Tax Working Group Public Submissions Information Release

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In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) of the Official Information Act.

30 April 2018

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Re: Tax Review

This submission is on behalf of the New Zealand Centre for Political Research, a public policy think tank established in 2005 by former MP Dr Muriel Newman.

Many thousands of New Zealanders, who follow our work, share our concerns about the prospect of New Zealand's tax burden being increased through a raft of new forms of taxation.

The NZCPR strongly believes that the future of tax reform should be towards lower and flatter taxes for New Zealand and submit that a maximum level of 20 percent for personal, trust, and company tax should be the goal.

This lower tax goal should be accompanied by a reduction in government spending towards a target of 25 percent of GDP, which has been identified as the optimum level of government spending for a high performing economy.

As the American Economist and Senior Fellow at the Hoover Institution, Thomas Sowell, said, "The real goal should be reduced government spending, rather than balanced budgets achieved by ever rising tax rates to cover ever rising spending."

If new taxes are recommended by the Working Group, we submit that there should be a commensurate reduction in existing forms and levels of taxation. Further, since under the present tax system, inflation continually pushes taxpayers into higher income tax brackets, we also submit that annual income tax threshold adjustments indexed to inflation should be introduced.

In particular, the NZCPR opposes *all* new taxes including environmental taxes, lifestyle taxes, and land taxes. We oppose the introduction of all new GST exemptions, and the NZCPR strongly opposes all tax concessions based on ancestry.

We would like to make more substantive comments on three issues: company tax, the taxation of charities, and a capital gains tax.

Company Tax:

The NZCPR submit's that New Zealand's company tax rate should be reduced to 20 percent to incentivise jobs and growth by ensuring an internationally competitive rate.

While New Zealand's company tax rate was, at one time, one of the lowest in the OECD, at 28 percent it is now one of the *highest*. That makes it extremely difficult for Kiwi exporters to compete in global markets – especially once the cost of transport and the other disadvantages of being a small isolated country are factored in.

All around the world, company tax rates are falling, as countries compete against each other for business in the global marketplace. In Europe, corporate tax rates have declined from an average of 40 percent in 1980 to 18 percent in 2017, with Switzerland the lowest on 8.5 percent, followed by Hungary on 9 percent.

Some countries introduced significant cuts to company tax years ago to position themselves as a magnet for international business. Ireland reduced the tax on business profits to 12.5 percent in 2003. In 2015, it further reduced the corporate tax rate to 6.5 percent for business activities arising from research and development in Ireland. Their objective is to attract high value jobs to the country.

In 2010, Singapore followed Ireland's lead and introduced an exemption, reducing their corporate tax rate of 17 percent to 8.5 percent for business income up to S$300,000.

In fact, since the global financial crisis, the downward trend for company tax has been accelerating around the world as governments have lowered their rates to chase GDP growth.

In the UK, corporate tax will be reduced from 19 percent to 17 percent by 2020. Sweden is cutting corporate tax from 22 percent to 20 percent. Corporate taxes have recently been reduced in Japan, Spain, Israel, Norway, and Italy.

At the present time, only five countries – France, Belgium, Mexico, Australia and Greece – now have corporate tax rates that are higher than New Zealand's, and almost all of these are in the process of reducing their rates. In Belgium their 34 percent tax rate will be lowered to 25 percent by 2020, with a 20 percent rate already in place for smaller companies. In Greece, the 29 percent corporate tax rate will be lowered to 26 percent by 2020.

In France, President Emmanuel Macron has promised to reduce corporate income tax from 33.3 percent down to 25 percent over the next five years, and in Australia, company tax is set to reduce from 30 percent to 25 percent over a ten year period.

Contrary to what the critics say, over the long term, reducing company tax does *not* result in a loss of revenue, since the incentive effects of lower taxes broaden the tax base, boosting economic growth and job creation.

In Canada, when the federal company tax rate was reduced from a high of 38 percent in the mid-1980s to 15 percent in 2012, tax revenues increased to greater levels than when the rate was more than double.

It was the same story in Britain – in the 1980s when corporate taxes were 52 percent, revenue was equivalent to 2 percent of GDP, while in 2015, when the rate was lowered to 19 percent, tax revenue was higher at 2.4 percent of GDP.

To remain internationally competitive, it is crucial for an export based economy like New Zealand, to have lower business taxes – especially now that the US has slashed their corporate tax from 35 percent to 20 percent.

New Zealand should follow suit.

The NZCPR submits that the Tax Working Group should recommend a company tax reduction to 20 percent – along with the top rate of personal tax, and the trust tax rate – to boost economic growth and business expansion.

We further submit that any move to introduce a progressive company tax system should be abandoned, since a two-tier system would create the unintended consequence of incentivising small businesses to stay small to retain a lower tax rates instead of seeking to expand to create further jobs and growth.

Without a doubt the best way to encourage small businesses to grow into large ones is to keep taxes low for all sizes of business. Further, since many small business owners pay tax at the personal rate, aligning income tax to business tax and cutting both the 20 percent, would provide the best incentive to growth.

Taxation of Charities:

We submit that the Tax Working Group should recommend the removal of the tax 'loophole' that is being used by some of the country's biggest commercial operators, including iwi business corporations, to avoid paying tax. This would mean changing the law so that any profits generated by commercial charities, that was being used for their charitable purpose would be tax free, while all other income would be taxed at their normal business rate.

The charity loophole involves 'for-profit' commercial businesses that register as charities, yet use only a fraction of their 'tax free' income on their 'charitable purpose'.

These commercial charities include Sanitarium, and iwi corporations – including the Ngai Tahu Charitable Group, which operates the bus company, *Go Bus*, the tourist attraction *Shotover Jet*, and more than 30 other commercial businesses.

Charities play an important role in society. But they are also very big business. Figures from 2017 show there are over 27,000 registered charities in New Zealand, managing an asset base of over $40 billion. Their annual income is estimated to be over $15 billion, including $6 billion of government grants, and almost $3 billion of public donations.

Tax rebates on those donations cost the Government around $260 million a year, while the tax revenue that the Government is missing out on is estimated to be in the region of $1.5 billion.

Local councils miss out too, as many charities are exempt from rates, despite using local services.

At the present time there is no cap on charitable giving – people and companies can claim rebates and deductions for charitable donations up to the level of their annual net income.

When it comes to charities that operate businesses, the Income Tax Act states, "Income derived directly or indirectly from a business carried on by, or for the benefit of a trust, society, or institution is *exempt* income if it carries out its charitable purposes in New Zealand, is registered as a charitable entity, and no person with some control over the business is able to direct or divert, to their own benefit or advantage, an amount derived from the business."

Essentially this means that for-profit businesses that register as charities are tax free, with little oversight as to whether their profits are used for charitable purposes.

Over the years, successive governments have recommended tightening up these laws.

Back in 1966, the Holyoake Government carried out a review and recommended that "Profits from trading derived directly or indirectly by charitable organisations and dividends derived from any company substantially owned by such organisations are assessable for income tax at normal rates."

In 1987, then Minister of Finance Roger Douglas proposed a number of law changes to prevent tax avoidance by charities: "No charity receiving donations would have to pay tax on any aspect of that operation, but a charity that was involved in commercial business to raise money would be treated like any other business. It would pay tax on its profits, but its legitimate expenses would be deductible".

The Minister explained that "the reason for including income from charitable activities – but not from donations – in the tax base was to limit the scope for charities to be used for tax avoidance."

In 2001, then Minister of Finance Dr Michael Cullen recommended taxing the trading operations of charities: "Make trading operations owned by charities subject to income tax in the same way as other businesses, but with an unlimited deduction for distributions made for the relevant charitable purposes".

None of these recommendations were implemented.

As a result of the 2005 reforms, the Charities Act established the Charities Commission, as an autonomous Crown entity to take over the regulation of the sector from the IRD, which, until that time, had administered charitable income tax exemptions.

These reforms also allowed Maori tribal groups to register as charities for the first time. Until then, any group wanting to register as a charity not only had to have a legitimate *charitable purpose* – involving the relief of poverty, the advancement of education or religion, or any other matter beneficial to the community – but they also had to meet a *public benefit test*, to ensure charitable benefits flow into the *wider* community and not to private individuals and their relatives.

Since Maori tribal organisations are based on the blood ties of relatives, they failed the public benefit test and could not gain charitable status. However, section 5 (2) of the Charities Act introduced an exemption from the blood tie disqualification for those involved in the administration and management of a *marae*.

This law change paved the way for some of the country's biggest and richest business corporations, to register as charities and avoid paying tax.

In essence, this means that many of the contributors to the $40 billion combined wealth of the Maori economy, such as Ngai Tahu, are essentially tax free. In other words they have organised their affairs to avoid paying their fair share of tax.

During National's first term in Government, the Charities Commission was disestablished and the functions were transferred to the Department of Internal Affairs.

While there have been a number of other law changes over the years to tighten up the reporting standards for charities, none have addressed the fact that for-profit commercial charities are avoiding paying tax.

While New Zealand has failed to resolve this issue, other countries, including the UK, have confronted it. There, charities are classified as 'trading' if they sell goods or services to customers. But if that trading is *part* of the charity's primary purpose, such as an independent school charging students tuition fees – or if it *helps* the charity's primary purpose, such as a museum running a cafe for visitors – no tax needs to be paid on the profits. However, if the trading is *unrelated* to the primary purpose, its profits are taxed.

What's worse is that according to their website, the IRD no longer even keeps a 'watching brief' on charities: "If your charitable organisation is assessed as being fully exempt from income tax, *you don't need to file an income tax return* unless we ask for one."

That means there is no adequate monitoring as to whether the billions of dollars of business income generated by commercial charities is genuinely being used for their specified charitable purpose.

We submit that the most sensible way forward would be for the Tax Working Group to recommend enacting Dr Cullen's 2001 suggestion, to tax for-profit businesses owned by charities in the same way that private firms are taxed, while allowing unlimited deductions on distributions made to their relevant charities. This policy change would provide significant tax revenue for the Government by removing the unfair tax advantage that charity-owned businesses have over private firms, and,

through taxing retained earnings, there would be an increased incentive for businesses to make a greater investment into their charitable purpose.

In essence, under this proposed law change, any profits generated by commercial charities that were used for their charitable purpose would be tax free, while all other income would be taxed at their normal business rate.

Capital Gains Tax:

Finally, we strongly submit that the Tax Working Group should reject all forms of capital gains tax.

A partial capital gains tax that excludes the family home would raise very little revenue, but would add huge complications and compliance costs to the tax system. This is one of the main reasons that none of the five government tax reviews over the years have recommended a partial capital gains tax with a multitude of exemptions.

The 1967 review of the tax system by the Ross Committee examined the feasibility of a capital gains tax but rejected it on the basis of the low revenue yield, the huge complexities, and the disincentive effect that such a tax would have on risk taking and growth investment.

The 1982 Task Force on Tax Reform conducted by the McCaw Committee also examined a capital gains tax, finally recommending against such a tax on the basis that it would not produce significant revenue but would create substantial complexity within the tax system.

The 1989 review by the Valabh Committee recommended that a comprehensive capital gains tax with no exemptions should be introduced – in conjunction with a reduction in income and other taxes. In other words, the Committee saw the introduction of a comprehensive capital gains tax that included private housing and all other assets, as a legitimate mechanism to broaden New Zealand's tax base and lower tax rates across the board.

The McLeod Committee's 2001 Tax Review opposed the introduction of a capital gains tax on the basis that it would not make the tax system fairer or more efficient, and that it would not raise substantial revenue but would instead increase the complexity and costs of the tax system.

The 2010 Tax Working Group on the other hand came out in favour of a capital gains tax, but only if it was comprehensive, and accompanied by a general reduction in income tax and company tax across the board. They also strongly recommended that company tax, Trust tax and the top income tax rates be aligned to reduce distortions within the tax system.

In other words, none of the expert working groups have recommended a partial capital gains tax with exemptions for the family home, Maori land, gambling winnings and so on - of the sort that the Labour Party has promoted in the past.

Thank you for providing the opportunity for the NZCPR to present our recommendations for New Zealand's taxation system. We do hope the Tax Working Group will take them on board.

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