Corporate Taxpayers Group

29 April 2022

LTIB topics
c/o David Carrigan
Inland Revenue Department
PO Box 2198
WELLINGTON 6140

Dear David

Tax, Foreign Investment and Productivity: Draft Long-Term Insights Briefing

Introduction

In its submission on 6 September 2021, the Corporate Taxpayers Group ("**the Group**") supported Inland Revenue scoping its current Long-Term Insights Briefing ("**LTIB**"). The Group considers the LTIB process to be a valuable one and supports continuing this process.

We have been asked for feedback on the draft LTIB. Our overall feedback is that the Group struggles to understand the focus of the draft LTIB. Paragraph 1 of the Executive Summary states that the draft LTIB:

> *"Examines how New Zealand tax settings are likely to affect incentives for firms to invest into New Zealand and benchmarks New Zealand tax settings against those in other countries."*

This seems to be a focus on the taxation of inbound investment and whether this is increasing the cost of capital, reducing investment, and thus lowering potential productivity and wages.

However, paragraph 9 of the Executive Summary states that the aim of the draft LTIB is to initiate a process of discussion on whether to change our tax settings more generally and "how best to change it if change is deemed desirable". It then lists possible changes for consideration with detailed questions of views on each of these:

- A cut in the company tax rate
- Accelerated depreciation provisions
- Inflation indexation of the tax base
- A higher thin capitalisation rule safe harbour
- An allowance for corporate equity
- Special industry-specific or firm-specific incentives
- A dual income tax system.

Contact the CTG:
c/o Robyn Walker, Deloitte
PO Box 1990
Wellington 6140, New Zealand
DDI: 04 470 3615
Email: robwalker@deloitte.co.nz

This seems a much wider focus than the previously stated focus on inbound investment. We term the above broader tax policy settings in contrast to the narrower tax policy settings on how New Zealand taxes inbound investment.

The rationale for this focus on broader tax policy settings seems to be based on the argument advanced in the draft LTIB that although New Zealand has high effective marginal tax rates (**EMTRs**) on inbound investment as measured by OECD and similar studies, actual EMTRs on particular investments are highly variable and in some cases are much lower than the data for EMTRs on inbound investment suggests and may even be negative. A general lowering of EMTRs on inbound investment may therefore not be welfare enhancing. Reform may be better focused on the broader tax policy settings by trying for more uniform (and positive) EMTRs across the board.

If this is the argument being advanced, it would assist ongoing dialogue if that were clearer.

The Group would support reforms to the broader tax policy settings that would increase investment in a way that improves productivity and is welfare enhancing to the extent these are consistent with the Group's (4 C's) principles of:

- High certainty and low business risk
- Low compliance costs
- Positive contribution of tax to society
- International competitiveness with our major trading partners and competitors, especially Australia.

Some of the measures suggested for consideration (such as a cut in the corporate tax rate) seem justified on this basis. However, the measures have potential ramifications for the tax system and more detailed analysis seems necessary before the Group could come to a definitive view on them. For example, as the draft LTIB recognises, comprehensive indexation of the tax base raises numerous issues.

The Group supports developing a process where reform of these broader tax settings can be discussed with a view to improving productivity. The Group does not, however, consider that this should be at the cost of not giving consideration to the evidence on how current policy discourages inbound investment. While there are caveats and gaps in our knowledge and data, the Group submits that the economic theory and the evidence in the draft LTIB strongly support a policy direction of lowering tax on inbound investment, so as to lower the cost of capital, increase investment and thus enhance productivity and wages. However, the Group believes that recent policy changes have been consistently increasing tax on inbound investment. Consideration of measures to reduce the variability of EMTRs in the broader policy setting can be advanced in tandem with measures that reflect a change of direction so that tax policy aims to attract inbound investment instead of penalising it for fiscal gain at every opportunity.

What the Group is suggesting is that the LTIB be used to develop a process whereby the strategic direction of tax policy is established in a way that accords with national welfare and is clear, pragmatic, reasonably simple and consistently forms the basis of advice Officials provide to government. We consider this is very achievable and something New Zealand had in the past but has now been lost. The number of incoherent ad hoc policy announcements we now see is testimony to that. Adopting a clear and pragmatic approach to the taxation of inbound investment would be a good place to start. This seems likely to mean rolling back some of the international tax measures adopted over the past few years.

We do agree, however, that consideration should also be given to the broader tax policy settings.

The Group's reading of the draft LTIB is that it sets out three categories of issues:

1. The impact on investment and productivity of the high EMTRs New Zealand has on capital in general and inbound investment in particular.
2. Issues with the alignment of the company tax rate and personal tax rates and the role of capital gains tax in buttressing misalignment.
3. The tax treatment of particular types of investment – depreciation, indexation, and specific tax concessions.

The Group recognises that these can be viewed as related issues. High tax rates on capital can be reduced by a reduction in the company tax rate but that gives rise to misalignment of the company and personal rates. Alternatively high tax rates can be reduced by more generous tax rules on over-taxed types of investment (depreciation, indexation, and concessions) but that can lead to more variable rates depending on types of investment unless the more favourable tax treatment is limited to those types of investment facing highest rates.

While recognising these relationships, a more constructive dialogue on future tax policy settings seems more likely to be obtained by a more structured discussion. In our view this involves:

- Establishing that our EMTRs on capital in general and inbound investment are too high. Pragmatic policies to reduce those rates should be advanced to the extent feasible. This could involve rolling back some recent measures to increase EMTRs.
- The above would include considering more generous depreciation rates and measures successfully adopted by other countries to reduce tax on investment.
- A policy goal of alignment of company and personal rates is a barrier to initiatives that might otherwise be pursued and the need for alignment and the extent the tax system can efficiently and fairly operate with a lower company tax rate should be explored.

As a final general comment, if the final LTIB is to canvass broader tax policy settings, then it would seem useful to discuss this in the context of Treasury's paper "Looking to the Future – New Zealand's Long-Term Fiscal Challenges". That paper envisaged an increasing level of taxation being required to fund increasing government expenditure. In the Group's submission on the Treasury paper we noted note that any material increase in the overall tax burden is likely to put pressure on the robust and sound tax system based on income tax and GST we currently have. The Group concluded:

> "In any such reconfiguration of tax policy settings the Group's view is that priorities should be consistent with the policy objective of a tax system that is conducive to increased domestic and international investment in New Zealand business with increased productivity from that investment. In particular:
>
> - The company tax rate should be at an internationally competitive level.
> - The tax rules need to be designed so as to attract inbound foreign investment
> - We need to avoid high personal tax rates that discourage or impose high costs on the employment of internationally mobile skills."

The Group considers these points relevant to the broader tax setting issues raised by the draft LTIB.

The Group has no comment on the methodology used to calculate EMTRs, leaving that to those with expertise in that area.

The Evidence as to the EMTRs New Zealand Levies on Inbound Investment

The draft LTIB clearly presents the evidence that New Zealand has gone from having internationally a relatively low corporate tax rate to a high corporate tax rate (page 10). It also shows that relative to other countries our EMTRs on inbound investment are now high (page 28). This presents a clear message that New Zealand is a highly taxed country that in tax terms is not attractive to foreign investors.

The draft LTIB suggests we should compare ourselves with other small, advanced economies when considering our international competitiveness. The Group agrees noting New Zealand is geographically distanced from foreign investors and trading partners. Tax barriers seem more important to small economies trying to attract the sort of investment that advanced economies need to lift productivity. In general an MNE will want to invest in USA and China. Those countries also offer economies of scale making detailed investment analysis on potential investments cost-effective. New Zealand has to stand out. A message that we choose not to be internationally competitive in our tax settings sends a very clear adverse message. The draft LTIB demonstrates that by comparison with other small, advanced economies New Zealand stands out – but for the wrong reasons. We are the highest taxing of such economies by a significant margin (page 31).

Finally, the draft LTIB usefully extends the normal OECD EMTR analysis to consider some recent quite micro changes to tax policy settings – such as changes to thin capitalisation, AIL and NRWT rules (Chapter 4). It concludes that these have further increased the EMTRs New Zealand levies, making us an even less desirable place to invest in.

Despite the above, the draft LTIB does not seem to conclude that our policy settings in this area are wrong. This seems to be because it points to investments where in theory EMTRs on foreign investment can be much lower than the OECD type models capture. An example given is an appreciating asset where costs are expensed and that is financed by interest bearing debt in times of moderate or more inflation. The combination of no tax on the gain in the appreciating asset (no capital gains tax), expensing and the allowance of deductions for nominal interest means, naturally enough, that rather than the EMTR being positive, it is negative – the investment produces a positive rate of return but income tax losses.

Obviously, this combination of circumstances should produce the tax loss given by the theory. However, there are in our view important caveats to suggesting that such theoretical models negate the more obvious conclusions that New Zealand under current policy is viewed as a country that from a tax perspective is unwelcoming to foreign investment:

- This is a combination of circumstances that is not reflected in much of the investment we require such as infrastructure. Such investments are highly taxed as per the international comparisons of EMTRs.
- The theoretical model assumes the losses over the investment phase resulting from expensing, the deduction for nominal interest and the non-taxation of the growth in value flowing from the increased present value of future taxable profits can be immediately used. Taking the example of an IT firm; such a firm often incurs high deductible personnel costs in its development phase, that produces tax losses. It then expects to make substantial profits as it rolls out product(s). The draft LTIB would seem to see the early losses as giving rise to a tax subsidy because the firm is building up the present value of future income while making overall tax losses, thus in economic terms expensing the costs of an asset. However, in practice more often than not the losses are only able to be carried

forward against future taxable income. As a result, the "immediate expensing" is theoretical but not real. This applies most specifically with foreign investment in such firms.

- An economic consideration of the impact of not taxing appreciating assets should take into account the risk assumed in acquiring them.

Consideration can be given to the wider tax settings giving rise to such negative EMTRs, but this does not justify ignoring the high EMTRs current policy levies on inbound investment in general.

Do high EMTRs on Inbound Investment Matter?

Surprisingly, in the Group's view, whether the high EMTRs New Zealand levies on inbound investment negatively impacts on New Zealand's cost of capital and the level of investment available to us does not seem to get much focus in the draft LTIB. The LTIB would benefit from more consideration of this.

The Group considers that the analysis should begin with the economic theory and literature. As the draft LTIB discusses, the economic theory is that taxing foreign investors increases the costs of capital, reduces investment, productivity and wages. The economic incidence of the tax on foreigners is not borne by the foreigners but by domestic labour because foreign investment is very sensitive to local tax. Our understanding is that economic literature over recent years has increasingly seen this theory as reflective of the real world suggesting that our high EMTRs on foreign investment significantly damage investment and productivity here.

This seems especially likely given we are a small open economy. New Zealand does not figure on the radar screens of most large international investors. If our tax settings seem unattractive, investment options here are unlikely to be even considered.

As the draft LTIB notes, there are caveats to and assumptions underlying the theory – the presence of:

- Overseas tax credits to offset New Zealand tax,
- Location specific economic rents in New Zealand,
- Sunk investments.

However, all theories have caveats and assumptions. Fundamental to most economic analysis is the assumption of pure markets. Even though it is clear that many markets are far from pure, the theory is useful in modelling the real world modified by the knowledge that economic theory will diverge from reality in some respects.

Officials' starting position should be that there needs to be very strong evidence that the economic theory and literature suggesting high welfare costs from high EMTRs on foreign investment does not apply in the case of New Zealand. The Group is unaware of any such strong evidence.

The Group concedes that there is a little amount of empirical evidence supporting a high correlation between foreign investment and EMTRs. That may simply reflect the number of such studies. There are, however, a number of reasons why an empirical correlation between EMTRs and the level of foreign investment may not reflect the extent of the welfare costs of our high EMTRs:

- The most valuable foreign investments are of a long-term nature and thus consider the long term impact of tax policy settings. While empirical studies measure the immediate impact of current settings, long term investors are concerned with the overall strategic direction of those settings. This means a reduction in the company tax rate may not have its full impact on investment decisions for some time. It also means that the strategic direction of reform and messaging are as important as the current rules. Countries attractive to foreign investors (such as Singapore and Ireland) have a clearly signalled tax welcoming mat. Our perspective is that New Zealand used to signal it welcomed foreign investment with a long-term direction of lowering EMTRs but in more recent times a different strategic direction and messaging has been adopted with a number of measures increasing tax on foreign investment being announced and justified on the basis of combating "tax avoidance" (particularly by multinationals) or closing "loopholes." This is a very clear negative message to long term investors while wrongly focusing on the legal, as opposed to the more relevant economic incidence, of the tax measures proposed.

- In the tax area complex technical tax rules meet the complexity of the real world. It is thus difficult to model the likely impact of quite detailed tax rules. For example, various measures to increase the tax New Zealand applies to hybrid instruments would be hard to model empirically. However, the impact has been to impose much higher tax wedges on the international funding of our banking sector and that flows through to higher cost of borrowing throughout the economy.
- How tax laws are administered can be as important as the detail of the rules. It seems reasonable to hypothesise that our generally honest and competent tax administration is a national benefit in this regard (and investment to maintain those standards should be made). However, in recent times IR seems to have taken a relatively aggressive approach challenging tax benefits that foreign investors relied upon. Again, such a factor is not likely to be able to be incorporated into empirical studies on the impact of EMTRs on investment.

On the basis of the above the Group considers that the LTIB should be clearer on the likely negative impact of our internationally high EMTRs on inbound investment.

Implications for the LTIB

In the Group's view the LTIB should form the basis for a dialogue that can establish a clear strategic direction for New Zealand tax policy settings. This should be based on an analysis of the relevant economic theory and literature fleshing this out with feedback as to what is impacting on investment decisions in the real world. While anecdotal feedback may be seen as lacking modelling rigour, it usefully supplements modelling to give context to how taxes work in reality. The policy that emerges from that will be incremental but should be consistent with the strategic direction. Of necessity considerable pragmatism will be required in turning strategy into actual policy.

Based on the theory and literature, the focus should be on reducing to the extent possible the EMTRs on investment and especially inbound investment. We do not consider that the draft LTIB makes a convincing case for focusing instead on reducing the variability of EMTRs on different forms of investment under domestic tax rules. Reducing the variability of EMTRs should instead be pursued to the extent possible and justified in tandem with the overall need to reduce tax barriers to investment. In other words, we do not see a strategic approach of lowering EMTRs for investment generally as inconsistent with also making EMTRs on types of investment less variable.

The (McLeod) Tax Review 2001 raised the inherent tension between a policy objective of alignment of personal and top personal tax rates and reducing EMTRs on capital and in particular inbound investment. It noted however that the apparent high EMTRs on inbound investment were lowered to the extent the investment was financed by debt (at least for Foreign Direct Investment – **FDI**). The implication at least is that low tax on debt investment is a useful feature of our tax system by ameliorating the otherwise high EMTRs.

The draft LTIB is useful in expanding the OECD type EMTR analysis to incorporate this aspect. However, in recent years in the name of closing "loopholes" the scope of the transfer pricing rules, thin capitalisation rules, NRWT and AIL has been expanded so as to increase the tax we impose on debt financed investment.

It would be useful if the LTIB clarified Officials thinking on the extent to which New Zealand should be taxing inbound debt investment so as to provide a basis for ongoing dialogue on the issue. There are obvious limitations in the McLeod Review approach and these are alluded to in the draft LTIB:

- It may ameliorate high EMTRs on FDI but has limited impact on the EMTRs on Foreign Portfolio Investment (**FPI**).
- The interest deductions that lower EMTRs can be offset by the tax on interest imposed by the investor's home jurisdiction.

Responses to these points have been considered in the past and innovative thinking should be encouraged. For example, consideration could be given to cashing out a proportion of imputation credits received by foreign investors. One response to the tax that investor home jurisdictions imposed on interest was that New Zealand allowed deductions on an accrual basis whereas NRWT (and often home jurisdiction tax) was imposed only on payments. However, this was identified by Officials as a "loophole" and NRWT has been extended to cover accrued interest costs.

It is always necessary to bear in mind that we have to design tax rules pragmatically and perfect solutions are seldom available.

The draft LTIB seems to imply a view that the longer-term alignment of the company and top personal rate may not be a stable policy setting for New Zealand. This seems to be the basis for the draft LTIB raising alternative tax policy settings not based on such alignment – an allowance for corporate equity and a dual income tax system.

These raise complexities and issues of their own. There is a natural tendency to see faults in the settings we have close experience with but underestimate the issues alternatives give rise to. It would be useful to assist dialogue on this to develop a clearer view as to limits where lack of alignment of tax rates is likely to create unmanageable integrity issues without radical change. For example, governments could be relaxed about income not readily substitutable for employment income not being taxed at personal rates. Governments could be relaxed about any income re-invested and not used in personal consumption being taxed at less than personal tax rates. The less concerned governments are about taxing all income at personal tax rates the more a reduction in the company tax rate (which the Group would support) can be seen as viable.

Implicit in the draft LTIB seems to be the view that any reduction in the company tax rate (or a more general move to a dual income tax system) would need to be buttressed by the taxation of capital gains – at least on the sale of shares. The Group is not convinced by the comments in the draft LTIB on this point.

Any consideration of the role of taxing capital gains needs to take into account not just any buttressing benefits such a tax would involve but also its disadvantages. The problems with taxing capital gains are many and varied as set out in the report of the Tax Working Group, even by the majority who supported such a tax. This included complexity of the rules, compliance costs, lock-in effects, and the impact of taxing gains only on realisation so that the tax becomes transactional in nature. The taxing of share gains seems especially problematic, particularly how taxing share gains can work efficiently under an imputation system. One problem identified was that the capital gains tax designed by the TWG would have increased the tax levied on

New Zealanders investing in New Zealand companies but not increase the tax levied on New Zealanders investing in offshore companies (or foreigners investing in New Zealand companies). The potential result was seen as the hallowing out of the New Zealand equity market to the detriment of the economy generally.

Indexation, Depreciation and Concessions

The draft LTIB raises the option of comprehensive indexation of the tax base. The rationale is that even at moderate levels of inflation a nominal tax system creates considerable variability in the EMTRs applying to diverse types of investment and the draft LTIB seems to suggest these can be more economically costly than high EMTRs on inbound investment. Examples are:

- High EMTRs on inventory
- High EMTRs on depreciable assets especially short-lived assets.
- Low or negative EMTRs on debt financed investment.

Comprehensive indexation of the tax base has been explored in the past and found to be impractical. Indexation of financial assets (debt) seems especially problematic. That is not only on grounds of complexity and compliance costs but conceptually. For example, a business that has issued debt at low interest rates would find that if inflation increases materially in real terms its interest rate would become negative. It would then be deemed to have derived taxable income even though it has to continue to pay interest as a cash outflow. This would be a material risk for firms increasing uncertainty of the impact of our tax laws. The Group does not consider this to be a viable option.

The Group does however consider partial indexation measures could usefully be considered. That would include indexing depreciation deductions (so the book value of assets is increased each year for inflation) and moving inventory to say a LIFO from FIFO system. Such measures would seem consistent with a long-term strategy of decreasing EMTRs on investment and inbound investment in particular.

The Group also considers that overseas examples of successful tax concessions should be considered. We provided examples in the Group's 6 September 2021 submission on the Long Term Insights Consultative Document. Specific tax concessions are most likely to be justified in attracting internationally mobile activities that other countries court with attractive offers. The main economic argument against tax concessions is that they need to be funded by higher taxes on other firms (assuming a set revenue need) and they divert resources to activities generating a lower overall return. However, such objections do not hold to the extent tax concessions attract activities here that contribute tax revenue but would not locate here without concessions and that engage resources (including personnel) that would otherwise not be here.

With respect to depreciation rates, these have been set based on models of the economic life of assets. It would be appropriate to question this approach and explore further the basis on which actual investment decisions are made. As technology makes investment timeframes shorter it seems likely that investment timeframes are much less than modelled economic life of assets. This suggests higher depreciation rates than currently available.

We attach as an Appendix the Group's comments in relation to the questions for response in Chapters 7 to 12 of the briefing.

Please let us know if you have any queries in relation to the matters set out in this letter, we would be happy to discuss these further.

For your information, the members of the Corporate Taxpayers Group are:

1	AIA New Zealand Limited	24	Methanex New Zealand Limited
2	Air New Zealand Limited	25	New Zealand Superannuation Fund
3	Airways Corporation of New Zealand	26	Oji Fibre Solutions (NZ) Limited
4	ANZ Bank New Zealand Limited	27	OMV New Zealand Limited
5	ASB Bank Limited	28	Pacific Aluminium (New Zealand) Limited
6	Auckland International Airport Limited	29	Powerco Limited
7	Bank of New Zealand	30	Resolution Life Australasia Limited
8	Chorus Limited	31	SkyCity Entertainment Group Limited
9	Contact Energy Limited	32	Sky Network Television Limited
10	Downer New Zealand Limited	33	Spark New Zealand Limited
11	First Gas Limited	34	Summerset Group Holdings Limited
12	Fisher & Paykel Appliances Limited	35	Suncorp New Zealand
13	Fisher & Paykel Healthcare Limited	36	T & G Global Limited
14	Fletcher Building Limited	37	TAB New Zealand
15	Fonterra Cooperative Group Limited	38	The Todd Corporation Limited
16	Genesis Energy Limited	39	Vodafone New Zealand Limited
17	Heartland Bank	40	Watercare Services Limited
18	IAG New Zealand Limited	41	Westpac New Zealand Limited
19	Infratil Limited	42	WSP
20	Kiwibank Limited	43	Xero Limited
21	Lion Pty Limited	44	Z Energy Limited
22	Mercury NZ Limited	45	ZESPRI International Limited
23	Meridian Energy Limited		

We note the views in this document are a reflection of the views of the Corporate Taxpayers Group and do not necessarily reflect the views of individual members.

Yours sincerely

John Payne

John Payne
For the Corporate Taxpayers Group

APPENDIX ONE

Comments on Specific Questions Asked.

Question 6 – page 53. The Group supports a reduction in the company tax rate but the extent to which that would require buttressing measures should be discussed.

Question 7 – page 60. The Group supports reconsidering depreciation rules and higher depreciation rates. Details should be developed in discussions.

Question 8 – page 67. The Group supports consideration being given to indexing depreciation and inventory but not financial assets.

Question 9 – page 74. Our thin capitalisation rules should be reviewed with a focus on New Zealand becoming more attractive for inbound investment rather than just a revenue focus. With respect to FDI and FPI, both are of benefit to the country but pragmatically the main option for reducing EMTRs on FPI is to reduce the company tax rate whereas other options are available with respect to FDI.

Question 10 – page 80 and Q12 - page 93. As part of a broader discussion of the need for alignment of company and personal tax rates both a dual income and allowance for equity systems should be explored.

Question 11 – page 85. In general, the Group considers tax rules should not be industry specific unless there are pragmatic reasons for that (such as forestry, petroleum mining etc.). However, consideration should be given to adopting tax concessions that other countries have successfully implemented as discussed above.