

Tax Working Group Public Submissions Information Release

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SUBMISSION

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Submission on: **The Future of Tax Submissions Background Paper**

From: **Federated Farmers of New Zealand**

Date: 30 April 2018

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**SUBMISSION TO THE TAX WORKING GROUP
ON THE FUTURE OF TAX SUBMISSIONS BACKGROUND PAPER**

1. INTRODUCTION

- 1.1 Federated Farmers of New Zealand welcomes the opportunity to submit to the Tax Working Group on its *Future of Tax Submissions Background Paper*.
- 1.2 Overall, Federated Farmers supports New Zealand's current 'broad-base low-rate' tax system and its adherence to well-established principles of good taxation which are well summarised on page 5 of the Background Paper:
- Efficiency;
 - Equity and fairness;
 - Revenue integrity;
 - Fiscal adequacy;
 - Compliance and administration costs; and
 - Coherence.
- 1.3 New Zealand has relatively low tax compliance costs by international standards and we congratulate successive Governments for their work to achieve this. The tax system is also relatively neutral and non-distortionary.
- 1.4 Any Tax Working Group proposals to change the tax system should be assessed against the above principles and consistency with the need to retain a broad-base low-rate system with low compliance costs. They should also be fiscally neutral – the revenue raised by any new tax or increase in an existing tax should be offset by reductions in other taxes.
- 1.5 Federated Farmers undertook a comprehensive member survey to inform this submission. The results of the survey are attached as Appendix 1. Generally speaking, farmers are satisfied with the current tax system and consider it to be fair.
- 1.6 Our members endorsed the Government objective¹ that the tax system should support a sustainable revenue base to fund government operating expenditure around its historical level of 30% of GDP². Any decisions on the quantum of tax revenue (increases or decreases) should be made on their own merits and on wider macroeconomic considerations.
- 1.7 Small and medium sized enterprises (SMEs) are not well represented in the world of tax policy. While we do not pretend to speak on behalf of all SMEs, Federated Farmers is a key representative of SMEs. The perspectives we bring to the table on behalf of our farmer members will apply to a significant number of enterprises throughout the wider economy. As outlined on the Ministry of Business Innovation and Employment's website, SMEs of up to 20 employees are an important part of the New Zealand economy, accounting for 97% of all enterprises, 29% of all employees and an estimated 26% of New Zealand's Gross Domestic Product.³

¹ One of the terms of reference of the Tax Working Group at page 53-54 of the Background Paper.

² 81% of the members that responded agreed with this, 5% disagreed, and 14% did not know.

³ <http://www.mbie.govt.nz/info-services/business/business-growth-and-internationalisation/small-enterprise>

- 1.8 Federated Farmers acknowledges individual submissions from its members and we have read and support the submissions made by Dairy New Zealand, Horticulture New Zealand, and Irrigation New Zealand.
- 1.9 Federated Farmers would appreciate the opportunity to meet with the Tax Working Group to discuss this submission.
- 1.10 The remainder of this submission is in four sections:
- Submission Points;
 - Goods & Services Tax and Income Tax;
 - Taxes on Capital (Capital Gains Tax and Land Tax); and
 - Tax and the Environment.
- 1.11 We have also attached four appendixes:
1. Results from Federated Farmers survey on tax
 2. Capital gains tax examples
 3. NZIER report *How to Think About Taxes*
 4. Environmental regulatory framework as it effects farmers

2. SUMMARY OF SUBMISSION POINTS

2.1 Goods & Services Tax and Income Tax

General

(a) Federated Farmers endorses New Zealand's current high-level GST and Income Tax settings including the imputation regime.

Goods & Services Tax

(b) Federated Farmers endorses the comprehensive nature of the current GST. Thus, we disagree with any suggestion of targeted GST exemptions.

Income Tax

(c) The top rate of personal income tax and the trust rate should continue to be aligned so as to prevent aggressive tax planning of the sort that occurred in the 2000s when these rates were not aligned.

(d) The margin between the top rate of personal income tax and the company tax rate should be as small as practicable and should not be any larger than the current margin of 5%. We understand that Inland Revenue is concerned that tax planning is occurring because the current margin already provides a sufficient incentive.

(e) The removal of intra-family enterprise resident withholding tax (RWT) obligations on interest and dividends would further reduce compliance costs without real risk to the tax base.

(f) We do not agree with the proposal for a progressive company tax rate.

2.2 Taxes on Capital (Capital Gains Tax and Land Tax)

Capital gains tax

(a) Federated Farmers supports the current taxation regime that provides the ability to tax the earnings of individuals and firms that are in the business of trading property but we are opposed to a 'comprehensive' capital gains tax (CGT). Our opposition is both philosophical and pragmatic. There are considerable challenges in making a capital gains tax workable. These include:

- How to deal with double taxation or double losses (caused by capital gains and losses in the company being reflected in the share price, which is also subject to CGT);
- How to deal with livestock Herd Scheme gains and losses which are currently regarded as being on capital account;
- How to index gains so the inflation component is not taxed (the same issues currently exist with income tax on revenue account property and monies on deposit for interest); and
- How to deal with roll-over relief for intra-family and intra-group company transactions and for transactions involving Maori land and its owners.

(b) The 'KISS' (keep it simple) principle should apply. If there is a particular problem about 'speculation', then perhaps the bright-line test might be a better solution.

(c) Without prejudice, we submit that no commitment to a CGT should be made until it has been established that the practical concerns can be addressed in a manner

that is appropriate in the New Zealand context. This includes the need to keep compliance costs low.

Land tax

- (d) Federated Farmers is opposed to land tax. A land tax would be punitive and inequitable on farming.
- (e) A land tax is suffered by the owner of the land when the tax is introduced – as that value will decrease by the present value of the future land tax payments. Future owners pay a lesser price to acquire the land, but this is offset by the annual obligation to pay land tax.
- (f) Land tax has the potential to turn highly geared enterprises equity-negative, potentially with a flow on effect to banks and other financiers. Further, developing businesses, or businesses whose annual income fluctuates, may not have sufficient cash flow in any one year to pay a land tax. This is a particular concern for farming that can have significant and often unpredictable variations in gross revenue due to the vagaries of international commodity prices, exchange rates, interest rates, and the weather.
- (g) There may also be cash flow problems for owners of fallow land, and this could particularly affect Maori land.

2.3 Tax and the Environment

- (a) The consideration of taxation in isolation as a response to environmental issues is flawed. There is a range of levers, including regulation and industry-led initiatives, as well as taxation, that can be used. These other levers are efficient and can work in a way that is more targeted and is iterative. Indeed, New Zealand has been focusing on regulation for some time now, along with some support from the taxation system (in the form of deductions for some environmental expenditure).
- (b) As is illustrated in Appendix 4, there are a significant number of regulatory frameworks that are currently in place that affect farmers that are working well and that actively encourage (by specifying) remedial activities. Unless there is clear evidence that these frameworks are irretrievably broken there is little point in trying to substitute taxation for these frameworks.
- (c) Further, we note in this context a tax might not encourage appropriate remedial activities. Taxpayers might decide it is cheaper to simply pay the tax, particularly if they have limited ability to change/respond. At the least the law of diminishing returns will apply and the tax rate will likely have to be significant to encourage the outliers, as is the case with cigarette smoking. In contrast, regulation is compulsory.
- (d) Any further projects in the environment space should start with a robust problem definition which is based on science. It is only once the problem has been defined that solutions, which may or may not include taxation, can be considered in the context of the wider economic framework. Obviously, compliance and administration costs will be an important part of any solution and these must always be considered.
- (e) The costs of maintaining QE II covenanted land should be expressly deductible.

3. INCOME TAX AND GOODS & SERVICES TAX

- 3.1 Federated Farmers believes that the current New Zealand income tax and GST settings are about right. We agree with the general high-level findings of the Tax Review 2001 and the Victoria University Tax Working Group (VUTWG) that the “broad base low rate” approach that was entrenched in the late 1980s is the correct approach for New Zealand.
- 3.2 In particular, we note that past tax reviews have enunciated six principles considered important when considering change to the income tax and GST regimes. These are reiterated in the Background Paper:
- Efficiency and growth;
 - Equity and fairness;
 - Revenue integrity;
 - Fiscal cost;
 - Compliance and administration costs; and
 - Coherence.
- 3.3 We endorse the concepts that underpin these principles and agree that all taxation proposals should be considered against these principles.
- 3.4 However, having regard to the Tax Working Group’s mandate, we have some specific comments about features we regard as important.

Goods & Services Tax

- 3.5 New Zealand’s comprehensive GST regime is regarded as being the best in the world. It is simple and certain and has, by international standards, very low compliance (taxpayer) and administration (Inland Revenue) costs.
- 3.6 We disagree with the suggestion that certain basic items, such as food, should be removed from the GST regime. The simplicity and certainty that the current regime provides should not be abandoned in any circumstances. The “slippery slope” rule would apply as the lobbying for relief would be intense (as it was when GST was introduced). There are other government policy mechanisms that are better placed to address concerns about the affordability of basic items.
- 3.7 Further, a targeted reduction in GST may only have a short-term effect on consumers and we note that food prices in particular can be very volatile and seasonal.
- 3.8 66% of respondents to our member survey opposed exempting basic items from GST while 29% supported doing so.

Company tax

- 3.9 New Zealand’s company tax rate is currently 28%. While this is a judgement call, we think that this is at an appropriate level. Our member survey confirms this, with 66% saying it is ‘about right’.
- 3.10 New Zealand’s company tax fills two roles:

1. With imputation, company tax is a withholding tax for New Zealand shareholders. This would suggest that there should not be a gap, or too big a gap, between the company tax rate and the top individual tax rate or the trust tax rate; and
2. Company tax is a final tax for foreigners who invest into New Zealand (inbound investment). If the New Zealand company tax rate gets too much higher than those of our major inbound investors this could put pressure on base maintenance as the inbound investors' taxation behaviour would be more aggressive. Yet if the rate is not as high as it reasonably can be we could be 'giving away' tax to inbound investors.

Imputation

- 3.11 New Zealand and Australia are the only two countries in the world that have imputation. Imputation gives shareholders a tax credit for New Zealand taxation paid by the company. Thus, as noted above, company tax is a withholding tax for a New Zealand shareholder and imputation ensures that there is no double taxation, as would occur under the classical dividend regime where shareholders get no credit for company tax paid. Federated Farmers endorses the imputation regime.

Individual and trust tax rates

- 3.12 The top individual marginal tax rate is 33% and the trust rate is the same. When these rates were out of alignment in the 2000s there was a significant amount of inappropriate tax planning and tax avoidance.
- 3.13 As noted above, the bigger the gap is between the company tax rate and the top individual rate the more risk there is of inappropriate tax planning. Care should be taken to ensure that this gap is as small as is practicable. Even with the current 5c gap we understand that Inland Revenue is concerned about some of the tax planning that is currently taking place.

Compliance costs

- 3.14 The fact that New Zealand's income tax regimes all link together coherently mean that compliance and administration costs in New Zealand are low. However, as is the case all around the world, compliance costs as a percentage of net income are higher for SMEs, and this is particularly apparent when an SME has its first employee. We congratulate the Government on the recent extension of the Payroll subsidy and for ongoing efforts to simplify tax compliance costs.
- 3.15 We do have a suggestion on SME compliance costs. RWT on interest and dividends was understandably introduced to counter evasion – the non-returning of the interest and dividend income. However, this evasion was not occurring in the intra-family entity transactions that typically occur in the family business. Rather, it was interest from commercial deposits and dividends from listed shares that was the concern. There would be reasonable compliance costs savings for SMEs if RWT on SME intra-family entity interest and dividends was abolished. It would be replaced by provisional and terminal tax. We do not think that there would be fiscal risk in this area.

SME company tax rate

3.16 The background paper asks for submissions on whether a 26% tax rate would assist SME companies. While we appreciate the intent of this suggestion, we believe that there are a number of problems with this, including:

- A significant percentage of SMEs are not companies. There are individuals and sometimes trusts and there may or may not be partnerships of these persons. Further, look-through companies are treated for tax purposes as a partnership, or, if there is one shareholder, as a sole trader. This is particularly the case for farming. According to Statistics NZ's Business Demography Statistics 2017, only 36.6% of agriculture, forestry and fishing businesses were structured as limited liability companies, compared to 55.6% for all businesses. There are still more partnerships than companies in the agriculture, forestry and fishing sector.
- The benefit is only a timing benefit – with the imputation regime it reverses when the company income is paid out to the shareholder(s).
- The temporary saving would only be \$2,000 per \$100,000 of taxable income – while all savings are helpful, this is not likely to be very significant.
- It would significantly complicate the imputation regime as there would have to be two separate company tax rates, and as companies move over or under the SME threshold (whatever that is) they would be required to keep an imputation account for each rate of company tax.
- Given that New Zealand can't discriminate vis-à-vis tax rates with foreign companies some New Zealand companies owned by multi-nationals may qualify for the lower tax rate.
- The increase in the gap between the SME company tax rate and the individual's top marginal tax rate would likely cause even more inappropriate tax planning.
- How would SMEs be defined – turnover, taxable income, assets or number of shareholders? This will be difficult.
- There would be transitional issues to work through.

3.17 In our member survey those opposed to a progressive company tax rate outnumbered those who supported it by 2 to 1 (i.e., 26% to 12%). There were a large number (55%) who said 'maybe' but judging by the comments many of them were aware of the problems listed above. Therefore, Federated Farmers does not support a progressive company tax.

Submission points – Goods & Services Tax and Income Tax

General

3.18 Federated Farmers endorses New Zealand's current high-level GST and Income Tax settings including the imputation regime.

Goods & Services Tax

3.19 Federated Farmers endorses the comprehensive nature of the current GST. Thus, we disagree with any suggestion of targeted GST exemptions.

Income Tax

3.20 The top rate of personal income tax and the trust rate should continue to be aligned so as to prevent aggressive tax planning of the sort that occurred in the 2000s when these rates were not aligned.

- 3.21 The margin between the top rate of personal income tax and the company tax rate should be as small as practicable and should not be any larger than the current margin of 5%. We understand that Inland Revenue is concerned that tax planning is occurring because the current margin already provides sufficient incentive.
- 3.22 The removal of intra-family enterprise resident withholding tax (RWT) obligations on interest and dividends would further reduce compliance costs without real risk to the tax base.
- 3.23 We do not agree with the proposal for a progressive company tax rate.

4. TAXES ON CAPITAL (CAPITAL GAINS TAX AND LAND TAX)

4.1 The background paper discusses two taxes on capital:

- A tax on capital gains (CGT); and
- A land tax;

4.2 In both cases the proposed tax base excludes the family home.

4.3 The VUTWG discussed both of these taxes in its January 2010 report. Its conclusions were:

- A comprehensive CGT was supported by some members of the VUTWG, seemingly because of its conceptual attractiveness, however, most members opposed it because they were concerned about the practical challenges and the efficiency implications of introducing a CGT; and
- Most members of the VUTWG supported a low-rate land tax but noted that there were concerns over political sustainability and other issues.

4.4 Conceptually, the base for a CGT or a land tax should be comprehensive, that is have few exemptions. While we understand the political reasoning for the exclusion of the family home from the bases of both a CGT and a land tax, this means that neither of these tax bases would be fully comprehensive. Likely necessity for further exemptions will further exacerbate this problem. An outcome is that family homes would (if overseas guidance is any indicator) become over-capitalised and this could cause house prices to rise overall. If the goal of these taxes is to address housing affordability, then neither are likely to succeed.

CGT discussion

4.5 The long-standing separation of income from capital assets (the fruit) from any gains from the capital itself (the tree) emanates from old English trust law. New Zealand's income tax law is based on this separation. New Zealand should only deviate from this successful separation of income from capital model if very good reasons exist. To date no general case has been made to change this model.

4.6 Conceptually an ideal capital gains tax will:

- Tax gains on assets that are within the base as they accrue. In practice this cannot be achieved as it would require annual valuation. Thus, any CGT would apply on a realisation basis, with the resulting lock-in effect as CGT would then become a transaction tax; and
- Apply to all assets other than consumable assets (such as depreciating cars, white-ware etc.) so as to prevent distortions in investment. This cannot be achieved because of, most notably, the exclusion of the family home.

4.7 Thus, any CGT in New Zealand will not be conceptually correct. We acknowledge that these two issues are a general problem in countries that do tax capital gains, but in combination they will distort economic behaviour.

4.8 Our member survey indicated strong opposition to a CGT, with 81% opposing and only 11% supporting the proposal.

Bright-line test

- 4.9 In some circumstances New Zealand currently taxes capital gains when undertaken by people regarded as ‘traders’. Land is the most notable example. To buttress the intention test (property acquired with the intention of sale is on tax account) the previous Government enacted a rule (known as the bright-line test) that taxes gains on residential property, other than the primary residence, if it is sold within two years of acquisition. This two-year rule has just been extended to five years.
- 4.10 We understand that the two-year rule has resulted in ‘over-reach’ in that it has captured ordinary New Zealanders selling property for non-profit related reasons as well as genuine property traders/speculators. That is, it applies to some sales of residential property that were clearly held on capital account (as opposed to the tax account). This over-reach will be exacerbated by the recent extension from two years to five years.
- 4.11 The bright-line test means New Zealand already taxes residential property that is held on capital account where that property is sold within five years of acquisition. Federated Farmers did not oppose either the two-year rule, or the extension from two years to five years.
- 4.12 If the problem that a CGT is supposed to address is speculation in land, then the effect of the five-year extension to the bright-line test should be analysed first. We believe that the five-year rule will substantially address any real concerns about land speculation, in which case a CGT as well would be largely redundant.
- 4.13 According to our member survey, opposition to a CGT did reduce if it were framed as a bright-line test. 47% supported the bright-line test, with five years the most favoured period. That said, 45% still opposed a CGT under any circumstance.

Implementation issues

- 4.14 If the Tax Working Group does want to recommend a CGT, it should only do so after it has satisfied itself that it can be implemented in a fair fashion without the incurrance of onerous compliance and administration costs.
- 4.15 There is a plethora of issues that would have to be addressed as part of its implementation. In no particular order these include:
- Presently the portfolio investment (PIE) rules exempt from income tax certain trading gains that ordinarily would be taxable. These rules would have to be rethought.
 - The issue of double taxation or double losses caused by capital gains and losses in a company being reflected in the company’s share price if both bases are subject to a comprehensive CGT has to be addressed (see Appendix 2 for examples);
 - Livestock Herd Scheme gains and losses which are currently treated as being on capital account would have to be reconsidered. Intuitively this would likely cause the herd scheme to be abolished as there seems to be no appropriate halfway house (and this itself would create issues as farmers have paid (taxation on entry) to enjoy the benefits of the herd scheme);
 - Special rules will be needed where the primary residence is a component of a larger land-owning activity, such as farming (and given that some farms are companies, will the primary residence rule actually apply to these residences?);

- Where there is no change in ownership, the treatment of houses that move in and out of the CGT tax base as their usage changes from being a home to a rental house and vice versa will have to be considered. Will this require valuations at the point of the change, or apportionment or what;
- Indexing asset cost base so the inflation component is not taxed will be an issue (the same issues currently exist with income tax on revenue account property and monies on deposit for interest and this would have to be addressed at the same time);
- Dealing with roll-over relief for intra-family and intra-group company transactions and for transactions involving Maori land and its owners will be essential (see Appendix 3 for an example);
- The same roll-over relief problem exists for transactions within a group of companies. This is of particular relevance where the group is a wholly-owned group of companies as in an intra-group transaction there is no change of the ultimate owners; and
- The question of which assets should be included in the CGT base will have to be considered. For example, almost all cars depreciate over time, but some do appreciate. For example, a car may not be an appreciating asset until it has been owned for a (large) number of years – if cars that appreciate are included in the base, when is this appreciation determined and how is their CGT cost ascertained. If this is not handled carefully there could be considerable compliance costs.

4.16 Clearly, addressing these implementation issues will be complex and will lead to complex tax law. The biggest winners will be accountants and lawyers. A number of our members strongly believe in the KISS principle, and almost by definition, a CGT is not simple. Simplicity as a design objective is very important.

4.17 Obviously transitional issues would have to be addressed as well as implementation issues.

Land tax discussion

4.18 The VUTWG considered land tax in some detail. While a majority of the TWG thought that a land tax was appropriate, they noted the issue of political sustainability.

4.19 VUTWG noted that land tax has some conceptual advantages:

- The supply of land is finite;
- A low rate land tax will raise a reasonable amount of revenue; and
- Collection is relatively easy.

4.20 However, they also went on to comment:

- A land tax would be suffered by those who owned the land at the date the land tax was introduced, because land values would fall (conceptually) by the present value of the future land tax payments. This fall could cause highly geared land owners to have negative equity, and could adversely affect mortgagors;
- Any resultant fall in land values might not affect rents as the landlords would have an extra expense to suffer. If the present value of the land tax is not fully reflected in land values landlords may even expect to increase rents to ensure that their net return is unchanged;
- As a land tax would only tax one form of wealth and not others, it would seem to cause horizontal equity problems between land owners and other taxpayers;

- Annual payment of a land tax could give rise to cash-flow difficulties, particularly for activities that are based on extensive landholdings, such as farming and forestry. For a single cycle forest where there is no income until harvest (25 or more years after planting) this would be particularly acute;
- The more exemptions are provided (such as land under the family home), the less sustainable a land tax would be; and
- There would also be concerns about some Maori land and other fallow land. Presumably land that is subject to QE II covenants would also have to be exempted.

4.21 Farmers have a particular concern about local authority rates. Rates are a charge on land or capital values to fund local authorities. Federated Farmers has always contended that rates should reflect a charge for services provided to ratepayers or categories of ratepayers rather than be 'just a tax'. However, many in local government argue that rates should simply be regarded as a tax on assets owned rather than a payment for services provided. Because of this, many of our members, with some justification, believe rates have an element of unjustified taxation.

4.22 This concern was certainly reflected in our member survey where 91% opposed a land tax and this opposition remained overwhelming (80%) no matter the option to ameliorate it (such as making it fiscally neutral, applying a lower rate for farmland, or having it apply across all land with no exemptions).

4.23 Federated Farmers therefore strongly opposes a land tax.

Submission Points - taxes on capital (capital gains tax and land tax)

Capital gains tax

4.24 Federated Farmers supports the current taxation regime that provides the ability to tax the earnings of individuals and firms that are in the business of trading property but we are opposed to a 'comprehensive' capital gains tax (CGT). Our opposition is both philosophical and pragmatic. There are considerable challenges in making a capital gains tax workable. These include:

- How to deal with double taxation or double losses (caused by capital gains and losses in the company being reflected in the share price, which is also subject to CGT);
- How to deal with livestock Herd Scheme gains and losses which are currently regarded as being on capital account;
- How to index gains so the inflation component is not taxed (the same issues currently exists with income tax on revenue account property and monies on deposit for interest); and
- How to deal with roll-over relief for intra-family and intra-group company transactions and for transactions involving Maori land and its owners.

4.25 The 'KISS' (keep it simple) principle should apply. If there is a particular problem about 'speculation', then perhaps the bright-line test might be a better solution.

4.26 Without prejudice, we submit that no commitment to a CGT should be made until it has been established that the practical concerns can be addressed in a manner that is appropriate in the New Zealand context. This includes the need to keep compliance costs low.

Land tax

- 4.27 Federated Farmers is opposed to land tax. A land tax would be punitive and inequitable on farming.
- 4.28 A land tax is suffered by the owner of the land when the tax is introduced – as that value will decrease by the present value of the future land tax payments. Future owners pay a lesser price to acquire the land, but this is offset by the annual obligation to pay land tax.
- 4.29 Land tax has the potential to turn highly geared enterprises equity-negative, potentially with a flow on effect to banks and other financiers. Further, developing businesses, or businesses whose annual income fluctuates, may not have sufficient cash flow in any one year to pay a land tax. This is a particular concern for farming that can have significant and often unpredictable variations in gross revenue due to the vagaries of international commodity prices, exchange rates, interest rates, and the weather.
- 4.30 There may also be cash flow problems for owners of fallow land, and this could particularly affect Maori land.

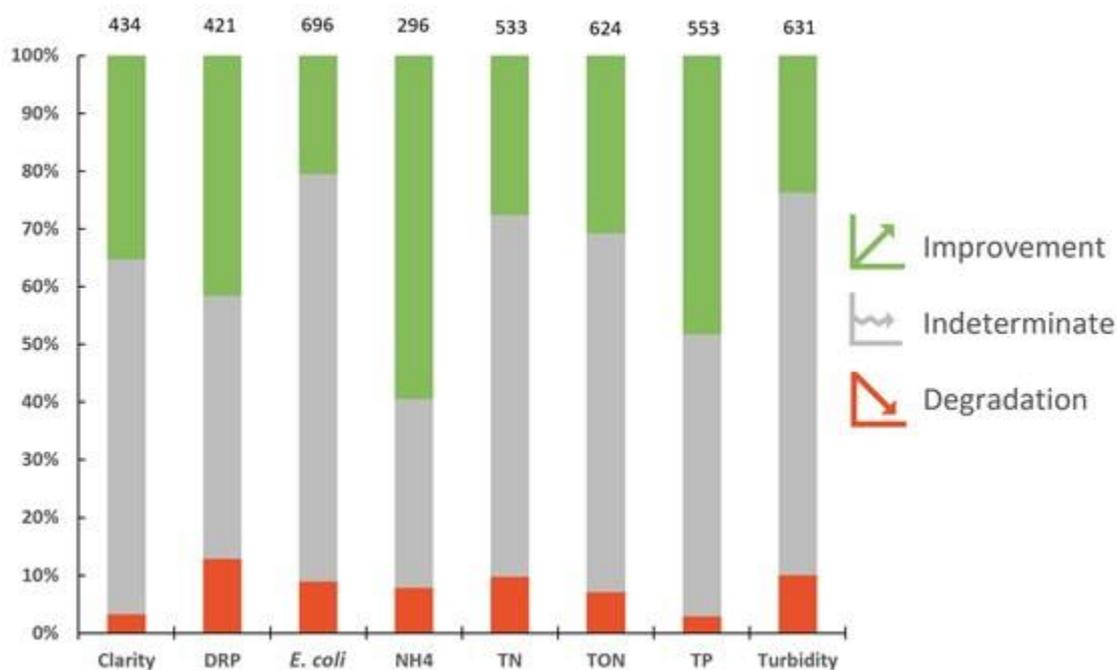
5. TAX AND THE ENVIRONMENT

- 5.1 The Tax Working Group's mandate for this discussion flows out the terms of reference: "What role [can] the taxation system can play in delivering positive environmental and ecological outcomes, especially over the longer term." Given this wording it is clear that this could involve further taxes or further tax incentives and that "tax" can be widely defined.
- 5.2 The request for submissions on tax and the environment is contained in three paragraphs in Chapter 2 (The future environment), three paragraphs in Chapter 5 (The results of the current tax system) and six paragraphs in Chapter 7 (Specific challenges) of the Background Paper.

Environmental taxes in context

- 5.3 Federated Farmers believes that it is inappropriate to consider tax in isolation as 'the solution' to environmental issues. Like the environment itself, consideration of how to care for the environment is complex and has a number of layers to it. Further, a number of environmental aspects, including those discussed in the background paper, are already being dealt with by other policy and regulation.
- 5.4 Thus we question whether the Tax Working Group, which solely has a focus on tax, is the most appropriate forum for considering the environment and tax issues. However, we do acknowledge Tax Working Group's mandate.
- 5.5 Federated Farmers' member survey showed strong opposition (82%) to environmental taxes. Opposition did reduce provided the revenue raised was spent to fund on-farm environmental expenditure, but 51% still opposed them no matter what. Compliance and administration costs were as significant a concern as the amount of tax paid.
- 5.6 Federated Farmers believes that if the Government wishes to further consider environmental issues it should first identify the problem or problems, and then should prioritise these. This would then allow for full consideration, in the context of the wider economic environment and existing frameworks, of the range of potential solutions. Taxation might be one and regulation another, but a combination may be the best option. There are also industry-led initiatives, such as the Clean Streams accord which was developed by the dairy industry.
- 5.7 This consideration should be based on empirical data. While a lot of anecdotal evidence exists, a properly prepared body of scientific data is necessary. Further, behavioural implications and potential unintended consequences should be considered.
- 5.8 We suggest that the use of tax to encourage better environmental behaviour may be inappropriate because it puts a price on the non-complying behaviour which some taxpayers may simply accept (as do New Zealand's diminishing, but not disappearing, cigarette smokers).
- 5.9 We also note that some of the taxes that have been proposed to address environmental issues fail against the principles of good taxation. We attach as Appendix 3 a report by NZIER for primary sector organisations assessing a resource rental on water, a nitrates tax, and extending the Emissions Trading Scheme (ETS) to include biological agricultural emissions. Only extending the ETS would not fail comprehensively against the principles and even then much depends on how it would be designed.

- 5.10 This is not to say that taxation might not have a role, it is just that the wider questions need to be considered before solutions (which may or may not include tax) can be prioritised and considered. In some cases, a combination of carrots and sticks may be appropriate. For example, regulation requires farmers to plant alongside fenced waterways, and the current tax rules incentivise this expenditure.
- 5.11 We note that over the last few years, farmers have been subject to a considerable amount of regulation, a lot of it in the environmental space. For example, dairy farms are subject to strict regulations imposed at a regional level concerning dairy shed effluent and its disposal. For a number of farmers this requirement caused significant costs. However, almost all dairy farmers accepted and met their obligations because they were properly marketed and were regionally targeted.
- 5.12 These regulations are starting to show positive effects. LAW A (Land, Air, Water Aotearoa) in their Press Release dated 16 April 2018 stated that “for all river quality parameters monitored over a 10-year period, more sites were improving than deteriorating and that about 90% were either improving or stable. This encouraging national picture has been welcomed by scientists and local government who pointed to freshwater ecosystem management practices as likely contributing to the progress.”
- 5.13 The graph from the LAW A media statement follows below: It illustrates that there has been a net improvement in water quality



- 5.14 We attach as Appendix 4 a number of examples of national regulatory frameworks in the environment space that affect farmers. The fundamental point is New Zealand already has existing regulatory frameworks for addressing sustainable management of identified environmental issues. These frameworks are iterative and constantly changing, as details around threats to the environment, or new information/practices aimed at protecting these environmental goods, emerge. These regulatory frameworks are able to adapt to, and are better targeted to, addressing issues at a local level in response to specific ecosystems and issues. A taxation approach, particularly one developed at a national level, would be nowhere near as adaptable.

- 5.15 Gaps in the regulatory response to these regulatory issues have largely been driven by resource management frameworks being too slow to adapt, and not forward thinking enough. Many of the resource management issues we are dealing with today were not even on the radar 20 years ago. There is also a paucity of both information and understanding of the interaction between different resource management issues. Taxation is a blunt tool that will not address these nuanced needs. The fact these issues are emerging or are still issues is not because of any great failure in legislative/regulatory frameworks, more it is the fact we are playing catch-up and the understanding of often complex and interacting environmental functions has lagged.
- 5.16 Federated Farmers is concerned about the narrow definition of “environmental tax” that the Tax Working Group is using. This is “a charge levied on a tax base that has a proven, specific, negative impact on the environment.” Tax concessions that support the environment (the carrot), such as immediate deductibility for riparian planting, are not included within this definition. Thankfully the Tax Working Group mandate in this space and some of the detail in Chapter 7 of the Background Paper indicate that this is not a limitation.

Detailed comment on the Background Paper’s environmental discussion

- 5.17 The following points are made on the thirteen paragraphs in the Background Paper which relate to the environment:

TWG paragraph	Federated Farmer’s comment
Page 14, last paragraph. Climate change background including comment that New Zealand’s emissions reduction options are limited because of the proportion of emissions that come from the primary sector.	New Zealand has a detailed emissions reduction plan in place. This is currently being reviewed with the likely outcome that farmers will be more exposed to carbon pricing.
Page 15, paragraph 1. Notwithstanding the recently established Climate Change Commission and its focus TWG suggests that the tax system could be used.	We recommend that the TWG leave this issue to the Interim Climate Change Commission which is specifically charged with addressing it.
Page 15, paragraph 2. Biodiversity is a major problem and the use of pricing and taxation instruments may be (part of) an answer.	As we have submitted, tax needs to be put into a perspective and discussed as one of a range of potential tools, not talked about in isolation. Further, we wonder if this presumes that the present mechanisms are perceived as not working, or if tax might be a better solution. However, we note in this submission that QE II covenants can encourage biodiversity and that it would be appropriate for expenditure on QE II land to be expressly tax deductible.
Page 40, paragraph 1. “New Zealand’s resource-based economy and the wellbeing of New Zealanders are heavily dependent on protecting our natural capital.” There is then discussion on biodiversity and surface water use.	No association is made between these paragraphs and taxation. Nor is there a discussion on the potential impacts of existing and pending regulation in addressing loss of natural capital. The acknowledgement that “protection” [regulations] have stemmed the loss of especially native forest” is constructive. It has been contended by some that the single greatest threat to terrestrial and freshwater

<p>Page 40, paragraph 2. Nitrate levels have generally worsened, although phosphorous levels have improved. New Zealand's carbon emissions are increasing, and not withstanding comprehensive fishing quotas, fishing stocks are at risk.</p>	<p>ecosystems is from introduced species. If so it is difficult to see how this could be a tax issue.</p> <p>It is interesting that water quality is not directly discussed, nor are the issues to do with nitrate and phosphorous put in context. There is good discussion of water quality issue in MfE's 2015 report <i>Environment Aotearoa</i>. The high-level water quality finding of that report is (unsurprisingly) that "water quality is poorer where there are pressures from urban and agricultural land use".</p>
<p>Page 41, paragraph 1. New Zealand charges royalties on extraction of [certain] natural resources. An alternative would be a resource tax to ensure that what economists call "rents" are taxed.</p>	<p>In this context we agree that a royalty is a tax, but to our knowledge the royalties in place in New Zealand have nothing to do with the environment.</p>
<p>Page 49, paragraph 1 under the environmental heading. "Environmental taxes are levied on tax bases that have a proven, specific negative impact on the environment." It is acknowledged that environmental taxes sit alongside regulation, incentive programmes as policy options.</p>	<p>The acknowledgement that tax is only one of the relevant levers that can be used to enhance the environment is appropriate and constructive.</p>
<p>Page 49, paragraph 2. "New Zealand collects relatively little revenue from environmental taxes as a percentage of GDP compared to other OECD countries." The paragraph acknowledges that fuel taxes, even if hypothecated to roading, is regarded as an environmental tax.</p> <p>The paragraph goes on to note that "The OECD notes that many environmental taxes in OECD countries are poorly designed and targeted."</p>	<p>The paper's own evidence at Figure 22 shows that New Zealand's environmental tax to GDP is only marginally below the OECD average. The bigger problem is that the OECD data is misleading because of its treatment of fuel taxes (usually excise, but also road user charges) that are hypothecated to roading.</p> <p>This suggests that environmental taxes need to be carefully thought through and targeted.</p>
<p>Page 49, paragraph 3. "Environmental taxes can be a powerful tool Other tools include government regulation (fines and penalties under industry specific regimes) and limiting supply through quota systems.</p>	<p>It is correct to recognise that there is a range of tools that can be used. However, as noted above, before tools can be discussed it is appropriate to first define the environmental problem(s). It is also notable that New Zealand is well down the regulatory path in addressing environmental issues, and in particular those discussed in the Paper.</p>
<p>Page 49, last paragraph. "New Zealand offers some tax incentives [carrots] to promote activities that align with environmental objectives. However, tax incentives can have disadvantages relative to the levying of an environmental tax [sticks]."</p> <p>Further they can involve picking winners and are fiscally costly.</p>	<p>It would be interesting to tabulate the present environmental tax incentives contrasted with comparable regulation. Put another way, are they always substitutable? The costs of planting and maintaining forests is currently immediately deductible – it is tax incentivised. Can we even design a regulatory system that would not lead to a decrease in the area planted (whether for harvest or only for conservation)?</p> <p>Riparian planting is deductible to farmers – when this was enacted no fiscal cost was forecast because this</p>

	was simply codifying the current actual tax treatment. However, in general we accept there is a fiscal cost to providing tax incentives, - the question is, as always, what is the “public good” created by the incentive.
Page 50, paragraph 1. This paragraph describes some of the existing incentives, including forestry and the electric vehicles from road user charges.	As noted above, to the extent road user charges are hypothecated to roading we do not regard this as a tax incentive although we agree that the EV exemption from road user charges is an incentive.
Page 50, paragraph 2. This paragraph comments on taxation rules that unintentionally may favour certain activities that might not be appropriate from an environmental perspective. The lack of FBT on [most] employer provided car parks is provided as an example.	We understand the point being made, but with regard to FBT on car parks we would recommend proceeding with caution. Previously governments have tried repeatedly to address this issue – the problem is defining which car parks should the FBT apply to? The nurses’ parks at Wellington Hospital and the teachers’ parks at Flemington School (a rural Hawkes Bay primary school) are two examples that illustrate the difficulties.

QE II covenants

- 5.18 It is Federated Farmers’ understanding that all costs incurred by a farmer in looking after land subject to a QE II covenant are treated as deductible expenses. This is completely understandable given the “greater good” (biodiversity etc.) nature of the covenants. However, if this deductibility was made expressly enacted it may short-cut discussions between farmers and Inland Revenue about the nature and purpose of the costs. It would confirm present treatment and therefore come without a fiscal cost.
- 5.19 It is not only farmers who own covenanted land. We are aware of some QE II covenanted land that is not owned by farmers. Again, given the “greater good” principle deductions should be available to all businesses or individuals that own such land. We cannot comment on any fiscal cost that this might cause as we have no information.
- 5.20 Our member survey indicated strong support for this sort expenditure being tax deductible – 84% supported tax being used as a ‘carrot’ for the environment. We believe this is particularly useful approach when regulation is being used as a ‘stick’.

Submission points – tax and the environment

- 5.21 The consideration of taxation in isolation as a response to environmental issues is flawed. There is a range of levers, including regulation and industry-led initiatives, as well as taxation, that can be used. These other levers are efficient and can work in a way that is more targeted and is iterative. Indeed, New Zealand has been focusing on regulation for some time now, along with some support from the taxation system (in the form of deductions for some environmental expenditure).
- 5.22 As is illustrated in Appendix 4, there are a significant number of regulatory frameworks that are currently in place that affect farmers that are working well and that actively encourage (by specifying) remedial activities. Unless there is clear evidence that these frameworks are irretrievably broken there is little point in trying to substitute taxation for these frameworks.

- 5.23 Further, we note in this context a tax might not encourage appropriate remedial activities. Taxpayers might decide it is cheaper to simply pay the tax, particularly if they have limited ability to change/respond. At the least the law of diminishing returns will apply and the tax rate will likely have to be significant to encourage the outliers, as is the case with cigarette smoking. In contrast, regulation is compulsory.
- 5.24 Any further projects in the environment space should start with a robust problem definition which is based on science. It is only once the problem has been defined that solutions, which may or may not include taxation, can be considered in the context of the wider economic framework. Obviously, compliance and administration costs will be an important part of any solution and these must always be considered.
- 5.25 The costs of maintaining QE II covenanted land should be expressly deductible

6. ABOUT FEDERATED FARMERS

- 6.1 Federated Farmers is a member based organisation that represents farmers and other rural businesses. Federated Farmers has a long and proud history of representing the needs and interests of New Zealand's farmers.
- 6.2 The Federation aims to add value to its members' business. Our key strategic outcomes include the need for New Zealand to provide an economic and social environment within which:
- Our members may operate their business in a fair and flexible commercial environment;
 - Our members' families and their staff have access to services essential to the needs of the rural community; and
 - Our members adopt responsible management and environmental practices.

7. APPENDIXES

Note, the following appendixes are attached:

5. Results from Federated Farmers survey on tax
6. Capital gains tax examples
7. NZIER report *How to Think About Taxes*
8. Environmental regulatory framework as it effects farmers