewed. A lower rate of 3% to 4% should be considered, along with a set review period, perhaps five yearly.

[3] RBNZ KiwiSaver statistics – KiwiSaver T43, rbnz.govt.nz

[4] IRD Issues Paper, Ring-fencing rental losses, 28 March 2018

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3. Consistent taxation methodology across investments

Not only does the rate of tax impost differ across asset classes, but so does the calculation method. Cash and bonds are subject to the financial arrangement rules, local shares are under the dividend-only approach, rental properties are taxed on net rents with no capital gains taxed if held for more than five years, while global shares are taxed under the foreign investment fund regime, the mainstay of which is a deemed taxable fair dividend rate (FDR) of 5% per annum.

Recommendations

a. **Consider aligning methodologies where possible** - While we believe it would be beneficial to simplify this situation and apply a standard approach across all asset classes, in practice this may prove challenging given the differing nature of asset classes.

   Injecting a capital gains tax on rental property would add another 'unique' approach for a single asset class. However, we believe the alignment of tax rates across asset classes is more important than having a consistent methodology.

   The different tax methodologies used for local shares and global shares is an obvious distinction that warrants discussion. Local shares are generally taxed on dividends only while global shares have been taxed under the Foreign Investment Fund (FIF) regime since 2007. They were previously treated in the same way as local shares and only dividends were taxable.

   The FIF regime is complex and has a perceived additional tax impost over and above local shares. We understand it is also fundamentally different from any other tax in New Zealand, and perhaps globally, in that it is effectively a tax on unrealised capital gains.

   The fact that, if net dividend income is insufficient, underlying assets may need to be sold to provide cash to pay the tax is out of step with the structure of capital gains taxes overseas. These apply only to realised gains, which provides the liquidity needed to fund the tax.

   This fundamental flaw means FDR could not be applied to less liquid asset classes, like rental property. In our view, the FIF regime has only been tenable since its introduction a decade ago because investors have drawn on other cash, or have been able to sell some global shares. We also note that this invokes additional costs on these investors as selling assets incurs transaction costs.

   These factors have undoubtedly led to reluctance from some investors to invest in global shares, which undermines prudent diversification. Data on how much impact it has had on weightings to this asset class is difficult to ascertain as other factors are also at play, such as the strong performance of local shares over the past decade.

   Local investors we deal with have become accustomed to the FIF regime and investment firms now have well-embedded reporting systems. However, given the increased global mobility of labour and capital, we believe the fact that the FIF regime is out of step with other capital gains tax methodologies around the world should be recognised and considered as part of this review.

b. **Local equities, capital versus revenue account** – An issue that arose when the PIE regime was established is that PIE fund managers are able to actively buy and sell local equities on capital account while private investors cannot. While most private investors, in our view, take a long-term approach when owning shares, there are some who prefer a more active approach. The taxation certainty provided to fund managers under the PIE regime is not available to private investors. This uncertainty creates deadweight costs for private investors and is inequitable. A consistent approach which is fair to both PIE managers and private investors should be considered.

4. Savings incentives

KiwiSaver has been an indisputable success since its launch a little over a decade ago. The tax incentives on KiwiSaver have clearly supported this growth. Recognising the social and economic benefits that accrue from a higher savings rate, we believe there is scope to further lift tax incentives in KiwiSaver.

Being mindful of the TWG's mandate to be fiscally neutral, lifting the tax revenue on rental property would, we believe, provide the scope to raise savings incentives.

Recommendations

a. **Retirement savings incentives could be boosted** – The key taxation incentive in New Zealand is the differential between the Prescribed Investor Rate (PIR) tax rate on Portfolio Investment Entities (PIEs) and personal tax rates. There is also an annual member tax credit of a maximum of $521.43. As KiwiSaver balances continue to build, this will become less material.

   The current incentive provided by the PIR rates is small as the differential between the PIR rates and personal rates is modest. Lower PIR rates may help encourage more New Zealanders to use KiwiSaver as their preferred long-term savings vehicle. More compelling incentives are required in our view, to balance the 'locked-up' nature of KiwiSaver.

   Tax policy could be used to boost savings in New Zealand by reducing PIR rates given 90% of retirement income is generated by (compounding) investment income[5].

   As noted in the Submissions Background Paper, New Zealand has a TTE approach to the taxation of retirement savings. We believe this should be shifted towards an EET approach. Tax on investment returns is a significant cost borne by those saving for retirement in financial assets, like cash, shares and KiwiSaver. As such, an EET approach can provide a material boost to the ultimate value of a saver's retirement nest-egg[6].

b. **Apply PIE rates to directly held investments** – Many people prefer to save outside KiwiSaver or PIEs. They should be able to apply the PIR tax rates to these direct investments as well.

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[5] 2011 Savings Working Group, referenced by Terry Baucher on interest.co.nz, 29 August 2017, *Why KiwiSaver and Bitcoin mean some form of comprehensive capital taxation is inevitable*

[6] The tax barrier to retirement prosperity in New Zealand, Financial Services Council, 2013