Inland Revenue

Information Release

Public submissions and external reviews received on Inland Revenue's draft long-term insights briefing

August 2022

Availability

This information release is available on Inland Revenue's tax policy website at https://taxpolicy.ird.govt.nz/publications/2022/2022-ir-draft-ltib-submissions-external-reviews

Documents in this information release

Submission number	Submitter
1	Chartered Accountants Australia and New Zealand
2	Individual submitter - name withheld
3	BusinessNZ
4	Mayne Wetherell
5	Cantin Consulting
6	Corporate Taxpayers Group
7	Strategic Tax Management

External review	Reviewer
1	Professor Jack M Mintz
2	Professor Michael Keen

Additional information

Inland Revenue's draft long-term insights briefing[1] was released for feedback in February 2022. Submissions closed in April 2022, and 7 public submissions were received. In addition two external reviews were commissioned.

Inland Revenue's final long-term insights briefing[2] was released in August 2022.

[1] Inland Revenue. (2022). *Tax, foreign investment and productivity – draft long-term insights briefing.* https://taxpolicy.ird.govt.nz/publications/2022/2022-other-draft-ltib

[2] Inland Revenue. (2022). *Tax, foreign investment and productivity – Long-term insights briefing.* https://taxpolicy.ird.govt.nz/publications/2022/2022-other-final-ltib

Information withheld

The Official Information Act 1982 (the Act) was used to decide what information was withheld.

Sections of the Act under which information was withheld:

9(2)(a) to protect the privacy of natural persons, including deceased people

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CHARTERED ACCOUNTANTS™
AUSTRALIA + NEW ZEALAND

14 April 2022

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

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

Dear David

Draft long-term insights briefing

Thank you for the opportunity to comment on Inland Revenue's draft long-term insights briefing titled Tax, foreign investment and productivity (the draft briefing paper).

At the outset we welcome Inland Revenue undertaking this work. Foreign Direct Investment (FDI) is critical to the New Zealand economy and we support work to determine whether our tax rules are deterring overseas investment. We appreciate that the objective of the work is to provide medium-term and long-term trends, risks and opportunities and impartial analysis on possible policy responses.

In summary, the long-term insights briefing raises some very important questions, but we are concerned at both the narrow focus and the lack of evidence connecting increasing FDI and our corporate tax settings.

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Summary table

Overall comments

The analysis should consider whether and how tax settings affect FDI, and it does not appear to do this.

The analysis should take account of the work undertaken for the New Zealand Treasury LTIB.

The work should be used to develop a forward-looking policy framework, and should be broader and consistent with the Government's policy developed in the Living Standards Framework.

General comments

The analysis does not take into account transfer pricing arrangements, which might have a material effect on the tax raised by FDI.

The comparison with other economies does not consider differences in situation, nor is it up to date.

More work should be done to determine how to quantify costs not quantified to date.

Specific measures

None of the specific measures proposed seem viable, with the exception of the Nordic tax system.

However, as this would involve introducing an effective capital gains tax, we do not believe this is viable in either the short or medium term.

Our more detailed comments are below.

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Overall comments

Foreign direct investment

The aim of the long-term insights briefing (LTIB) was to examine how New Zealand's tax settings are likely to affect decisions for overseas firms to invest into New Zealand. This draft has also benchmarked New Zealand's tax settings against those in other countries.

It is our understanding that this work forms part of Inland Revenue's role as steward of the tax system, to ensure the long-term health of the system.

FDI is vital to the New Zealand economy. We have high infrastructure needs and will continue to have in the coming years. We also have an aging population and will arguably need to increase productivity if we are to fund increasing government superannuation and related health costs. The draft briefing paper notes in paragraph 1.7 that "New Zealand's investment demand exceeds the pool of domestic savings of domestic residents, so we rely to a considerable extend on imported capital to fund domestic investments." That is, we need FDI. What do we need to do as a country to access further FDI/make it more attractive for foreign investors to want to invest here?

It is not clear to us whether this draft briefing paper achieves its aims. There is no analysis of the effect that tax settings have on FDI, nor evidence provided that there is a connection on the two factors. The draft outlines how each of the different options would affect Effective Marginal Tax Rates (EMTRs) but provides little analysis as to whether any of the options would improve FDI. There is no consideration as to how much FDI will be needed and to what extent the various options may affect it. This is fundamental.

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It seems from the draft briefing paper that there is not a lot of data about whether or how tax settings affect FDI. In that case, it may have been preferable to limit the scope to discovering if or how tax settings affect FDI before undertaking further analysis.

We understand that the purpose of the report is to present options rather than recommendations or conclusions. However, the briefing paper does not provide any real insight as to what the suggestions would or could do for FDI in New Zealand. Without this step, the research has limited utility.

While the briefing paper provides a good summary of the factors considered it is relatively narrow in scope. New Zealand's inability to improve productivity over an extended period is a fundamental issue. This is acknowledged yet the paper does not consider the taxation of individuals. It is primarily focused on efficiency and hence can be criticised because it departs from mainstream government policy which would consider overall well-being in accordance with the Living Standards Framework. We believe that all four capitals should be considered in a long-term insights briefing, not just financial and physical capital.[1]

Work undertaken by the New Zealand Treasury

The draft briefing paper refers to the complementary Treasury project undertaken in 2021. At paragraph 5.5 it notes that the Treasury LTIB[2] raised the importance of the sustainability of the tax system given future fiscal pressures such as an aging population, rising healthcare demand and the wider costs of Covid-19.

[1] https://www.treasury.govt.nz/publications/tp/living-standards-framework-2021-html
[2] Briefing and Long-Term Fiscal Position He Tirohanga Mokopuna 2021, the New Zealand Treasury

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Despite this reference, the work in the draft LTIB seems to have been undertaken in isolation from the earlier Treasury work. In our view, the Treasury findings should be used as a reference point in the Inland Revenue analysis. The Treasury insights consider issues that will impact New Zealand and its citizens. Inland Revenue should consider broadening the scope of its briefing paper to be more relevant.

Given the Treasury findings, it may have made sense to assume the tax system was needed to increase revenue (or at least maintain current levels) when considering how best to attract FDI.

Once the level of revenue needed has been determined, the next step should be to determine whether non-residents are being taxed appropriately. Are non-residents paying sufficient tax relative to New Zealand residents? If not, how could they be taxed more or less? The draft LTIB considers options for reform in isolation. In our view this work should form part of a larger project across IR and Treasury to determine whether non-residents are paying the right amount of tax and/or the impact that tax settings have on attracting the required level of FDI into New Zealand.

Outcome of the work

In our submission on the scope, we recommended that the work done as part of the LTIB be used to develop a framework to evaluate policy decisions going forward.

It would have been useful if the draft LTIB had considered the direction of tax reform more generally. For example - does New Zealand need more FDI? Is there a link between tax settings and FDI? Are current tax settings for non-residents appropriate? If not, what types of changes would be useful? Which are likely to affect FDI?

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From there, a framework could be developed to inform tax policy decisions going forward. Instead, the draft LTIB has generated specific and isolated reform options that may be either implemented or not. We recommend that the analysis in the draft LTIB be extended to consider any overall policy trends or frameworks that should be pursued in future international tax policy development.

General comments

Overlay of transfer pricing requirements

The analysis also fails to take into account transfer pricing rules. The transfer pricing rules mean that non-residents do not always calculate and return tax in the same way as domestic residents.

Overseas entities operating in New Zealand often transact with related parties. This is particularly true of internationally recognised brands. Product manufacture and development (whether goods or services) is done centrally to ensure quality and consistency. International firms set up entities in market countries to market and distribute their product.

As you are aware, transfer pricing is a set of rules that requires cross-border associated party transactions to be conducted on an arm's length basis. The aim of the rules is to ensure that the multinational enterprise is returning sufficient profit in New Zealand relative to the economic activity performed here. Overseas entities are required to have robust transfer pricing documentation. This involves documenting (and often agreeing with Inland Revenue) the method used to determine their New Zealand profit.

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There are two general categories of transfer pricing methods. The first is transaction methods, which look at the price paid for the goods or services. The second category is profit methods, which look at the profit made on transactions here.

Many overseas firms use a profit method, usually one agreed with Inland Revenue. For example, a large soft drink manufacturer might investigate and agree to return profit based on a percentage of sales; and to pay tax on that profit. That is, non-residents do not always calculate and return tax in the same way as a domestic resident.

Where a profit method is used, which is common, most of the measures outlined in the draft LTIB will be irrelevant. An overseas firm's decision to invest in New Zealand will not be influenced by depreciation rates, indexation, incentives for specific businesses or an allowance for corporate equity if their taxable income is a percentage of sales. Thin capitalisation may still be relevant.

Comparison with other economies

The draft briefing uses OECD comparative analysis to determine the merits or otherwise of the New Zealand tax system

Some of the information used in the comparisons is out of date. For example, the tax rates for companies in other jurisdictions. This is discussed further in the Appendix under our comments on Chapter 6 of the draft briefing paper (Reducing the company tax rate).

Another limit on the OECD comparative analysis is the lack of consideration of capital gains tax. As the draft LTIB notes at 3.21, New Zealand is unusual in that regard. Thus, although

table 3.1 (page 28) shows that buildings are highly taxed by international standards, this ignores that we do not tax on exit (other than by way of tax depreciation recovery capped at cost).

The work underpinning the draft briefing also relies heavily on comparisons with other small, open economies (see in particular figure 3.1 on page 31). While this is useful, we note that the other economies considered (for example Norway, Sweden, Belgium and the Netherlands) generally have contiguous land borders with other large economies; or are situated very close to a larger market (for example, Ireland, which is part of the EU).

New Zealand faces some unique challenges. Foreign investors may choose not to put their money here for many reasons. Distance, size and a lack of familiarity with the country or culture mean that overseas investors are less likely to place their money here. Australia is more likely to attract foreign capital than New Zealand because it is larger, has (arguably) a more attractive climate, and is better known on the international stage. These merits are nothing to do with its tax system. This is discussed further under "Unquantified costs", below.

Unquantified costs

In our submission on the scope of the LTIB, we noted factors that do not concern the rate of tax but may affect a business's decision to invest here. Examples of these are:

- Distance from markets
- Compliance costs
- Market size
- Familiarity with market
- Climate
- Ease of doing business

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We realise these will not be easy to quantify; however, we recommend more work is done to determine how they may be taken into account.

As well as our general comments, we have commented on each of the individual measures considered in the Appendix, under the chapter headings used in the draft briefing paper.

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

Yours faithfully

John Cuthbertson FCA

CA ANZ NZ Tax and Financial Services Leader

Scott Mason FCA

NZ Tax Advisory Group Chair

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Appendix: Specific measures

Chapter 6: Reducing the company tax rate

We have looked at the economic analysis in chapter six of the draft LTIB. In summary, the chapter considers whether a reduction in the company tax rate would decrease EMTRs.

While the analysis is extensive, we do not believe it gives sufficient justification for reducing the company tax rate.

The trend analysis for corporate tax rates ends at 2019. However, the world has changed in the past three years. In 2019. In the spring budget of 2021, the United Kingdom announced an increase in their corporate tax rate (for those companies earning more than £250,000) from 19% to 25%. We understand that the US has also signalled interest in increasing its corporate tax rate in order to pay for the cost of the pandemic, although legislation has yet to be introduced. This global trend to higher corporate taxation is one material factor which deserves consideration and reflection.

Moreover, the OECD work on Base Erosion and Profit Shifting (BEPS) is well advanced. As you are aware, BEPS looks to impose a standard set of tax rules on some of the world's largest multi-national entities to ensure that they are paying sufficient tax overall. At a high level, it would involve coordination between countries to enact similar tax rules in each country. This points towards greater global cooperation in some respects, rather than the global competition which sits as a fundamental part of this analysis.

The current misalignment of tax rates – in particular, the 11% differential between the top personal tax rate and the corporate rate – has resulted in Inland Revenue having to

undertake additional anti-avoidance activity and Government suggesting further integrity measures. The integrity measures will add significant complexity to the system and have the potential to blur the lines of our current tax policy framework – including the distinction between income and capital gains.

There is also limited reconciliation to previous advice provided by Inland Revenue. For example, the recommendation of the Secretariat to the Tax Working Group in 2018 advised against a reduction in corporate income tax, saying:[3]

> "All of this leads us to conclude that, on balance, in the judgement of the Secretariat it would not be in New Zealand's best interests to lower the company tax rate."

In addition, the company tax rate should not be reduced without considering the other factors we refer to in our overall and general comments at the start of the submission.

Overall, we do not believe it would be appropriate to reduce New Zealand's company tax rate.

[3] Paragraph 40 of the report, Appendix 2: Company tax rate issues Background Paper for Sessions 6 and 7 of the Tax Working Group (2018), available at https://taxworkinggroup.govt.nz/sites/default/files/2018-09/twg-bg-appendix-2--company-tax-rate-issues.pdf

Reducing the company tax rate: Key questions to consider		
6.1	If New Zealand wished to reduce EMTRs, should reducing the company tax rate be an option to be considered?	No
	If governments wanted to reduce costs of capital and EMTRs without reducing the progressivity of the tax system, what accompanying tax changes would you suggest?	Not considered
6.3	Would the case for or against company tax rate cuts depend materially on what happens to company tax rates in other countries?	In part, as the current global trends tend towards cooperation
6.4	If there were a cut in the company tax rate, should there be changes to other tax rates at the same time?	If the company tax rate is to be cut, government should consider cutting other rates at the same time to address issues caused by rate misalignment

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Chapter 7: Accelerated depreciation

The analysis considers whether allowing additional depreciation deductions would improve EMTRs.

Broadly speaking, accelerated depreciation is a means to give businesses additional deductions for capital costs. The draft briefing paper considers two main methods:

- Depreciation loading; and
- Partial expensing

Undertaking this type of change would go to the heart of our tax policy system, which is a "broad base low rate" structure. This proposal seems similar to initiatives undertaken towards the end of the 20th century where the tax system was used by some governments as a tool to incentivise particular businesses or industries. As it runs against the overall philosophy of our tax system, it should not be undertaken without wider consultation on the structure of the system as a whole. As we have noted in our general comments, this work is not explored in the draft LTIB.

Our preference would be to move to a more simplified system of depreciation rates rather than reintroduce loadings, which will bring in further complexity. We would support consideration of partial expensing, particularly for items that are currently black hole expenditure

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Accelerated depreciation: Key questions to consider

7.1	If New Zealand wished to reduce EMTRs, should accelerated depreciation be considered as an option?	No
7.2	If accelerated depreciation measures are considered, should these be restricted to new investments, or available for both new and existing investments?	New investments only
7.3	If accelerated depreciation measures, or other measures that increase the value of depreciation deductions, are considered, are there reasons to prefer depreciation loading, partial expensing or some other scheme?	Partial expensing should be preferred if it results in a simpler regime

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Chapter 8: Indexation

This chapter considers whether our income tax system should be indexed for inflation.

Broadly speaking, the concept is premised on the basis that a component of the income received by individuals and businesses is compensation for inflation. This is particularly true of interest income, which is partly compensation for the time value of money and partly compensation for the value of the money reducing in real terms over the time it is held by the borrower.

This chapter of the draft LTIB explains that, in theory, the two could be split out and only actual income taxed.

In reality indexation is likely to lead to further complexity, it would permeate through or need to be considered for all income sources and could potentially result in a significant reduction in Government revenue. The draft LTIB notes that no other country has adopted this approach.

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Indexation: Key questions to consider

8.1	Might comprehensive indexation of the tax base, including indexation of interest, depreciation and trading stock, be worth considering further and does the answer depend on future inflation and interest rates?	Not under current settings
8.2	Might partial indexation of the tax base, including indexation of depreciation deductions or indexation of both depreciation deductions and trading stock, be worth considering further and does the answer depend on future inflation and interest rates?	Not under current settings
8.3	How do these measures compare with other ways of reducing higher EMTRs and reducing current tax distortions?	Overly complex and no evidence that either measure would attract FDI to New Zealand

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Chapter 9: Thin capitalisation

The draft briefing also considers New Zealand's thin capitalisation rules.

Broadly speaking, "thin capitalisation" refers to a set of rules that govern interest deductibility for foreign owners. The aim of the rules is to prevent foreign companies that do business here from sheltering their New Zealand profits against interest deductions so that they pay little or no New Zealand tax. The rules work by limiting the amount of deductible interest over a certain debt threshold.

While increasing the debt threshold may improve EMTRs, this option should not be considered in isolation. As we have mentioned earlier in our submission, an overall policy decision needs to be made as to whether non-residents pay the right amount of tax currently before making changes to the thin capitalisation rules.

Moreover, taxation of non-residents is often borne ultimately by New Zealand residents through lower wages or rental income. If the measure was implemented, it could increase New Zealand's productivity through higher wages or rental incomes earned from non-residents. However, it is also possible that the increased return received by the non-resident through paying less tax could be simply retained by the non-resident as additional profit. It is not clear whether either of the potential changes in tax settings would attract additional FDI, or merely benefit existing foreign investors.

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Thin capitalisation: Key questions to consider

9.1	Would it be sensible for the tax rules to be as neutral as possible between foreign direct investment and foreign portfolio investment or are there good grounds to promote one form of investment over another? If so what should be promoted and why?	Not considered
9.2	Is the current 60% thin capitalisation safe harbour broadly reasonable? If not, should it be increased or decreased?	Yes broadly reasonable

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Chapter 10: Allowance for corporate equity

Broadly speaking, an allowance for corporate equity (ACE) would allow a company a deduction for the cost of its equity finance. The draft briefing paper notes that:

- In theory this would add more neutrality to the tax system; and
- It would be practically impossible to implement unless changes were made to the personal income tax system.

We agree with both these points. However, our overall comment is that implementing an ACE would be too complex, particularly given the changes needed to the personal tax system.

We note that a separate issues paper has been released which proposes, among other things, a change to the rules regarding share sales[4]. If this change is to be made (which we disagree with), it should be evaluated on its own merits and not be implemented as a stepping-stone to an allowance for corporate equity.

[4] Dividend integrity and personal services income attribution: A Government discussion document, 16 March 2022 https://taxpolicy.ird.govt.nz/-/media/project/ir/tp/publications/2022/2022-dd-dividend-integrity-psa/2022-dd-dividend-integrity-psa-pdf.pdf?modified=20220315155634&modified=20220315155634

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Allowance for corporate equity: Key questions to consider		
10.1	If problems of integration with personal taxes could be resolved, would an ACE be a viable tax reform option if governments wish to reduce EMTRs and make investment decisions more neutral?	Not under current policy settings
10.2	Are there ways of integrating an ACE with personal taxes and, if so, what are they?	Not considered
10.3	If an ACE system were to be introduced, would it be viable to levy a tax on firms with negative equity? If not, would the neutrality properties of the tax be sufficiently compromised for this to be an unattractive option?	Not considered

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Chapter 11: Incentives for specific businesses

This chapter of the draft briefing considers whether New Zealand should provide tax incentives for specific businesses or industries to encourage them to invest here.

Undertaking this type of change would go to the heart of our tax policy design, which is to retain a "broad base low rate" structure as much as possible. Departing from this structure would be a significant policy decision which should be undertaken only after a broader examination of New Zealand's tax policy frameworks.

Incentives for specific businesses: Key questions to consider		
11.1	Are there specific businesses or industries where spillovers are large enough to justify lower tax rates?	No
11.2	Are there specific businesses or industries where economic rents are large enough to justify higher tax rates to fund lower general business tax rates?	No
11.3	Are there any other arguments for specific incentives?	No

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Chapter 12: Dual income tax system

The final option considered in the draft paper is the introduction of a dual, or "Nordic", income tax system. Broadly speaking, a Nordic tax system is one where high, progressive tax rates are applied to labour income and lower rates to capital income.

While the paper does not provide any recommendations it would seem that, of all the options considered, this would be the most attractive. We agree. While there is no data to suggest that it would increase FDI, it is the most coherent suggestion, would effectively reduce EMTRs and would alleviate some of the other issues currently facing the tax system such as the incredible level of complexity in the new bright-line test rules, denying interest deductions on residential property and the taxation of share sales.

However, this option would, in essence, involve introducing a capital gains tax. This is unlikely to be politically palatable in the short or medium term. Moreover, as we have previously mentioned, the current tax rate differentials have created additional complexity in the tax system which is not desirable. For these reasons, we do not believe this is a realistic option.

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Dual income tax system: Key questions to consider

12.1	Is a dual income tax worth considering as a way of allowing costs of capital and EMTRs to be reduced?	Yes
12.2	Would a dual income tax be worth considering as a way of reducing distortions in the way that different forms of savings are taxed?	Not considered
12.3	Is a dual income tax only worth considering in the future if it becomes harder to tax capital income at high marginal rates?	No

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From: s 9(2)(a)
To: Policy Webmaster
Subject: LTIB first draft
Date: Wednesday, 20 April 2022 4:55:28 PM
Attachments: s 9(2)(a)

Feedback summary

1. Thank you for the opportunity to comment. My apologies for the lateness and brevity of my comments s 9(2)

2. The views expressed herein are those of the author and those views are not necessarily those of s 9(2)( )

3. In summary, I give the LTIB first draft a well-earned 'F'. 'Well-earned' because the IRD is in no position to evaluate this topic impartially. 'F' because IRD has purported to do its analyses impartially and has soundly failed to do so.

4. As it stands, this paper is, and in my estimation intentionally so, a 'conversation killer' though whilst in draft might yet be saved.

5. I may be contacted to discuss the points raised, if required. Please note my comments are deliberately provocative because that is what appears needed. As such, my comments are for the IRD and are not provided for public consumption without prior consent.

'Well-earned' because the IRD is in no position to evaluate this topic impartially

6. Section 8 of the Public Service Act 2020 provides as follows:

> Long-term insights briefings
> (1) A chief executive of a department must give a long-term insights briefing to the appropriate Minister at least once every 3 years and must do so independently of Ministers.
> (2) The purpose of a briefing is to make available into the public domain
> (a) information about medium- and long-term trends, risks, and opportunities that affect or may affect New Zealand and New Zealand society:
> (b) **information and impartial analysis**, including policy options for responding to matters in the categories referred to in paragraph (a).
> (3) A briefing may set out the strengths and weaknesses of policy options **but without indicating a preference** for a particular policy option.
> (4) The subject matter must be selected by a chief executive taking into account—
> (a) the purpose of the briefing; and
> (b) the matters in the categories in subclause (2)(a) that the chief executive considers are particularly relevant to the functions of their department.
> (5) Two or more chief executives may give a joint briefing that meets the requirements of this clause for each of the departments covered by the briefing.
> (6) Any agency in the State services may contribute to a briefing by a department or departments on subject matter relevant to the operation of their agency.
> (7) The Minister must present a copy of a briefing to the House of Representatives as soon as is reasonably practicable after receiving it.
> **[emphasis added]**

7. Section 6A of the Tax Administration Act 1994 sets out Commissioner's duty of care and management

> **Care and management**
> (1) The Commissioner is charged with the care and management of the taxes covered by the Inland Revenue Acts and with such other functions as may be conferred on the Commissioner.
>
> **Highest net revenue practicable within the law**

(2) In collecting the taxes committed to the Commissioner's charge, and despite anything in the Inland Revenue Acts, it is the duty of the Commissioner to collect over time the highest net revenue that is practicable within the law having regard to—

(a) the resources available to the Commissioner; and

(b) the importance of promoting compliance, especially voluntary compliance, by all persons with the Inland Revenue Acts; and

(c) the compliance costs incurred by persons.

8. In short, the Commissioner is statutorily charged to be, and is in fact, anything but impartial in relation to possibilities that might be construed as causing or having the possibility of causing reductions in net revenue. Put another way, this choice of topic was a brave one on the terms prescribed.

'F' because IRD has purported to do its analyses impartially and has soundly failed

9. For over 35 years IRD has promoted and successfully pursued a "broad base low rate" ("BBLR") paradigm. It has been so successful in this that, capital gains aside, there are probably more examples of systematic over-taxation than there are of systematic under-taxation1. BBLR has become an unchallengeable metaphor for what the IRD considers an effective tax system for a small open economy and one generating the highest net revenue over time. And IRD is rightly proud of this and entitled to be so.

10. However, to define a scope for this LTIB topic impartially, never-mind to carry it out impartially, the Commissioner must first get outside of its BBLR metaphor and she has not. BBLR currently infects the choice of scope, the work that has not yet been done, the amount of investment in the project, the lack of collaboration, the timing of requiring submissions and the structure of the draft report. Dare I say it, the paper appears designed to conclude BBLR whatever evidence it encounters in its way, including no matter how compelling.

11. By way of example, in chapter 3 of the draft LTIB evidence is presented that NZ's FDI is woeful. That fact is left hanging. Then, buried at paragraph 5.7 is the conclusion:

> "At the same time, chapter 3 provided evidence that New Zealand does appear to be an outlier in the way it taxes inbound investment. Costs of capital and EMTRs are higher in New Zealand than in most other OECD countries."

12. Surely the conclusion "does appear to be an outlier" is a key finding and one that merits deep exploration?

13. Given the typically very high quality of IRD policy papers and related processes on matters consistent with its BBLR metaphor these defects cannot be dismissed as accidental. On the other hand, those defects could well be evidence of a 'Kodak' moment2 for the Commissioner.

Conversation killer

14. I observed earlier that this topic choice was a brave one. I must unfortunately now qualify that it could have been brave. Instead, in its lack of bravery, it comes across as in my view as an unashamed attempt to kill an important conversation.

Might yet be saved:

15. First, by dropping BBLR as a unidirectional relic necessitated by a time and tax administration system that is no longer so readily compartmentalised.

15. Second, by developing a more mature metaphor for the role of tax and tax systems in regulating the economy – a metaphor befitting a modern economy and the $1.5b investment in START. As Deirdre McCloskey, author of "The Rhetoric of Economics", says "metaphors are not just a pasted-on ornament … they're terribly consequential."

16. Third, and mandatory (for impartiality), would be to approach the topic from a wider perspective than tax (i.e. limiting the focus to tax is like analysing liver function whilst ignoring the body of which it is a part – an LTIB put out by the Commissioner must surely deal with the real world not merely first year university tax theory and equivalent level assumptions?)3.

Footnotes:

1 Note every occasion where policy papers have identified over-taxation and excused this on the basis of fiscal constraints.

2 An infamous moment when Kodak could have gone on to dominate digital photo technology having invented it but could not follow through to reinvent itself – instead the market did and the rest is history.

3 In line with what at least one submitter on the scoping document recommended.

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DRAFT SUBMISSION

22 April 2022

LTIB First Draft
c/- Deputy Commissioner, Policy and Regulatory Stewardship
Inland Revenue Department
PO Box 2198
Wellington 6140

Dear Sir/Madam

Re: Tax, Foreign Investment and Productivity draft long-term insights briefing

I am writing to you regarding the consultation document entitled '*Tax, foreign investment and productivity'* (referred to as "the Document").

BusinessNZ took the opportunity to submit on IRD's previous Document that consulted on its proposal to focus its 2022 Long Term Insights Briefing (LTIB) on tax and its impact on investment and productivity. We agreed on this focus given investment and productivity are important factors affecting long-term living standards in New Zealand. Therefore, we are pleased to see the release of the current Document, and broadly support the LTIB process whereby key future issues are examined by Government Departments every three years.

The Document examines a number of potential measures to initiate a process of discussion. We welcome the decision to look at a number of different options, rather than concentrate on only a few that may not provide the broadest spectrum of choices to consider. We agree with the point raised in the Document that there is unlikely to be a single best option, so it is important to consider and rank the best options going forward given it may involve a number of difficult questions and conversations to be had.

As we have mentioned previously to IRD, we believe the main challenge for New Zealand will be to ensure that as a small country, it is sufficiently internationally competitive and that the full suite of taxes on individuals and business is not onerous, curtailing growth and/or risk-taking. While we obviously have an interest in taxes affecting the business community, we are also very cognisant of New Zealand's tax system in general, taking into account that taxes fall on both individuals and

entities. A tax system that works well as a total system, with minimal distortions, has the best chance of improving economic growth.

We believe the main aim of tax policy is for New Zealand to continue its journey towards achieving a broad-based, low-rate tax system, collecting taxes in the most optimal way possible, and creating minimal disruption for the general population. In terms of this specific Document, we agree with the point made in paragraph 12 that *"the aim of this draft LTIB is to start a conversation"*. BusinessNZ sees it as the start of a journey towards meaningful change in lowering the costs of capital and improving inbound investment in New Zealand.

1. Setting the Scene

Benchmarking and the case for change

In our submission on the initial LTIB in September 2021, we noted that Document's sobering statistics about New Zealand's current investment and economic path, which highlight the need for a deeper examination of our investment and productivity challenge. The current Document provides further evidence for the case for change.

Figures 1.2 and 1.3 of the current Document that outline foreign direct investment (FDI) and outbound direct investment (ODI) illustrate how far New Zealand lags behind the countries we typically compare ourselves with. We agree that there is unlikely to be a silver bullet to properly address our weak productivity and poor economic performance over a number of years, and believe that a mix of policy changes is required to lift our performance. We believe a fundamental question that IRD needs to ask itself both now and ahead is, *'What would be the tax policy mix that would make a foreign investor look to New Zealand to invest?'*. If this question is kept top of mind when assessing future policy options, we believe there will be a greater chance of ensuring new tax policies integrate with existing ones to create the best platform for raising investment.

A cross-government effort

The Document rightly acknowledges the fact that while tax policy is an important element in addressing productivity issues, tax policy alone is not always sufficient in ensuring the best solution. Instead, broader policy settings often need to be examined to ensure policy changes that have the best opportunity for success.

BusinessNZ strongly agrees that regulatory and policy settings will also play a significant role in addressing our productivity and investment concerns. Therefore, we support the publication of LTIBs across key Government departments to promote wider discussion around future policy options.

We note that chapter 5 of the Document mentions the 2021 Treasury LTIB that BusinessNZ also submitted on. Given the Treasury LTIB was very much focused on

long-term fiscal pressures from the aging population and rising healthcare demand, the link between future options that both Treasury and IRD outline are obvious.

Ideally, we would want the collective works of briefings across Government departments to be examined to ascertain what broad policy frameworks should be changed and/or introduced. This means Government policy needs to take a coordinated and considered approach, rather than the ad hoc, silo-bound, and often reactionary approach currently evident.

Recommendation: That the Government takes a coordinated approach across government to the various LTIBs being produced.

Estimated cost of capital

In our submission to the Tax Working Group in 2019, we noted that there is significant scope for the Government to conduct some updated research on the dynamic effects of reducing the CTR. While modeling work can only be as good as the structure and information fed into the model, there continued to be a serious hole in terms of research in this area where the Government tends to view changes in a static sense only. We noted that there is every chance that research into the dynamic implications of further reductions in the CTR may provide the greatest broad economic benefits, compared with changes in other direct taxes. We even supported private sector involvement via an economic agency becoming involved to help in the research.

Therefore, BusinessNZ is pleased to see that the current Document provides some in-depth modelling (based on OECD work) so as to provide a better understanding of the policy implications of various options.

Chapter 3 of the Document provides a useful outline of how New Zealand's company tax rate and tax depreciation rules likely compare to those in other OECD countries. In an attempt to analyse potential options, we support the modelling work IRD has undertaken on how tax rules can affect the cost of capital. While we acknowledge the caveats placed on the model IRD produced, it nevertheless provides a useful gauge of the likely outcomes of various tax rate changes.

We agree with the statement made in paragraph 3.20 of the Document, "…*that any economic model is no more than a partial insight. In particular, the OECD model treats the tax rules as certain and assumed to continue forever."* As a number of submitters including BusinessNZ have previously outlined, certainty has been in short supply. Haphazard decision-making that seems to be more political than policy-orientated has left the business community experiencing extreme uncertainty about the direction of Government policy. A clear and consistent policy pathway needs to be shown to entice investors to New Zealand, as opposed to the constant chopping and changing currently being experienced.

While we acknowledge the limitations and key assumptions of the OECD model used, table 3.1 summarising the data by country paints a fairly stark picture of where New Zealand currently sits with regard to estimated costs of capital over the four asset classes.

A ranking of 1st, 2nd, 3rd and 18th of 38 OECD countries tells us that if the table was ranked by overall ranking instead of alphabetically by country, New Zealand would rank first overall for cost of capital. Unlike paragraph 3.25 which states *"The OECD data suggest that New Zealand has relatively high costs of capital,"* we would go a step further and say without question New Zealand has the overall highest costs of capital in the OECD.

Furthermore, Paragraph 3.30 points out that, *"Little difference exists between New Zealand's costs of capital for the three main types of business investment included in the data … thus New Zealand's tax settings appear to be reasonably neutral across these three different aggregate assets."* While this is technically true, it misses the broader point above, that our overall ranking is significantly out of line with most other countries. In short, the neutrality of our tax settings across these assets does nothing to improve our chances of being seen as a viable country for investment.

Last, it does not surprise us that the restoration of building depreciation for commercial and industrial property in 2020 reduced the cost of capital for buildings from 4.9% to 4.1%. BusinessNZ strongly objected to the removal of depreciation on these buildings when it was initially discussed in 2010, given it placed New Zealand as a policy outlier with the rest of the world in terms of standard global tax practice. However, it should be pointed out that its reintroduction simply returned New Zealand to what is typically considered normal tax policy settings and cannot really be viewed as a recent proactive policy change to improve our investment competitiveness.

2. Options for the Future

The Document considers seven possible tax changes to initiate a process of discussion. For each option, we have included the specific questions asked in the Document, along with our overall thoughts and recommendations regarding their ability to see firms increase their investment in New Zealand.

The only overarching point we would like to make regarding the various options is that we have to be careful to avoid 'paralysis by analysis.' There are always costs and benefits associated with every policy option. However, the fact that some options would lead to certain costs should not automatically preclude them from consideration. Instead, we would expect that the policy journey to improve firms' inbound investment would eventually outline concrete options that the public and private sectors broadly view as the best way forward.

A. Reducing the Company Tax Rate

If New Zealand wished to reduce EMTRs, should reducing the company tax rate be an option to be considered?
If governments wanted to reduce costs of capital and EMTRs without reducing the progressivity of the tax system, what accompanying tax changes would you suggest?
Would the case for or against company tax rate cuts depend materially on what happens to company tax rates in other countries?
If there were a cut in the company tax rate, should there be changes to other tax rates at the same time?

Figure 3.1 in the Document highlights how high New Zealand's company tax rate (CTR) and Effective Marginal Tax Rates (EMTR) are, compared to not only other small, advanced economies, but also larger advanced economies. Whereas New Zealand once had a very competitive CTR and EMTR, this advantage has eroded over time. BusinessNZ has consistently argued for many years that our broad tax rate settings need to remain competitive to ensure we remain a viable and attractive country to invest and reside in. Unfortunately, we are now at the point where significant decisions need to be made to reverse our failing economic fortunes.

Some view the CTR as only one part of the overall assessment when deciding upon investing in a country. However, we believe the CTR is still considered a 'headline' rate when initial comparisons across countries are made. Obviously, we would expect any company that is looking to run operations in another country to do their due diligence, which would include examining the wider tax system of a country. Nevertheless, the setting of the CTR can often provide the first 'look in the room' regarding competition for foreign investment, with a favourable rate warranting further examination by the company.

To undertake a deeper look at costs of capital and EMTRs in New Zealand, we support IRD's examination into the key set of assets involving commercial and industrial buildings, plant, machinery and equipment, as well as a zero-depreciation asset. Further modelling work that culminates in table 6.1 in the Document shows reductions in the CTR would narrow the range of EMTRs, thus lowering costs of capital for investments that are heavily taxed and reducing tax subsidies for investments that are subsidised.

With regard to consistency, paragraphs 6.21 to 6.29 examine the issues of consistency, fairness and efficiency of personal income tax. While BusinessNZ understands the implications around fairness of a tax system that has significantly differing company and personal tax rates, the discussion seems to miss an obvious point that we believe should be addressed.

Prior to 1 April 2021, the top personal tax rate was 33%, which represented a 5-percentage point difference between the company tax rate, and a match for the trust

rate. The increase in the top personal tax rate to 39% since 1 April 2021 has already led to a significant difference of 11 percentage points between that and the company tax rate. New Zealand now has the largest percentage point differential for some decades. Historically, a gap between the company and the top personal rate can cause distortions and encourage avoidance. We note that paragraph 6.23 does mention that *'…reducing the company tax rate would exacerbate these gaps unless personal rates were cut at the same time. Cutting personal tax rates may be supported by some future governments but not by others.'*

Table 1 below outlines the percentage point difference scenarios for the top personal tax rate at 33% and 39%, along with the three company tax rate options as outlined in chapter 6.

Table 1: Top Personal Tax and Company Tax Rate Differentials

Top Personal Tax Rate	Company Tax Rate	Percentage Point Difference
33%	28%	5%
33%	24%	9%
33%	20%	13%
39%	28%	9%
39%	24%	15%
39%	20%	19%

This table tells us that a 33% top personal tax rate means more options are available if seeking to lower the company tax rate, and that a cut in one rate should also see a cut in the other.

The full tax picture of global comparisons

Paragraph 6.25 notes that even with a relatively new top marginal tax rate of 39%, the 11-percentage point difference between that and the company tax rate is not large compared with other OECD countries. The Document also notes that only six other OECD countries had a smaller gap than this in 2020. However, the Document does not elaborate on the dollar thresholds at which the top personal tax rate kicks in, across the various OECD countries.

While Australia has a top personal tax rate of 45% and begins at the same dollar amount as New Zealand's (AUS$180,000), there are a number of other countries that New Zealand typically compares itself with that have a top personal tax rate that begins at a much higher dollar amount. Therefore, it would be useful for any future consultation work to include analysis of where New Zealand sits regarding the top rate and the threshold where it begins.

Paragraph 6.32 outlines the current state of play in Australia, noting a reduction in the company tax rate there would increase incentives for profits to be streamed to Australia. It also points out the two-tiered company tax rate system in Australia,

which has a lower 26% rate for small-medium sized companies. While Australia has decided to go down this policy route, in no way would BusinessNZ support New Zealand doing the same, in an attempt to alleviate the issue around gaps in personal versus company tax rates. As we outlined to the Tax Working Group in 2018, a progressive CTR would move New Zealand away from the broad-based low-rate system we support, and in our view would create the unintended consequences outlined by the Tax Working Group. This would most probably lead to gaming via changes in the structures of the larger companies, and move us further away from a flat tax structure. Therefore, any change in the CTR should be a decrease that benefits all businesses.

Global trends

Paragraph 6.33 notes recent indications that there may be some movement back towards higher CTRs internationally, especially since the COVID-19 response has led to a weakening fiscal position for many countries. In addition, new international tax frameworks that would result in a global minimum CTR of 15% targeted at income from intangibles may indeed reverse the long downward trend in CTRs that have been ongoing for decades.

However, we believe New Zealand needs to be nimble in its tax policy decisions to ensure it covers every competitive position possible. Alignment is an important factor to consider, but this does not automatically mean increases and decreases in the CTR should be viewed equally. Therefore, if some countries that New Zealand typically compares itself with raise their CTR, there is an argument to be had that we could look to lower ours for competitive purposes. Further analysis could determine if the loss in revenue from the decrease would be outweighed by the overall increase in new business investment.

The key point from BusinessNZ's perspective is that this should be viewed as an opportunity and not a potential threat. As the Document mentions a number of times, New Zealand is a relatively small advanced remote economy that has to regularly compete with much larger countries that are able to influence global settings. Simply put, what New Zealand does or does not do has a much lesser impact than what other countries do that might affect us. For instance, a drop in the CTR to 15% in the USA is, on balance, likely to have a larger effect on New Zealand than what would happen in the USA if we decided to do the same thing.

As a small open economy, we should always seek opportunities that present themselves to remain competitive, while ensuring we hold true to the integrity of the tax system. If the future trend is indeed towards higher CTRs, it makes little sense for New Zealand to simply follow that trend.

Recommendation: That a decrease in the company tax rate is given the highest priority when examining how to improve New Zealand's inbound investment.

Implications for unincorporated enterprises and domestic SMEs operating as companies

Building on the discussion above, BusinessNZ is pleased to see that the document asks an important question regarding whether personal tax rates should be cut at the same time as the company tax rate. The Document takes the view that a reduction in the company tax rate, because of cost of capital concerns, should not provide a case for lower personal taxes. Instead, it should, *"…ensure that company income is adequately taxed at the personal level to ensure that company income ends up being taxed at appropriate personal rates"*.

BusinessNZ understands the point being raised in the Document. However, as we have pointed out, the practical implications of a company tax rate at say 20 or 24% and the continuation of a top personal tax rate of 39% does open a significant differential between the two rates. There is no doubt that this would move New Zealand further away from its traditional broad-based low-rate tax system. From our perspective, any serious consideration involving a reduction in the CTR should also take into account a reduction in the top personal tax rate to ensure ongoing integrity of the tax system.

Recommendation: That a decrease in the company tax rate is accompanied by a decrease in the top personal tax rate to ensure New Zealand retains its broad-based low-rate tax system.

Should future company tax rate cuts be signalled in advance?

In principle, BusinessNZ supports steps that provide improved settings for business, and certainly around the policy path ahead. If the Government decided to cut the company tax rate, we would broadly support the move.

Unfortunately, we note that, especially in recent times, politics have played too great a part in tax rate changes. Examples include announcements of tax cuts that have ended up not occurring. We have no problem with political parties announcing what changes they will make as part of their taxation policy heading into a General Election. However, we have seen in recent years the practice of an incumbent Government passing legislation to reduce personal tax rates etc, but for these not to be enacted till after the election. This strikes us as purely distractive electioneering, rather than a genuine attempt towards best tax policy practice. Often, there is very little reason for such changes to have to wait till after an election to be enacted.

Recommendation: That future tax rate cuts are both signalled and enacted within a Government's political term.

B. Accelerated Depreciation

If New Zealand wished to reduce EMTRs, should accelerated depreciation be considered as an option?
If accelerated depreciation measures are considered, should these be restricted to new investments or available for both new and existing investments?
If accelerated depreciation measures, or other measures that increase the present value of depreciation deductions, are considered, are there reasons to prefer depreciation loading, partial expensing or some other scheme?

While the Document points out that Australia introduced a partial expensing scheme as part of its response to COVID-19, we believe any re-introduction on this side of the Tasman should be based on long-term tax policy planning, rather than one-off economic shocks such as COVID-19. Given the on again/off again history of accelerated depreciation in New Zealand, we believe there needs to be a willingness across the policy and political spectrum to see its return. This would help minimise the incidence of chopping and changing as noted above.

BusinessNZ submitted to the Government as part of the 2009/2010 Tax Working Group review, saying we were not convinced that the options of reducing the loading figure or removing it, were the best steps forward for raising productivity levels, given the 20% addition to depreciation claims was introduced to encourage investment in income-producing assets. In addition, the savings for the Government by way of changing the policy was estimated to be around $0.3B, which in the scale of the Review seemed a punitive policy change for little gain. Therefore, we placed the options of removing or reducing loading as one of the 'least supported' as part of the review.

We were disappointed the Government at that time decided to remove accelerated depreciation. We have continued to hold the view that some sort of return to the pre-2010 policy of a 20% loading for purchases of new machinery and equipment should be allowed.

One option outlined in the Document sees accelerated depreciation being restricted to new assets only, which would mean that firms owning depreciable assets on the day a new scheme came into force would not benefit from a higher deprecation rate on these assets. While BusinessNZ sympathises with those businesses who would be caught in the time period where no accelerated depreciation on new assets were allowed, we generally agree with the point made in the Document that if the policy was implemented to incentivise investment, there would seem little reason to allow it on investments that have already taken place.

Recommendation: That some form of accelerated depreciation is reintroduced in New Zealand.

The analysis undertaken in the Document shows that both forms of accelerated depreciation (depreciation loading and partial expensing) reduce some of the higher costs of capital and EMTRs. In terms of which specific measure should be considered in the future, the Document believes depreciation loading would be better targeted at reducing costs of capital and EMTRs on the most heavily taxed depreciable assets. However, it should also be pointed out that partial expensing provides a significant benefit to all depreciating assets.

While BusinessNZ does not have any strong views regarding deprecation loading vs partial expensing, our interest is more geared towards having an overall accelerated depreciation scheme that best facilitates increased inbound investment, while still ensuring the general elements of good tax policy are maintained. Therefore, we are open to not only the two options outlined, but also the possibility of other options that may be suggested through the submission process.

Recommendation: That the scheme for the reintroduction of accelerated depreciation is predicated on the best options to improve inbound investment, while maintaining good tax policy practice.

C. Indexation

Might comprehensive indexation of the tax base, including indexation of interest, depreciation and trading stock, be worth considering further and does the answer depend on future inflation and interest rates?
Might partial indexation of the tax base, including indexation of depreciation deductions or indexation of both depreciation deductions and trading stock, be worth considering further and does the answer depend on future inflation and interest rates?

The two questions above examine the issue from either a comprehensive or partial indexation of the tax base. In principle, BusinessNZ is not against the idea of further consideration of indexation. If we were to look at personal taxes, we believe there is every justification to regularly index the personal tax rate thresholds. Although the Document clearly states that what it is examining here is different from the idea of inflation-indexing personal income tax thresholds, in many ways the same logic applies. Therefore, we see no reason why such measures should not be considered for other areas of tax policy.

However, as the Document rightly points out, complexity and practicality need to be taken into account when considering indexation. The fact that no other OECD country has comprehensively indexed their own tax system illustrates the potentially fraught compliance path ahead. Any steps taken in this space need to be well thought-through.

In relation to the current IRD Discussion Paper entitled *The Future of Tax Administration in New Zealand*, the way in which New Zealand administers its tax administration in a digital setting is very much open for change, with the private sector most likely becoming a key partner. Therefore, over time, there is every possibility that advances in technology and the increased use of private-sector software may present indexation as a viable option for a number of areas. However, that is a conversation still in its infancy, begging the question of whether indexation is an option for the near-term, or more appropriately the medium- or longer-term.

Comprehensive or partial indexation?
The Document asks for views on whether a comprehensive or partial index is the best way forward. Given our expectation of further policy work on digital tax administration in the foreseeable future, we are conscious of not putting the cart before the horse in terms of which option would best work for improving the neutrality of the tax system. This is perhaps a question better asked at a later date.

How do these measures compare with other ways of reducing higher EMTRs and reducing current tax distortions?
In comparison with other measures, we believe some of the other options outlined in the Document would be more appropriate to pursue at this time. However, this does not mean we should simply discard indexation as a viable option in the near future. As mentioned above, the speed at which the private and public sectors can collaborate to create products serving the specific needs of taxpayers will determine whether indexation can be introduced efficiently and effectively in the short-, medium-, or long-term.

Recommendation: That indexation is given further consideration at a future date when the relevant digital technology is at a sufficient level for this to occur.

D. Incentives for Specific Businesses or Industries

Are there specific businesses or industries where spillovers are large enough to justify lower tax rates?
Are there specific businesses or industries where economic rents are large enough to justify higher tax rates to fund lower general business tax rates?
Are there any other arguments for specific incentives?

As mentioned in the Document, *"The main objective of this policy option is to favour specific industries or activities where it is believed there will be too little of these industries or activities without an incentive."*

Overall, BusinessNZ **does not** support incentives for specific businesses or industries. We have strongly supported New Zealand's broad-based low-rate system, which has served the country well over many decades. The use of incentives is

effectively 'picking winners,' which historically no Government has ever been able to do properly.

We believe that once tax incentives are considered, this opens a Pandora's Box of concerns about what incentives should be introduced. We concur with the view expressed in the McLeod review and mentioned in the Document, that arguments for favourable tax treatment due to positive externalities or other benefits can become a platform for practically any lobbyist's reform agenda. As overseas evidence has shown over many years, there is no doubt the introduction of incentives distorts the market and creates its own set of problems requiring attention.

BusinessNZ would strongly object to any further consideration being given to the option of incentives for specific businesses or industries.

Recommendation: That the LTIB does not consider the future use of incentives for specific businesses or industries.

E. Dual Income Tax System

Is a dual income tax worth considering further as a way of allowing costs of capital and EMTRs to be reduced?
Would a dual income tax be worth considering as a way of reducing distortions in the way that different forms of savings are taxed?
Would a dual income tax be an attractive or unattractive measure on progressivity grounds?
Is a dual income tax only worth considering in the future if it becomes harder to tax capital income at high marginal tax rates?

BusinessNZ is not against the idea of examining other countries' tax systems to ascertain whether part or all of them could be introduced in New Zealand. It is important that the fundamental structures of New Zealand's tax base are examined from time to time to ensure they are the best fit for the competitiveness of the country.

Specifically, the dual income tax systems adopted by Nordic countries have been discussed for some time now, including as far back as 2009 when examining New Zealand tax reform. As the Document rightly points out, the introduction of a dual income tax system would represent a complex tax change and would present many detailed issues to work through. Therefore, if this was given serious consideration, there would have to be clear and unequivocal net benefits for New Zealand given our overall need for increased investment and reduced cost of capital.

Investigating a dual income tax system would require addressing a number of fundamental issues, such as New Zealand's use of transfer payments (including Working for Families), along with how high we would need to increase personal tax

rates (and other taxes such as GST) to compensate for a low tax rate on capital income.

While a dual income tax system may directly address some of the concerns we share around how to improve inbound investment in New Zealand, we believe that this option is not one that should be given first priority. From our perspective, this option represents the most radical solution, which should only be considered once other policy mechanisms have received consideration.

Recommendation: That a dual income tax system is only considered further when other tax setting options have been investigated for the improvement of inbound investment into New Zealand.

F. Thin Capitalisation and Allowance for Corporate Equity

Would it be sensible for the tax rules to be as neutral as possible between foreign direct investment and foreign portfolio investment or are there good grounds to promote one form of investment over another? If so, what should be promoted and why?
Is the current 60% thin capitalisation safe harbour broadly reasonable? If not, should it be increased or decreased?

If problems of integration with personal taxes could be resolved, would an ACE be a viable tax reform option if governments wish to reduce EMTRs and make investment decisions more neutral?
Are there viable ways of integrating an ACE with personal taxes and, if so, what are they?
If an ACE system were to be introduced, would it be viable to levy a tax on firms with negative equity? If not, would the neutrality properties of the tax be sufficiently compromised for this to be an unattractive option?

The two remaining areas for change involve thin capitalisation and an allowance for corporate equity. Regarding the former, BusinessNZ believes further investigation into the option of increasing the safe harbour threshold is warranted, given we believe there is potential for the benefits to outweigh the drawbacks if comprehensive future research is undertaken.

Interestingly, the last time the Government made a change to the safe harbour threshold for inbound investment was following the Tax Working Group review of 2009/10. At that time, IRD considered the 75% safe harbour was too generous and encouraged multinationals to over-allocate debt, rather than equity, to New Zealand. Therefore, from the 2011-12 income tax year it was reduced to 60%. The decrease in the safe harbour was also one way of making a fiscal gain given other tax changes at that time created a fiscal cost.

In our submission at that time to the 2009/10 Tax Working Group, we noted that lowering the safe harbour threshold from 75% to 60% could lead to more questions than answers and urged caution. The IRD paper recommending the drop did not specify the net benefit from reducing the threshold. The figure of 75% was essentially arbitrary, based on judgment and compromise, and so the reduction was one of the least supported options by BusinessNZ at that time.

Now in 2022, the discussion has returned to the possibility of returning tax settings to previous levels. While we have no strong view as to what a revised safe harbour threshold should be, the fact that we did not support the decrease in 2010 indicates that on balance, we favour it increasing. Also, if this is considered a viable option in the future, we encourage IRD undertake greater sensitivity analysis around a revised safe harbour threshold, including how it would sit with other possible future changes to improve inbound investment.

Recommendation: That the option of increasing the thin capitalisation safe harbour for inbound investment includes further sensitivity analysis regarding what an optimal threshold level should be.

Regarding the option of allowance for corporate equity, the Document states that this, *"…would be an option that would reduce the cost of capital on inbound investment without inducing firms to take on additional debt finance and apply to a much broader set of inbound investment."* While the Document does a good job of laying out the theoretical model, it also highlights some significant practical obstacles to overcome, including how it would properly integrate with personal taxes.

While BusinessNZ is not against this as a future option, we believe greater weight should be placed on other potential changes first, to ascertain whether they would provide a better pathway towards improving firms' inbound investment in New Zealand.

Recommendation: That the option of allowance for corporate equity is not considered at this time.

3. In Summary: Ranking of Options

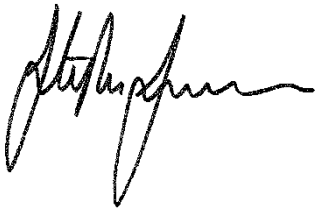
Table 2 below ranks the most preferred options through to those that should not be considered. BusinessNZ believes a reduction in the company tax rate and accelerated depreciation are two options of immediate benefit, while most of the remaining options will require further in-depth investigation and consultation. Of the seven options, we place incentives for specific businesses or industries last and prefer no further work be carried out in this space.

Table 2: Prioritisation of Options

Future Options	Ranking
Reducing the company tax rate	Most preferred
Accelerated depreciation	Worth further investigation
Thin capitalisation	Worth further investigation
Indexation	To be considered in the future
Allowance for corporate equity	Possible consideration for the future
Dual income tax system	Possible consideration for the future
Incentives for specific businesses or industries	Should not be considered

Thank you for the opportunity to comment, and we look forward to further developments in this space.

Kind regards,



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By email

LTIB first draft
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Submission on Inland Revenue's Draft Long-term Insights Briefing

Introduction

1. Thank you for the opportunity to submit on Inland Revenue's Draft Long-term Insights Briefing: Tax, Foreign Investment and Productivity (**Draft LTIB**).

2. The Draft LTIB is primarily concerned with the broad tax settings affecting foreign investment, including questions as to the tax rate, depreciation rates and thin capitalisation settings. These settings will affect the cost of capital for investment into New Zealand, as the Draft LTIB explains.

3. This submission focuses on how legislative design, and the way tax settings are implemented, may also affect incentives for firms to invest into New Zealand. As the Draft LTIB states (at [3.20]):

> Complexity of legislation and compliance costs may … have a negative impact on investment, especially if these cause foreign investors to question whether it is worth finding out if investing into New Zealand would be a good idea. If different rules apply to different types of firms, this can add to the complexity.

Summary of submission

4. It is appropriate for the Draft LTIB to recognise the complexity of tax legislation, and associated compliance costs, as potentially having a negative impact on foreign investment. We elaborate on that proposition in this submission, drawing on what we have observed in practice in advising foreign investors.

5. We submit that the Long-term Insights Briefing, when finalised, should:

   (a) recognise generally (as paragraph 3.20 of the Draft LTIB does) that the way tax laws are implemented and the legislation drafted may have a negative impact on foreign investment;

(b) note that, other things being equal, legislative rules and tests that depart from international norms or conflict with principles set out in double tax agreements to which New Zealand is party, will be more likely to have such a negative impact; and

(c) note that tax regimes such as the hybrid and branch mismatch rules (**Anti-hybrids Rules**), which make the tax treatment of amounts paid by a New Zealand branch or entity dependent upon an investigation of chains of payments within a multinational group and the tax treatment of those payments outside New Zealand, impose especially high compliance costs on New Zealand businesses and may disincentivise investments from particular countries.

Examples illustrating effect of complexity of legislation and associated compliance costs on foreign investment

Approach

6. We acknowledge that it may be more difficult to model the impact on foreign investment of the complexity of legislation and associated compliance costs than (for example) the impact of tax rates or thin capitalisation limits. It is, nonetheless, possible to identify that there is likely to be such an impact, and value in documenting this impact in the finalised Long-term Insights Briefing.

7. In many recent tax law reform initiatives, prescriptive or bright-line rules have been proposed in place of the enforcement of existing less prescriptive rules. It has been argued that the existing law is difficult for Inland Revenue to enforce, and that more prescriptive rules will be less resource-intensive for Inland Revenue. This was one aspect of the justification for enacting the restricted transfer pricing rules (**Restricted TP Rules**), which we discuss below.[1]

8. The argument that more prescriptive rules will be less resource-intensive has a superficial attractiveness, at least from Inland Revenue's viewpoint. The cost of fact-intensive disputes is highly visible, even if the number of cases that are disputed is a tiny fraction of all cases in which the rules are applied. On the other hand, if the costs to taxpayers of complying with the more prescriptive rules is greater than their costs would have been under the existing law, that cost is unlikely to be visible (at least from Inland Revenue's viewpoint), yet that increased compliance cost may affect all taxpayers who have to apply the rules, not just the fraction who would otherwise find themselves in dispute.

9. Seeking to better understand what features of legislative design drive higher compliance costs for taxpayers is therefore likely to be of value. It may help to guide decisions as to how future tax reforms should be implemented, and should help to counter the superficial attractiveness of the assumption that rules that are less resource-intensive for Inland Revenue are necessarily the lowest compliance cost option for New Zealand as a whole.

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1 Taxation (Neutralising Base Erosion and Profit Shifting) Bill, Commentary on the Bill, at pages 10 and 11. Eg, at page 11: "It can be difficult for Inland Revenue to challenge such arrangements under the transfer pricing rules as the taxpayer is typically able to identify a comparable arm's length arrangement that has similar conditions and a similarly high interest rate." And, at page 11: "Transfer pricing disputes can take years to resolve and can have high costs for taxpayers and Inland Revenue."

10. In this submission, we discuss two examples (being the Restricted TP Rules and the Anti-hybrids Rules). Both examples concern rules that affect the tax treatment of cross-border transactions and therefore have the potential to affect foreign investment into New Zealand.

Example one: Restricted TP Rules

11. The Restricted TP Rules (sections GC 15 to GC 19 of the Income Tax Act 2007) apply to certain cross-border related party debt. The rules can require that debt to be priced ignoring certain features (such as subordination or a term exceeding five years), and based on an assumed credit rating rather than the borrower's actual credit rating. Consequently, the rules will commonly result in the permitted rate of interest for New Zealand tax purposes being less than the arm's length rate determined under ordinary principles.

12. This outcome gives rise to at least two difficulties for foreign investors contemplating an investment in New Zealand that involves cross-border related party loans. Both difficulties arise from the fact that New Zealand's Restricted TP Rules depart from international norms:

    (a) The first difficulty is that the Restricted TP Rules expose investors to the possibility of double taxation. If New Zealand allows a deduction for (say) 5%, but the lender is required to recognise income based on the actual arm's length rate (say, 6%), the 1% difference is in effect taxed twice. It also results in additional advisory costs in New Zealand and the other relevant jurisdiction.

    (b) The second difficulty is the cost to the prospective investor of understanding New Zealand's Restricted TP Rules. Prior to the enactment of the Restricted TP Rules, an advisor explaining the effect of New Zealand's transfer pricing rules to a prospective investor could do so easily: the rules limited a deduction to an arm's length amount. Sophisticated investors were familiar with this internationally recognised concept. The arm's length principle has, in particular, been reflected in double tax agreements, which foreign investors rely on as a source of predictability as to the tax consequences of a cross-border investment. Explaining the Restricted TP Rules to such an investor, however, is obviously more difficult and therefore more costly (in terms of advisory costs as well as management time required to understand unfamiliar rules). In addition, in our experience, investors tend to be less comfortable working with regimes that depart from international norms to which they are accustomed.

Example two: Anti-hybrids Rules

13. The Anti-hybrids Rules in subpart FH of the Income Tax Act 2007 were intended to implement recommendations in two OECD reports to counter mismatches in the characterisation of entities or transactions as between the tax laws of different countries. Such differences in the characterisation of an entity or transaction are not uncommon, especially in arrangements involving the United States of America (which is one of New Zealand's largest trading and investment partners).

14. The Anti-hybrids Rules are highly complex. Aspects of the rules refer to, and must be read with, the OECD reports, which together run to more than 500 pages. Not all countries have

implemented the OECD reports, and those that have done so have sometimes included exceptions or other measures to reduce complexity and compliance costs. New Zealand, in contrast, has sought to implement the reports comprehensively. Unlike the arm's length principle in the transfer pricing context, there is no international norm as to the tax consequences of hybrid arrangements.

15. One rule that is especially complex is section FH 11, the imported mismatch rule. The imported mismatch rule may disallow a deduction for an otherwise deductible payment by a New Zealand entity if that payment is relevantly connected with a hybrid mismatch that arises in one or more other countries that do not have their own rules to counteract hybrid mismatch arrangements. Section FH 11 therefore may result in disallowance of a deduction for a payment made by a New Zealand subsidiary in a multinational group because that payment can be traced or linked to some other payment, elsewhere in the group, which results in a hybrid mismatch between two other countries.

16. The rule can therefore require New Zealand resident entities that are part of a multinational group to trace payments for which a deduction is claimed in New Zealand within the group, and to obtain information regarding the tax treatment of those other payments that do not involve New Zealand. We are aware of New Zealand businesses having decided not to contract with related entities in jurisdictions in which a hybrid mismatch might arise, even though the lowest cost (pre-tax) option is to do so, in order to avoid the compliance costs and risks associated with the imported mismatch rule. Such practices, if common across an industry, will likely result in increased costs to consumers.

Conclusion

17. The examples outlined above illustrate that rules that are complex, especially in a way that departs from international norms, or that are especially onerous to comply with, have the potential to be a barrier to foreign investment into New Zealand. It is appropriate that the finalised Long-term Insights Briefing record that these features of tax legislation may have such an effect, so that that can be taken into account in considering the legislative design for future tax reforms and the merits of simplification measures in relation to existing rules.

Yours faithfully
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LTIB First Draft
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26 April 2022

Dear Sir,

LTIB First Draft ('the Draft")

Thank you for the opportunity to respond to the LTIB First draft.

There is much in the Draft to consider. My response remains a work in progress. However, I find it useful to record my reactions to the Draft for me and hopefully the team at IR.

The project has two aims – to determine a cost of capital and to suggest policy responses that may be considered. The two are intertwined.

How much to tax FDI

I start with "what is the right tax for FDI?"

If the objective is to ensure tax has no impact on marginal FDI, the obvious answer is that no tax should be imposed on FDI. The LTIB Draft does not go that far. However, it would be useful to establish and state a target acceptable impact of tax on FDI. This will make it easier to assess the impact of tax on certain scenarios and also to consider policy solutions.

The model – convert to financial statement format

Despite a former Minister of Finance's response to a complaint regarding the use of formulae, "you should be able to understand it", I consider the model used is not readily accessible. The work to solve the equations and understand what they are doing to test the assumptions and conclusion is considerable. Economists and some others are used to doing this work. More readily accessible language is that of financial statements – balance sheets, profit and loss (with attendant tax calculations) and cashflows. The model should be converted to this format and be made available for consideration.

I appreciate this may not be simple to do. IR should therefore take a collaborative approach to developing this version of the model. It does not have to produce a definitive version, simply a version which can be tested and considered and improved where necessary. Clearly stating this as its approach should enable a ready response to any reaction which says the model is wrong (when first published).

(Some of) the model's assumptions

The model has assumptions (as it must). Some are simplifying, others are derived from observation. I comment on a few:

- The level of gearing is based on observed levels of debt in the economy. However, the modelled scenario, as I understand it, is not one represented in the observed levels. The model assumes a declining level of revenue over the expected life of the investment to match the declining value of the investment. In that scenario, I would expect the investment to be geared to the allowable thin capitalization level at the start of the investment and for debt to be repaid in step with the declining value of the investment (to maintain the maximum level of debt allowed). I would expect the tax impact on cost of capital to be lower than produced by the assumption made. I would also expect that to be more realistic. (I have separate comments on the observed levels of debt and the impact of inflation.)
- The draft notes that it is not possible to determine the effect of the restricted transfer pricing (RTP) rules. That is a gap that should be remedied. IR has completed international questionnaires on the impact of the RTP rules (amongst others). There is also practical experience of the application of those rules which I suggest would show something in the order of 66% of an arms-length rate is allowed under the RTP

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rules. As the RTP rules do not allow an arms-length rate of interest for related party borrowing, they must in principle increase the cost of capital.

- The model appears to assume that AIL is deductible while NRWT is not. For an NZ taxpayer subject to the financial arrangement rules, both would be deducted as a matter of course. In either case, whether or not there is a gross up clause, AIL and NRWT would be included in the cashflows from the loan financial arrangement and would be treated as interest expense. (The thin capitalisation rules and RTP may of course limit the allowable deductible but that does not seem to be the assumption being made.). The reasons for this assumption should be made clear or corrected.

Observed level of debt

Unlike the modelled scenario (with declining revenues), the observed levels of debt will be for businesses which expect to grow. Further, the initial investment will likely be historical. The observed level of debt and therefore the cost of capital calculated is an ex post and not an ex ante calculation. This can be justified as a cost of capital if the growth is seen to be financed by additional capital investment through retained earnings (i.e. each year a decision is made to reinvest profits). This means the observed levels of debt and the resulting cost of capital will be the result of multiple marginal investments made.

Of interest therefore should be whether the tax system or other factors mean that the additional investment is made as an equity and not a geared investment.

As above, the observed level of debt, is unlikely to be what would be done in practice for a known declining level of investment. A more realistic scenario should therefore be included in the modelled calculations of the cost of capital.

Impact of inflation

The model results show inflation as having the most impact on the cost of capital. As a policy response to address the impact of inflation would be substantial and technical, testing this impact is critical. Some comments:

- An accounting model version of the model would show the assumptions made more readily. These can be more widely tested.
- If prices are assumed to rise with inflation (as many contracts would allow a CPI adjustment), an investor can be expected to still have a cost of CPI x CIT. It is not clear that this is the only reason the model is showing a higher cost of capital for inflation (i.e. does the revenue decline reduce for inflation to reflect a CPI adjusted increase) . Note that I assume this is the tax cost of inflation as the deduction for the

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original investment does not change under current tax settings. Accordingly, any CPI adjusted revenue would be fully taxable.

- Further, given reported increased business profits in the current inflation environment, businesses may be able to mitigate the impact of tax by other measures (including raising prices at a rate greater than inflation.). This alternative, to a tax policy response, should be considered and researched (i.e. is a tax policy response required at all because other mitigations will reduce the tax impact).

Dual income systems

I have not focused on this possible policy response. However, I note there are proposals to further integrate company and personal tax through the taxation of sale of shares. The comments in that discussion document imply further integration rather than less. This is likely to be at odds with a dual income system.

Observed investment

The message from the Draft is that New Zealand's cost of capital is higher than other countries. Despite that there is FDI.

Does this mean that any effort to reduce the cost of capital is unnecessary? It may be unnecessary because there are no additional investments to be made?

These questions should be addressed before considering policy responses.

The impact of the home investor's tax and OECD measures

My reading of the Draft is the focus is on New Zealand's tax system and its impact on cost of capital. As the Draft rightly notes, the availability of credits and exemptions affects the total cost of capital for an FDI investor. Credits and exemptions may be available at different levels of the investment chain.

For example, a credit for NRWT may be available for interest income derived by the FDI investor who makes a loan. It is however rarely available to the ultimate portfolio investor in the FDI investor (i.e. a shareholder in an FDI investor company will be taxed on profits distributed as dividends without any credit for NRWT on the components of the profit distributed.). Further, an exemption (full or partial) may be available through the FDI investor using particular features of a tax regime (e.g. using a share buyback to distribute excess cash rather than paying a dividend).

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These effects have historically meant that a lower effective tax rate in New Zealand (and elsewhere) are optimal for an FDI investor.

It is worth modelling the home country effects of New Zealand FDI for the ultimate FDI investor. This should inform the possible policy responses.

However, we note the Pillar 1 and 2 responses proposed for the Inclusive Framework countries by the OECD. These proposals will not affect all FDI investors – they will not all be covered by one or both of the proposals. However, a minimum tax may alter behaviour. This should also be modelled.

Economic equivalence and capital gains

Broadly, the differences to an expected tax cost of capital are due to tax applying to a different result than the economic one. (For example, the effect of debt reduces the cost of capital because an equity investment is treated as a debt investment. The effect of inflation is due to nominal and not real returns being taxed.)

I take from this that the "standard" is the measure of tax against the real economic return. As the Draft acknowledges, the model does not account for capital gains,

It is not clear why the OECD model, from which the Draft's is derived, does not account for capital gains taxes. The expectation is that taking into account capital gains taxes would show a lower cost of capital for New Zealand than other countries. If so, not modelling capital gains may miss an opportunity to show that New Zealand's tax regime is competitive. However, it may also be the case that the effect of participation and non-resident exemptions mean that capital gains taxes do not apply to FDI into other countries. (For example, using Australia, a non-resident selling shares is generally exempt from Australia's capital gains tax unless the shares constitute Taxable Australian Real Property ("TARP"). Equally, exemptions may apply when an Australian sells a foreign investment.

This issue should be addressed as the LTIB project is progressed as the tax effect of capital gains should be an important part of the FDI decision.

General comment

The above implies on-going analysis and discussion. I encourage IR to continue its work through formal and informal consultation before it finalizes its LTIB.

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My response has benefited from the IFA session and some informal correspondence. Errors of understanding of what the model does and its implications remain mine.

I am happy to discuss my comments and questions should that be helpful.

Yours sincerely

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Corporate Taxpayers Group

29 April 2022

LTIB topics
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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.

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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.

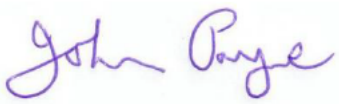
Please let us know if you have any queries in relation to the matters set out in this letter, we would be happy to discuss these further.

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

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

STRATEGIC TAX MANAGEMENT
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5 May 2022

By email: policymaster@ird.govt.nz

Re: Submission on Selected Areas of the LTIB

Dear Sir/Madam

1.0 Introduction and overview

1.1 We refer to the draft long term insights briefing (LTIB) dated February 2022 for which submissions were required by 14 April 2022. We wish to make a submission in general terms referencing specific aspects of the LTIB but also drawing upon subsequent policy announcements regarding Tax Principles and the topic of a Wealth tax.

1.2 The focus of the LTIB is how to attract foreign direct investment (FDI) and postulates various initiatives to attract further investment, most notably a reduction in the company tax rate and depreciation allowances or specific industry-based incentives.

1.3 This approach is diametrically opposed to the comments made in the context of developing a Tax Principles Act which talks about consistent treatment across taxpayers with the same economic income, and seeks to establish a progressive tax rates scale as economic income increases.

1.4 As an initial observation, there are some fundamental contradictions between these two approaches.

1.5 Firstly, based upon the information provided in the LTIB New Zealand requires further capital to feed economic growth from which tax revenue will be derived.

1.6 Secondly, the proposal to attract foreign capital presupposes concessions in tax rate either by a reduction in corporate rate across the board, an increase in depreciation allowances or specific industry incentives or a combination of all three. Economic value created by foreign direct investment will be owned by the foreign owners, not New Zealand tax residents. As a consequence, with the mobility of capital, if a more preferred or tax efficient destination for that foreign capital is identified then it is possible that the capital will leave New Zealand to find that lower taxed higher return destination.

1.7 One of the major distortions in the New Zealand tax system and investment options is the extent of domestic investment in housing stock both for personal occupation and for investment purposes. We have seen that this emphasis has played a part in an allocation of a very high proportion of investment capital to housing stock, but also providing incentives for investment due to the returns achieved which have been self-fulfilling given the economic settings that have prevailed in recent years (low interest rate, finite housing stock and high levels of demand).

1.8 The LTIB ignores outward direct investment (ODI) on the basis that recent tax changes to our international tax regime finalised in 2009 which were intended to be concessionary have not resulted in an increase in ODI of any magnitude. We see the taxation of ODI is more complicated than this. If we are to attract and retain the owners of investment capital in New Zealand then we need to ensure that the portion of the investment capital allocated to offshore investments is taxed efficiently. At the moment, ODI is discouraged by several tax settings and interpretations adopted.

1.9 The philosophy of our approach to ODI should be that it facilitates investment capital, or the owners of investment capital, residing in New Zealand and investing globally from New Zealand.

1.10 For example, if foreign tax credits cannot be claimed against New Zealand income tax in the year in which they arise they are forfeited. Because New Zealand measures taxable income differently to other jurisdictions it may be that there is foreign tax credit leakage as a result of that which could be due to timing issues for example. The taxation of foreign exchange, the timing of the recognition of economic interest under our financial arrangements regime can give rise to timing differences, as can depreciation rates. The compliance cost of managing ODI through all of its various structural options, combined with the inability to carry forward or match foreign tax credits to the New Zealand liability to which they relate provides an impediment to ODI.

1.11 Further, our interpretation of double tax treaties with respect to the availability of foreign tax credits is a further impediment, and is potentially contrary to international law principles. Double tax treaties are intended to do just that – remove double taxation. However, when determining the quantum of the credit to be allowed in New Zealand we have interpreted the words of the treaty to be that a credit is only available proportionate to the income to which it relates. Unlike other tax credits such as imputation credits which can offset any other form of income, a credit for foreign withholding tax is limited to the proportion of income that the tax bears. For example, if 10% is withheld from interest income then the recipient of that interest income can only claim a maximum 10% credit. If through managing ODI via trust arrangements, a taxable distribution of interest is made together with the entire foreign tax credit the recipient will only be able to claim 10% as opposed to the entire credit. This dramatically reduces the flexibility of

managing the tax on foreign sourced income derived via ODI, contrary to principles applied to the rest of the tax system. Clearly the tax credit for non-resident withholding tax is severable from the income to which it relates. It can be dealt with separately at trust law. But our interpretation of the double tax treaty preserves the right to view that eligibility very narrowly with the result that a credit is denied in situations where it should reasonably be made available. We make it hard for the tax on ODI to be managed effectively. As mentioned above, the most clear example is the inability to carry forward foreign tax credits notwithstanding that the timing and measurement of income and expenditure between two jurisdictions will naturally be different. As a consequence the effective tax rate and the compliance cost to manage ODI increases providing a significant disincentive.

1.12 We would like to see a review of these rules to try and encourage foreign capital to come to New Zealand and invest via New Zealand by providing more flexible foreign tax credit rules to reduce the effective tax rate of ODI and reduce compliance costs.

1.13 Our tax system also provides disincentives for large organisations to headquarter in New Zealand, or remain headquartered in New Zealand. Previously, section DB 55 provided a deduction for all head office costs in relation to the stewardship of overseas investment entities. With its repeal, albeit belatedly, an international organisation with a headquarters based in New Zealand will be denied a deduction for expenditure incurred on stewardship functions which cannot be attributed to the provision of services to its subsidiaries offshore and validly claimed as a deduction in that offshore jurisdictions. This introduces significant disincentive for successful New Zealand organisations to remain headquartered in New Zealand, and for foreign entities to come to New Zealand and establish headquarters here. We think that there should be a review of the economics of providing a deduction for those stewardship costs as section DB 55 used to do, and more broadly a review of the impediments to entities with international operations basing themselves in New Zealand.

1.14 A significant segment of successful businesses with overseas operations are involved in information technology, communication and related intellectual property services. As the proportion of New Zealand's income from exporting these skills and intellectual property assets greater focus will fall on how tax effective the New Zealand tax system is for those companies. We have mentioned above the inflexibility around the management of foreign tax credits. With respect to ODI by New Zealand businesses in the intellectual property and services sector, greater compliance costs are imposed through the controlled foreign company regime treating any intellectual property with the remotest connection to New Zealand as requiring a full attribution and compliance under New Zealand law to its New Zealand shareholders or owners. That is, where a New Zealand business derives income offshore from intellectual property which has or had a connection with New Zealand it must file a tax return returning the income of that foreign entity calculated under New Zealand rules, including foreign exchange and other timing

differences, as part of it's New Zealand tax obligations. If there is any difference between the New Zealand tax rate on that net income calculated according to our rules, and the amount of tax paid offshore, then a further payment will be required in New Zealand. As you can imagine, where businesses have multiple offshore jurisdictions this adds significantly to compliance costs in New Zealand and provides further encouragement for those businesses to relocate offshore.

1.15 We understand the underlying principle that royalty income and licence revenue is viewed as passive income which is mobile. That said, intellectual property will find its offshore market and be taxed accordingly. We propose that the treatment of offshore or foreign sourced revenues from intellectual property based businesses be reviewed to ensure that our tax system is not creating an impediment or disincentive for those businesses to continue to be based in New Zealand and execute their international growth strategies.

1.16 We do wonder whether the normal pattern of a sale of the intellectual property in toto to an offshore owner is significantly affected by the way in which we tax international organisations headquartered in New Zealand. We think further research needs to be undertaken to establish whether there is in fact a disincentive, and what type of changes might need to be made to remove those impediments or disincentives, let alone providing any incentive compared with bricks and mortar businesses. With an increasing mobility of skills, and the ability to work remotely, it is important to review the settings applied to these businesses so that New Zealand can retain both its skills and revenues from intellectual property. If our rules provided some incentive (or remove current disincentives) for IP-based companies to headquarter in New Zealand then that could increase the level of investment capital and skills capital New Zealand has in what is a very competitive international market.

1.17 Finally, there has been much discussion regarding the fairness of our tax system and the levels of tax applied to high-net-worth individuals when considering their economic income. There is a natural segue from the preceding comments to this issue. Any form of wealth tax imposed upon high-net-worth individuals will take capital out of the productive sector and reallocate it to the public sector. From our review of budget numbers, given the growth in the economy currently and in recent times being experienced, there is sufficient tax revenues from today's tax settings in order to fund the government expenditure. This is a complex and interrelated issue. Working for families tax credits reallocate income currently such that the bulk of tax cash flows are in fact funded by the highest income earners. There are inequities between the taxation of capital and income. However, we believe the real inequity is the rate of tax that income has born which funds consumption. By consumption we mean living expenses, which for a high-net-worth individual includes luxury houses, travel, motor cars et cetera. If we had a measure to ensure that no matter how funded, an individual pays tax based upon the amount of their consumption per annum then there would be an equity reached, combined with a

progressive tax rate scale. If a high-net-worth individual consumes the same amount as an average wage earner, and chooses to invest and continue to compound their investment capital, as opposed to consume it, then they should not be taxed differentially for doing so. As observed in the LTIB the key issue is a lack of investment capital. Taxing that investment capital on an unrealised or realised basis transfers resources from the private sector investment capital pool to the public sector social spending pool. If that transfer is not required then taking this approach reduces the investment capital available to the economy to fund future growth, which includes jobs and tax revenues which can then fund social services as the government of the day determines. Taking this approach, there is equity as between individuals if they are both taxed at marginal rates on the total consumption. We acknowledge this presents measurement issues which we have undertaken some consideration of which would tax distributions from trusts in particular having regard to the use to which the funds are applied. This approach would effectively abandon the ability to live from capital - living costs would be treated as income regardless of how they are funded, whether it be from tax paid trust income or capital gains. There would need to be credit given for underlying tax paid so that the uplift related to the additional tax paid at the natural person level depending on their marginal tax rate. The framework provided by our imputation credit regime could equally be applied to trusts to facilitate the passing through of underlying credits.

1.18 Adopting a different approach to impose a wealth tax provides a disincentive for that capital to remain in New Zealand rather than an incentive to allocate that capital to productive sources as opposed to consumption. This will exacerbate our deficit of investment capital and provide further influence to government spending with potential attendant inflation risks. The fundamental question is that capital collected via the wealth tax that is imposed due to a redistribution philosophy better invested by government or better invested productively by the private sector with consequential benefits in terms of economic growth, jobs et cetera? We think the latter approach produces a far superior economic outcome when the effect of retaining capital, and ideally attracting or encouraging the allocation of capital to productive sectors and the tax revenue that flows from that as well as employment is taken into account. Providing further capital to the government to allocate or reallocate will produce an inferior economic outcome, particularly where the government can fund all necessary social services under the current model/balance sheet.

1.19 Introducing a wealth or redistribution tax will be regressive. The current approach to provide support to lower income families through working for families is supported as an effective mechanism to ameliorate the effect of the percentage of income consumed, and which bears GST, and serves to redistribute a level of wealth via the tax take.

1.20 The palatability of proposed initiatives to impose another layer of tax which will increase the effective tax rate in New Zealand and make us less attractive as an investment destination needs to be factored into the determination of tax principles.

1.21 Why not provide a fair system to tax consumption and provide incentives to allocate capital to productive investment. That would provide an opportunity to deal with the bias towards property investment in New Zealand.

1.22 At a principle level, why should we tax the unrealised wealth of New Zealanders and take capital from the economy and allocate it to government, when the best place for that capital is to remain in its productive role. It is acceptable for individuals to be wealthy and to have created wealth as long as they are taxed fairly against their fellow man (or woman). A person who is a high consumer will pay for that whereas a person who is more frugal and focused on investment will benefit from investing in the productive sector which will benefit our economy.

We would welcome further discussion on the principles that we have raised. Clearly, we do not have the resources to model the effect of taxing consumption for income tax purposes but believe it to be feasible and would result in removing much of the concern around the ability of high-net-worth individuals to reduce their marginal tax rate through tax planning and the source of funding for their consumption. Our approach does require an acceptance that no matter who owns investment capital it should be taxed in accordance with the entity which derives it, as opposed to being attributed to natural person shareholders. If the investment capital is invested productively then we should let it do its job, rather than impose economic costs and distortions by seeking to attract foreign investment capital. Adopting this approach would encourage all persons to consider investing as opposed to consuming, where possible.

Yours sincerely,

Brett Whyte
Principal

Comments on "Tax, foreign investment and productivity":
Draft long-term insights briefing, February 2022

by

Jack M. Mintz
President's Fellow
School of Public Policy
University of Calgary
April 15, 2022

General Comments

By and large, this is a well-constructed detailed analysis of the impact of taxation on foreign direct investment. It contains some very useful information making the case that New Zealand has a higher cost of capital for foreign direct investment compared to OECD countries due to taxation. Its strength is its careful review of various options with respect to company tax reform, which I found particularly well developed.

In my review of the document, I want to raise several general issues that need more attention for further development. Specifically,

- Why do we care about foreign direct investment (as opposed to the sum of domestic and foreign controlled investment)?
- What taxes should be included in evaluation of effective tax rates on capital investment and how might this affect New Zealand's ranking?
- What alternative forms of international financial arbitrage could be considered in measuring effective tax rates?
- How does income and capital risk impact effective tax rates?

While I will try to reference some additional papers relevant to this discussion, I am afraid that I will borrow many concepts from the work that I have developed in the past forty years. Since 1984, I have worked with Finance Canada to help develop marginal effective tax rate (METR) analysis based on original work with Robin Boadway and Neil Bruce (the first piece published in the Canadian Journal of Economics in 1984). I have published many extensions to this work over the years considering risk and tax losses, inventory holdings, small businesses, financial arbitrage and complicated issues such as tax holidays, asset-based capital taxes, minimum taxes, time-to-build capital models, resource taxation and international taxation (such as interest limitations, double-dip financing and deferral taxation of subsidiary profits). I apologize for perhaps too much attention to this work but the points I raise should be relevant to further analysis to build upon this excellent paper by New Zealand's Inland Revenue department.

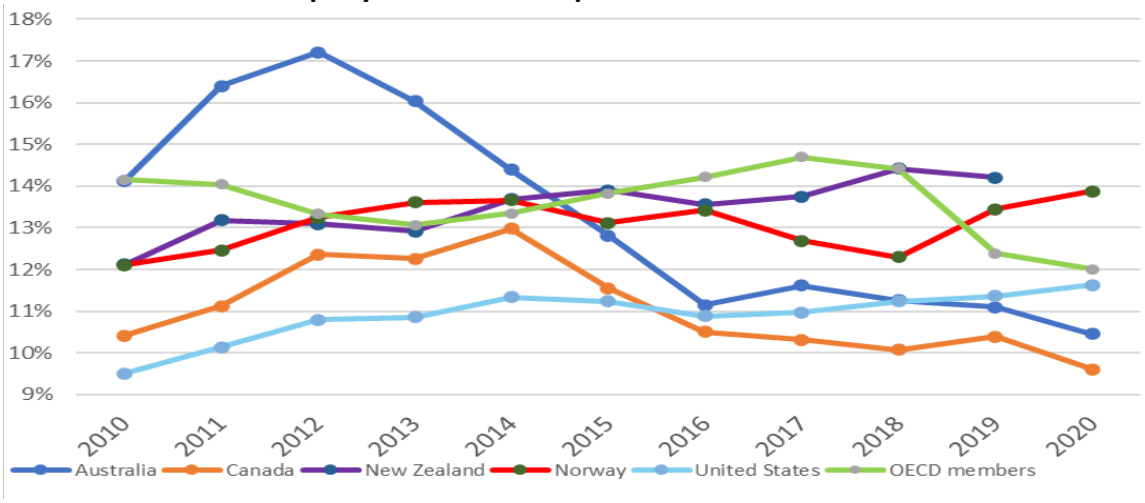
Below, I begin with several general points listed above. This will be followed by very specific comments on individual paragraphs through the report.

Why foreign direct investment as focus?

New Zealand's economic growth and productivity depends on total capital formation, both private and public investment. Of private investment, both domestic and foreign direct investment is critical for growth. As the paper makes clear, it is focused on foreign direct investment as an earlier paper written by Inland Revenue addressed tax policy and productivity. However, some justification is needed as to why limited foreign direct investment is a problem as opposed to private investment in general.

In some recent work, I happened to look at company investment as a share of GDP for various countries (OECD statistics), including New Zealand as shown in the figure below. As seen below, company gross fixed capital formation in New Zealand is better than Australia after 2015 and OECD countries in general. As the paper points out (page 11), foreign direct investment as a share of GDP in New Zealand is well below that in Australia and the OECD in general.

Company Gross Fixed Capital Formation as a share of GDP



There are differences in methodology when comparing fixed capital formation with foreign direct investment data that is important to keep in mind. Fixed capital formation is based on investment in real capital (e.g. machines, structures, and land). while foreign direct investment is typically measured as investment in foreign assets (equity and debt) with at least 10 percent ownership (which typically includes takeovers, retained earnings and greenfield investments). The point is whether New Zealand as an underinvestment problem with insufficient foreign direct investment.

A considerable literature has developed over the years regarding the benefits and costs of foreign direct investment. Benefits include access to international technology and management, higher rates of innovation and better productivity. It would be valuable for both policymakers and the public to know this literature and any documentation of FDI benefits in New Zealand.

What are the relevant tax policies impacting investment?

The paper focuses on company income taxes and withholding taxes on related and unrelated party debt interest. Yet, when it comes to the taxation of capital investment, several other taxes should also be considered including sales taxes on capital purchases, asset-based taxes (capital taxes and property taxes), and transfer taxes (stamp duties, real estate transfer taxes and financial transaction taxes which can impact interest rates). Non-credited withholding taxes on royalties and fees are also relevant. Data limitations might make it difficult to include some taxes such as municipal property taxes that are not easily measured by industry for most countries.

The New Zealand paper focuses on firm-level taxation for large companies and both firm and individual level taxation on dividends and capital gains (the latter absent in Australia) for small businesses. I will discuss below the issue of international financial arbitrage in an open economy. However, it is appropriate to exclude New Zealand's personal taxation in evaluating effective tax rates on FDI.

Some accounting firms will include taxes on labour such as payroll and personal income taxes in the cost of capital. This is incorrect to do so since it biases upwards effective tax rates. To understand this point, suppose two taxes are imposed on companies: company income taxes and an employer payroll tax. As often measured by some analysts, the effective tax rate would be equal to firm level taxes divided by profits gross of the company income and payroll taxes. However, the denominator of the effective tax rate is also expressed as after-tax profits plus company and payroll taxes. If the capital-labour ratio goes to zero, the effective tax rate is basically payroll taxes divided by payroll tax, or 100 percent. Instead, one should measure effective tax rates separately on capital, labour and other inputs (such as energy) and aggregate them to measure an effective tax rate on the marginal cost of production.[1]

In work that I have done over the years[2], we include sales taxes on capital purchases (which are important in some countries when some sales taxes are not refundable such as in Brazil, United States and Canada), asset-based taxes (except municipal property taxes), transfer taxes and withholding taxes applied to both residents and non-resident investors. The New Zealand paper covers the relevant ones for New Zealand since VAT is refundable for businesses and no transfer and general asset-based taxes are applied. However, when comparing rankings, it makes a significant difference as to which taxes are included. In our calculations, the stamp duty in Australia adds about 3 points to the METR, which would result in Australia having a

[1] See K. McKenzie, J. Mintz and K. Scharf, "The Measuring Effective Tax Rate in the Presence of Multiple Inputs: A Production-Based Approach", *International Tax and Public Finance*, Vol 4 (3), 1997, 337 - 360.

[2] For the latest version, see Philip Bazel and Jack Mintz, "2020 Tax Competitiveness Report: Canada's Investment Challenge", SPP Research Paper 14(21), The School of Public Policy, University of Calgary, September 2021. Finance Canada also includes sales taxes on capital purchases and asset-based taxes except property taxes. They do not include withholding taxes and real estate transfer taxes.

higher METR than New Zealand. The retail sales tax in the United States adds almost 5 points to the METR which in aggregate is 22.6 percent.

The OECD work only focuses on company income taxes as pointed out by the paper. It is also quite selective with sectoral and asset coverage which includes manufacturing, office buildings estate, transportation, communication, power, computers, software and research and development.[3] Excluded are resource sectors (agriculture, forestry, mining and oil/gas/coal) and other service sectors (business services (including many technology firms), construction, finance, wholesale and retail trade). The paper should acknowledge these limitations as various other studies have a wider breadth of coverage such as the Congressional Budget Office (United States) and Finance Canada.[4]

The important question, after adding more sectors and assets to the model, is whether it makes any difference to the qualitative conclusion that New Zealand investment is more heavily taxed with a METR of 20.1 percent than most OECD countries except for Costa Rica, Japan and Chile (company income tax only). It is also above the OECD average of roughly 23 percent.

In our work, using tax depreciation of 2 percent (declining balance) for structures, the New Zealand METR would be 25.7 percent. However, with our estimates, New Zealand's METR would be below five OECD countries: Japan (38.8 percent), South Korea (29.3 percent), Australia (28.1 percent), France (28.0 percent) and Germany at 26.1 percent).[5] [6] Many

[3] As the New Zealand paper notes, research and development is a small portion of capital in its METR model, consistent with most other studies. What should also be noted is that R&D might be supported by grants instead of tax support. For example, the US relies much more grants than tax support, which would result in a lower METR on capital if such support were included. In our work, we often exclude R&D since an international comparison should include both grants and tax support. When we have included tax and grant support, the METR declines by less than two points.

[4] Construction, mining and oil/gas and research and development are particularly complex to model since it involves a time-to-build model with two stages. Inputs (exploration, research and development, labour and capital) are hired to build capital (an office building, mineral reserves or a product) which takes several years. Once the capital is available for use (a building, reserves or patent), production takes place that leads to depreciation, amortization or depletion of the capital. For an example of time-to-build modelling for oil and gas, see J. Mintz, "Taxes, Royalties and Cross-Border Investments," in *International Taxation and the Extractive Industries*, ed. P. Daniel et al. (Washington D. C.: International Monetary Fund, Routledge, New York and London, 2016).

[5] In Bazel and Mintz 2021 (and earlier work), we use Finance Canada estimated economic depreciation rates for assets based on relatively up-to-date Statistics Canada analysis rather than BEA data that is out-dated. The average declining balance economic depreciation rate for structures is 6.7 percent (declining balance), over twice as high as average industrial and commercial depreciation rate used by New Zealand. An important factor in these estimates is the degree to which capital good prices fall, which might be higher in a Canada depending on the type of structures involved and temperature. However, Statistics Canada did find a substantial increase in economic depreciation in the past several years due to technological obsolescence (pipeline depreciation rates, for example, doubled when estimates were made in the past decade and half compared to the 1980s).

[6] If we matched the economic depreciation rate to tax depreciation rate at 2 percent for a METR of 19.8 percent, New Zealand would have a METR below 12 countries: Belgium (23.3 percent), Costa Rica 23.1 percent), United States (22.6 percent) Portugal 22.1 percent), United Kingdom (21.2 percent), Austria (20.6 percent) and Norway

countries that end up having a higher METR than New Zealand are due to other taxes on capital such as transfer taxes (Australia, France, Germany, South Korea and United States), asset-based taxes (Japan and United States) and sales taxes on capital purchases (United States).

The point is that there METR measurements vary significantly depending on the coverage of capital-related taxes, sectors, assumptions, and estimated parameters. The paper might wish to refer to some other studies to support the conclusion that New Zealand is a relatively high-tax country with respect to FDI.

International Financial Arbitrage

The most vexing problem in modelling effective tax rates on capital is with respect to financial arbitrage. Company investors include individuals who pay personal income tax on dividends and realized capital gains, pension funds that typically pay no tax on their capital income (although Australia is an exception) and non-residents who pay New Zealand withholding taxes and company or personal income taxes to their host governments. The key issue is that there are host of different tax rates across individual and intermediary investors.

Taking into account both company and personal taxes, some models have equalized before-tax rates of return on capital with differing after-tax returns. Others, perhaps arguably better grounded in theory, equalize the after-personal-tax returns earned by investors. Another approach is for the firm to be indifferent in issuing debt and equity (the cost of debt net of company tax savings is equal to the cost of equity finance), which implies after-personal-tax rates of return vary.

The New Zealand paper makes crucial assumptions that are helpful in sorting out international financial arbitrage. Foreign-owned multinational operating in New Zealand would invest in capital at the international rate of interest for debt and cost of equity finance. New Zealand savings are too small to affect the international cost of funds as it is a small open economy. Some empirical support might lend itself to home bias, based on asymmetric information, in equity financing that would be relevant to New Zealand-owned enterprises but for foreign-owned company investments in New Zealand companies, home bias is less relevant.

The paper assumes that the international interest rate on bonds is not equal to cost of finance on page 7 in the appendix, but these are equated in value (paragraph 2.13 page 12). This is a questionable assumption if investor tax rates on equity and debt are not the same. If one were to consider a global financial equilibrium, the international cost of funds at the margin would come from the investor who is indifferent between debt and equity, considering both company and personal income taxes [7]. This would be a global individual investor as corporate financial

(20 percent). I note that the OECD estimate of the METR for Canada is about half of the estimate made by Finance Canada primarily due to the absence of many sectors and certain non-company income taxes.

[7] The marginal source comes from investors who would be indifferent between equity and bond assets (Miller, M. H. 1977. "Debt and Taxes." *Journal of Finance,* vol. 32: 261–275. 1977). This implies that the marginal investor would be taxed on income with equal effective tax rates on equity and bonds, accounting for both corporate and

intermediaries and untaxed pension funds would prefer debt for tax reasons to avoid paying the company income tax. The paper might want to include some sensitivity calculations for different forms of international tax arbitrage in terms of how it impacts the cost of capital.

A significant advantage of the New Zealand paper model is to invoke an assumption similar to a static trade-off model for debt finance whereby companies trade off the bankruptcy/risk costs of debt finance with benefits of corporate tax deductibility. A weighted average cost of funds is used to discount future cash flows and the value of tax depreciation allowances.[8] Assuming the international investor is the marginal source of finance, the cost of equity would therefore be below the interest rate since the equity income is typically taxed more favourably (ignoring risk which is discussed below). One could also include bankruptcy cost in the cost of debt as well (by using a corporate bond rate).

However, the relevant personal taxes that affects the cost of equity finance depend on some sort of financial theory explaining dividend and retained earnings decisions. The "new" dividend theory argues that retained earnings is the marginal source equity finance (consistent with the "pecking-order" model of finance) so that dividend taxes are irrelevant in that they are capitalized in equity values. The after-tax cost of equity finance is therefore determined by the cost of finance reduced by (accrual-equivalent) capital gains taxes for the international investor which would be equal to the bond interest rate net of personal taxes paid on bond income. An alternative approach is the "traditional dividend theory" whereby dividends convey information to investors about the company's performance – both dividend and capital gains taxes affect the cost of equity finance. For the international investor, the after-personal tax cost of equity finance is reduced by both accrual-equivalent capital gains taxes and the dividend tax.[9]

Two additional complications are relevant to international arbitrage: incentives for foreign multinationals to finance investment in New Zealand with debt and incentive to shift profits out of New Zealand.

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personal taxes. Assuming binding constraints limiting short selling of securities, other investors would only hold debt or equity depending on their tax rates. Suppose the marginal investor is not taxed on capital gains and dividends at the individual level but fully taxed on interest. This would imply that the marginal investor holding New Zealand stocks would have an investor tax rate on interest equal to 28 per cent (those with higher personal tax rates would only buy equity and those with lower tax rates would buy only bonds).

[8] This approach is similar to A. Auerbach (https://www.nber.org/system/files/working_papers/w0254/w0254.pdf) and R. Boadway, N. Bruce and J. Mintz, "Taxation, Inflation and the Effective Marginal Tax Rate on Capital in Canada", *Canadian Journal of Economics*, 1984, 17 (1), 62-79. The OECD model is based on King and Fullerton (1984) that calculated METRs for each type of finance and then aggregated the METRs resulting in different discount rates for cash flows and tax depreciation allowances. No particular financial theory would support this latter approach.

[9] If international investors equate the after-tax returns on equity and bonds, then $i(1-m) = \rho(1-t)$, with i = bond interest rate, ρ = cost of equity finance, m = tax rate on interest income and t= tax rate on equity income. For the average G-7 individual investor we estimate the interest tax rate is 28 percent and the weighted average dividend and accrual-equivalent capital gains tax on equity income to be 22 percent. That implies the net-of-risk cost of equity finance to be about four-fifths of the bond interest rate.

Companies prefer to finance their international operations with debt issued in countries with high company tax rates and weak currencies (currencies that depreciate due to risk or high inflation). With a weak currency, a bond's expected value will fall leading to a capital loss. If the capital gains tax rate is below the regular tax rate, a firm issuing the bond in a country with a weak currency will benefit from this tax differential. Such exchange rate gains and losses could impact on the cost of finance for a subsidiary operating in New Zealand.

Until recently, New Zealand has had a relatively low inflation rate at a strong credit rating (unlike the 1980s and early 1990s when Kiwi bonds issued by multinationals were popular). The primary incentive for multinationals to issue bonds in New Zealand is to take advantage of its relatively high company tax rate compared to many countries with company tax rates below 28 percent. As the paper notes, foreign companies might use more debt relative to assets, reducing the METR. However, New Zealand's inflation rate has climbed to six percent. Although less than the United States, it is above some other countries like China and Japan that could result in further debt financing in New Zealand.

Like other countries, New Zealand has developed transfer pricing and thin capitalization rules to limit base erosion. However, some of these rules add additional complexity to modelling the METR. The thin capitalization rule is based on the ratio of New Zealand debt/asset ratio to the worldwide average. In the theoretical section of the paper (pp. 23 to 25), it does not appear that the theory for modelling investment takes into account the impact of capital investment and debt on the ability to deduct interest expense. Higher capital investment in New Zealand reduces the ratio of debt to assets (equity plus debt) enabling the company to issue more debt in New Zealand and lower the METR.[10]

A further complication is related to tax planning that could impact the METR calculation. With transfer pricing, investment in New Zealand will generate income that is partly taxed in other countries to the extent that profits are shifted abroad. This results in a lower METR on capital for FDI. If companies are using tax structures that enable "double dipping" for interest, the cost of finance will be much lower as company is able to deduct interest expense in multiple jurisdictions.[11] Without data, it is difficult to determine how much the METR is affected by tax planning strategies that are partly curtailed by thin capitalization rules. However, these issues need further exploration.

To that end, the global minimum company income tax will also affect the METR to the extent a company pays the top-up-tax either in the jurisdiction where the parent resides or in New Zealand should it impose a qualifying domestic minimum tax. While New Zealand company income tax rate is well above the minimum rate, it is possible some companies might pay

[10] See R. Altshuler and J. Mintz, "U.S. Interest Allocation Rules: Effects and Policy", *International Tax and Public Finance*, Vol. 2, No. 1, 1995, pp 7-36. analysis of the US water-edge interest limitation based on debt divided by domestic and net foreign assets. While these differ in impact compared to a world-wide ratio used by New Zealand, the point is that such rules can impact the METR calculation. See also Chen and Mintz 2009 at https://publications.gc.ca/collections/collection_2010/fin/F34-3-13-2009-eng.pdf.

[11] See Jack Mintz and Alfons Weichenrieder, *The Indirect Side of Direct Investment*, (MIT Press), 2010.

minimum tax with relatively fast write offs for capital (which is circumscribed in New Zealand). Much of this new with effects not fully understood yet.

Risk

The New Zealand recognized that the analysis becomes significantly complex when risk is considered (Appendix p. 28). It could be criticized for ignoring risk, but this is not the case. If risk is associated with income or gross profits (revenues net of current costs) and companies can fully write off losses on marginal investment from inframarginal profits, the model used is quite consistent. Leaving aside investor personal taxation, investors hold equity so long as the expected return on equity net of risk is equal to the bond interest rate. With full loss deductions, the cost of risk is implicitly deducted from the company income tax base, thereby resulting in risk not affecting the effective tax rate measure. For example, suppose the expected return on equity is 10 percent and cost of risk is 6 percent, leaving a net-of-risk return on equity equal to 4 percent. If the safe bond interest rate is 4 percent, the investor is indifferent between equity and bonds. Should the government impose a profit tax equal to 50 percent, after tax expected return falls from 10 to 5 percent. The cost of risk falls from 6 to 3 percent (due to full sharing of losses), leaving a net of risk return on equity equal to 2 percent. If bond interest is subject to a 50 percent tax rate as well, then the after-tax return falls from 4 to 2 percent. The investor is still indifferent between equity and bonds. If the expected return on equity is increased by one point as well as the risk premium, the effective tax rate remains the same at 50 percent.

As the paper acknowledges, these equivalencies with respect to risk break down in two ways. The first is related to "capital risk"[12], which arises from unknown economic depreciation of assets. Since tax depreciation is based on historical prices, the government does not share such capital risk. The capital risk term is added to the economic depreciation term, which is not multiplied by one minus the company tax rate. Given net revenues streams generated by capital investment are taxed, the lack of capital risk sharing raises the METR. It is not known how to measure this risk although Bulow and Summers used the risk premium from stock markets as a proxy.[13] The New Zealand paper notes this but wisely does not provide any estimates of capital risk impacts given the lack of estimates.

Income risk impacts the METR when loss offsetting is restricted. Even if losses are carried forward, they are not indexed at a nominal interest rate. The losses may also expire with a firm (although might be transferred to another company in a takeover). The New Zealand paper recognizes this issue but misses an important conclusion. Depending on its history, the lack of

[12] As termed by J. I. Bulow and L. H. Summers, [1984]: "The Taxation of Risky Assets," Journal of Political Economy, 92, 20-39.

[13] The METR should be calculated based on the cost of capital measured net of both depreciation and income or capital risk. V. Jog and J. Mintz, "Corporate Tax Reform and its Economic Impact: An Evaluation of the June 18, 1987 Proposals", in *Economic Impacts of Tax Reform*, ed. with J. Whalley, Canadian Tax Foundation, Toronto, 1989. 1989 show the impact of capital risk on the METR for Canada compared to the METR when only income risk is present. The METR is exceptionally higher using stock market premia.

loss offset under income risk can lead to higher or lower METRs. For those with a history of profits but incurring losses for the first time or start-up companies, the lack of loss-offsetting increases the cost of capital and the METR. However, if a firm is carrying forward past tax losses, the cost capital and METR may be reduced since profits are sheltered from taxation.[14]

Obviously, it would be very difficult to assess the impact of risk on New Zealand companies without detailed history on the timing of profits and losses in each sector. It should be recognized that some sectors might be more impacted by risk resulting in potentially higher METRs by examining estimates of equity risk premia. Further, international studies could be used to compare New Zealand's risk premia with other countries to understand the potential bias to enable some sensitivity calculations.

Conclusion: What is the best company tax?

As I final comment, I return to an overarching question that is quite relevant to company tax reform: what is the best company tax structure for productivity and competitiveness? Many companies will argue for competitiveness whereby a tax break might be needed given tax preferences available in other countries. This leads to a non-neutral domestic policy with some sectors more heavily taxed than others. An alternative view is not to compete on a case-by-case basis with other jurisdictions. Instead, one should pursue neutrality with equal tax burdens across business activities within New Zealand to improve productivity within New Zealand. The New Zealand paper makes a strong case for the latter (par. 2.28 in the main paper) in explaining the value of neutrality in this respect even if other trading countries choose a different approach favouring some jurisdictions.

[14] See R. Altshuler and A. Auerbach, "The Significance of Tax Law Asymmetries: An Empirical Investigation" The Quarterly Journal of Economics, Vol. 105, No. 1 (Feb., 1990), pp. 61-86.

Detailed Comments

Below I provide a list of other comments beginning with the main document numbered by each paragraph rather than page.

1.18 One might want to use the word “reduce” rather than “cut” since the latter is harsher in sound.

Figure 1.4: The switch in colours for countries compared to the earlier graphs makes it harder for the reader to follow. New Zealand should be red throughout.

1.27 The cost of capital formula could be adjusted for capital gains on holding assets as noted later. Economic depreciation is equal to d-q (d= physical wear and tear and q= real capital gains). One can modify equatio by imposing a tax rate on real capital gains for holding assets (the real capital gains can be obtained from deflators for assets assuming they are available). That would give NZ an advantage but empirically show how important it might be compared to other countries.

1.29 There are other small markets around the world (e.g. Ireland) that attract a lot of FDI.

1.32 Even if there are externalities, one cannot conclude what is the best form of intervention. Research support might be better given through a grant system rather than through the tax system as noted here. Further, if the global minimum tax goes through, NZ might want to switch tax credits into grants.

2.18 Do you have any estimates of “rents”. Once rents are adjusted for risk, how much is actually earned in NZ. If small, why worry about it? Further, are taxing rents accruing to foreigners appropriate or is it a form of tax exportation (as a fiscal externality)? Should rents be taxed on a source or consumption basis (note the VAT collects rents on a consumption basis for a country)?

3.3 As mentioned earlier, it would be helpful to make clear what assets, sectors and other key assumptions are used in the Hanappi OECD paper. Perhaps a box describing its methodology would be useful since the NZ paper relies so much on the OECD model comparisons.

3.9 Not sure I understand the statement here. A NZ multinational could be New Zealand controlled but still have a large portion (even majority) of its shares owned by non-residents. I know in Canada many large Canadian-controlled companies have significant non-resident ownership.

3.16 A point often forgotten is that a firm reinvesting profits causes its share value to increase (perhaps dollar for dollar). This results in capital gains that in many countries is taxable at least on a realization basis. Note NZ had top personal rate equal to the corporate income tax rate at one time – one could make a case for shares not be to be subject to capital gains taxes (as I

recall the top dividend tax rate net of the credit would also be zero if the company paid profit taxes at an effective rate equal to the top personal rate). With the drop in company income tax rates below the NZ top personal tax rates, capital gains taxation becomes more critical as noted in the paper.

4.4 Tax depreciation rates are provided throughout. It would be useful to readers to make clear that all reported rates are for declining balance (I understand that straightline can be used for real estate).

4.8 Some explanation is needed to explain why assets with faster depreciation rates have higher effective tax rates with inflation at 2 percent compared to no inflation. Inflation raises the cost of inventory and depreciable capital since cost deductions are based on historical prices. However, the deductibility of nominal interest is a benefit to the firm. The intuition is that assets that turnover more often than longer-lived assets, face a higher penalty (it is opposite of the argument made by Arnold Harberger that an investment tax credit favours investment in short-lived assets). I did differentiate the cost of capital with respect to the inflation rate using the assumption that a one-point increase in inflation causes the nominal interest rates to rise by one point. However, there is an alternative assumption: with personal taxation on nominal interest (and fixed after-tax return on bonds and equity), inflation would cause returns to rise by more than one point (a factor equal to 1 divided by the one minus the personal tax rate on equity or debt in this case). The appendix should be used to clarify these results.

4.8 It should be pointed out whether FIFO is used for inventory valuation as well as an assumption that inventories are held for less than one year. It is not immediately clear that the result is the same for the case of investment with 100% economic depreciation.

4.20 and 4.21 I am puzzled by the argument in this paragraph that a fully creditable withholding tax on interest causes the cost of borrowing to New Zealand to fall. It did not make sense to me in a typical small open economy setting. The effective tax rate might rise since both the company and fully creditable withholding tax are included as taxes (in the absence of the NRWT there would no NZ revenue but there would be foreign taxes payable that are not included in the METR). This does raise an issue about measuring the METR for NZ taxes, ignoring taxes paid by the parent.

5.4 The point that reductions in company income taxes removes the tax on profits earned on old capital is correct. However, this could be offset by a one-time wealth tax on the company to capture the benefit (this was suggested by the US Treasury report in 1984 when Reagan tax reform was proposed).

5.19 When discussing options for reform some mention should be made about the global minimum tax. Given NZ's company income tax rate, modest reductions will not have an impact on minimum taxes. However, accelerated depreciation and tax credits could be clawed back.

5.19 I agree that indexation for inflation is complicated but perhaps worthy when inflation rates become high enough. Also, removing indexation is a signal of tougher monetary policy to curb inflation. Of OECD countries, Mexico corrects liabilities for inflation as well as depreciation, inventory costs and capital gains. Chile has a partial correction for the liability side. Other countries that index profits for inflation include Argentina and, on the asset side, the Dominican Republic. As mentioned, some countries dropped indexation such as Israel and Brazil when inflation was controlled. However, even at 2 percent, inflation does create distortions.

5.19 The allowance for corporate equity will result in more companies in a tax loss position. If losses deductions are restricted, that creates a more unstable company tax over time (the move to lower rates and broaden bases in the mid-1980s was in part driven by the instability caused by growing loss pools). If losses are fully refundable, NZ could become a dumping ground for losses if other countries do not provide full loss refundability.

6.18 Does the global minimum tax put a floor on income from intangibles only. The carveout eventually equal to 5 percent of labour compensation and tangible assets may not be equal to income earned on tangible assets.

6.20 It is not clear as to why one cannot have a separate rent tax on location-specific rents over and above the company income tax. In fact, many countries do this for resource profits that are location specific. For example, the British Columbia, Alberta, UK and Norway have a general company tax applied to all sectors and then a specific company tax applied to rents earned by mining or oil and gas companies (in Alberta and British Columbia the additional tax is called a royalty or mining profit tax respectively, but it is essentially a rent tax for oil sands and mining respectively). If the company income tax is reduced, Norway raises the specific company tax rate as an offset. If rents are not related to location but instead innovation, what would be the implication for company tax policy in NZ? This should be made clear.

6.29 The problem of imposing a rent tax with full taxation of dividends and realized capital gains is that it becomes a double tax on rents. Companies will have an incentive to pay out rents in deductible payments like royalties, employment compensation or fees. The Mirrlees Report was consistent in that it recommended rent taxation at both the personal and company levels.

6.33 Even in 2019 and 2020, the weighted average company income tax rate among OECD countries has slightly fallen (not increased). However, some countries have been raising rates. It is true the simple and weighted average company income tax rates have fallen over time but a wide variation in statutory tax rates across countries remains. The race to the bottom is not leading to convergence to zero. I believe 137 countries have not signed the agreement for Pillar Two at this point although the final outcome still hinges on unanimity in Europe and US Congress passing legislation. If countries put in place the minimum tax, some might reduce the general company income tax rate to maintain productivity or competitiveness, as some experts predict.

7.3 It could be mentioned that the investment tax credit is equal to accelerated depreciation multiplied by the company income tax rate (under the global minimum tax accelerated depreciation will be preferable given the approach to timing differences and deferred tax liabilities that maintain some value – the ITC benefit can be entirely clawed back).

7.7 One could introduce an allowance for inventory costs as an offset for inflation that has been adopted by some countries in the past.

7.15 It is not at clear that only taxpaying firms with high METRs are of concern. Start-up companies could have an even higher METR by not being able to use cost deductions when in a loss position (the METR could be higher than the taxpaying firm METR).

7.17 One could have different acceleration depreciation rates for structures and machinery to provide a "neutral" tax preference for different economic depreciation rates.

8.16 If inflation provides a benefit to companies issuing debt but results in higher taxes on interest income for bond investors, is a correction for liabilities required if corporate and personal income tax rates are equal?

9.2 If there are specific liabilities associated with subsidiaries in a country, different from the corporate group, equity and debt financing may not be perfect substitutes. Further, managerial incentives for a subsidiary are affected by the choice of internal debt versus equity.

9.4 Given opportunities for tax planning, such as double-dip interest deductions, the high NZ company income tax rate makes such planning more attractive (tax relief is the sum of company tax rates faced by the parent and subsidiary).

9.5 As mentioned above, the METR is affected by the ratio of global debt to assets used to limit interest deductions. A company increasing its investment in New Zealand will find it can write off more interest expense, giving an extra incentive for investment. In other words, thin capitalization could actually reduce the cost of capital when this happens. This should be explicitly modelled.

10.5 It should be mentioned that the ACE recommended by the Mirrlees report would be compatible its suggested personal tax reform, which uses a tax free allowance for savings. This is much different than keeping capital income taxes at the personal level.

10.6 The ACE removes the tax on marginal inbound investments if we know how to measure the true normal rate of return that exempts profits. Using the government long term bond rate might not be sufficient to recognize risk when loss offsetting is imperfect, as the paper mentioned below. Further, marginal investments for multinational companies might have negative METRs if they can borrow abroad to finance investment in NZ, getting a second deduction for equity costs (a point recognized elsewhere) as found in Belgium. Further,

companies can lease capital abroad and still benefit from ACE. International tax planning will be easier.

10.9 If the global minimum tax is adopted by New Zealand would ACE be clawed back?

Box on page 77. I suggest adding the word “taxable” in front of retained earnings.

10.14 How would the risk premium be assessed? If loss offsetting is imperfect or firms are credit constrained (eg. smaller companies), we really don’t know how to measure the appropriate interest rate. If the allowance is wrong, the METR will be higher or lower than zero. If one looks at carry forward rates for cash flow taxes in Australia, Canada, Norway and UK, they are all over the map. Further, the ACE will increase the incidence of non-taxpaying companies that in itself creates instability in the tax system as companies try to trade tax losses.

11.3 One could also mention investor or equity financing tax credit incentives. These often undermine productivity since it encourages companies with poor economic prospects to issue equity to investors who are focussed on tax benefits.

11.12 Would a patent box regime with benefits tied to R&D activities be a good idea?

11.4 It would be useful to understand how much location-specific rent is earned in NZ.

11.15 Not all countries are able to get away with 78 percent tax rates on rents (most countries provide a deduction of the rent tax from taxable company income). It helps that the Norwegian government has a controlling share of some of its oil and gas companies. Countries with low rents and political instability provide a greater share of rents to attract the top resource companies. Note the METR with a resource rent tax is not zero when the company income tax is based on shareholder profits (there are important interaction effects), a point that I have made in several papers.

11.18 In a principal-agent model with the government as owner of the resource serving as the principal and the agent being a company with unknown quality, the contract will result in rent sharing in order to attract the best agent to satisfy a participation constraint (see Laffont and Mortimont). The discussion regarding Norway is more theoretical than consistent with experience.

11.23 Perhaps more should be said about tax holidays that many countries use (happily not New Zealand). Such holidays can result in higher METRs than the regular system given the lack of interest deductibility and mandatory accelerated depreciation as a company with long-lived assets has little depreciation to be taken at the end of the holiday. They open opportunities for tax planning as well.

12.3 With regard to full relief for double taxation do you include both dividends and capital gains? Capital gains arising from after-tax reinvested profits have already been taxed once.

Footnote 41 Company income tax collections depend not only on company tax policy. Norway has significant company tax revenues due to resource profits (Canada collects now 4 percent of GDP in company tax revenues largely due to its resource-based industrial structure). It might be useful to show what company tax revenues come from which sectors in New Zealand early in the document.

12.8 A significant reason for Sweden adopting the dual income tax was to reduce the disparity in effective tax rates on housing versus other assets. With mortgage interest deductibility and an insufficient including of imputed rent in the tax base, many Swedes refinanced their homes with debt resulting in tax losses from home ownership that was used to reduce their taxes. The dual income reduced the incentive to finance housing with debt (I heard this in a seminar given by one of the key individuals involved with the reform).

12.11 In recent years with negative real rates, taxation of nominal interest drives the real rate even more negative. This provides additional incentive for investment by borrowers, making the distortion even worse.

12.27 The exempt return is problematical to estimate for reasons given above. With negative interest rates for government bonds in Europe, some countries have had to adjust their allowance policies.

Comments on the appendix.

1.6 I would have introduced interest deductibility under the company tax in equation 1. It is done later so at least provide a forewarning since it is surprising not to see it here. It is provided clearly later in equation (4). While I would have started with a different cost of finance, I do find the presentation otherwise quite well done especially the clarity with equation (4).

1.8 Should depreciation be discounted by the nominal weighted average cost of finance (adjusted for company income taxes), not the real discount rate? The analysis later makes clear it is nominal finance costs that are used for discounting. Again, it would have been easier to have started with nominal and real costs and taxation in equation (1).

1.13 I am not clear how A is calculated until presented in 1.22. Some reference should be provided to the later discussion.

1.29 A reminder for a reader should be given why “m” is the appropriate tax rate given the imputation system for dividends.

2.13 As I mentioned above in discussion international financial arbitrage, it is not clear that the real return on equity should be equal to the real return on debt. Perhaps some justification should be provided here like equal personal tax rates for the marginal investor including zero.

2.16 It might be useful to different the cost of capital with respect to Π show that the cost of capital rises by A(1-τ) so that assets written off more quickly (higher A) results in a bigger inflationary impact. I derived this under the assumption that nominal interest rates rise point by point with inflation.

2.20 Are debt and assets based on market value, real values or book values?

2.28 It would be useful to be clear about inventory valuation under the company taxlaw. Is it FIFO, LIFO, averaging or optional? If averaging, then that affect the cost of capital by reducing the inflationary impact by a half.

2.54 It does not seem to me that actual interest rate limitation has been modelled to derive the METR. I should mention it can be complicated when the parent also faces an interest rate limitation rule in their own jurisdiction as well. No one has modelled both sides that I know of.

Comments on: "Draft Long-term Insights Briefing Paper: Tax, Foreign Investment and Productivity"

These comments combine reflections on both elements of the Draft LTIB: the Main Report (MR) and the Technical Appendices (TA).

A. Overall Assessment

This is impressive work, and was a pleasure to read. I learnt a good deal, not only on New Zealand specifics, but also on the assessment of alternative corporate tax regimes more broadly.

The coverage is comprehensive and appropriate.[1] The technical analysis is careful and clear—it is of the highest professional standards. The presentation of pros and cons of the reform options is very balanced. And the exposition strikes a good balance between comprehensibility and rigor. The Draft LTIB thus does an admirable job of reaching the objective set out in MR ¶12 "of "start[ing] a conversation on what people see as the most important objectives for reform and whether particular reforms are worth considering further. enabling an informed public discussion of these issues."

All this means that my comments are relatively minor, being mainly suggestions for clarification or elaboration. I hope they are helpful.

B. General Observations

1. Framing the Problem

Exaggerating somewhat, the report is rooted in two claims: (1) Conceptually, a higher EMTR than is found in other countries is a—implicitly, the—major potential tax impediment to inward investment, and (2) Empirically, there is reason to suppose that EMTRs in New Zealand are indeed high relative to those found elsewhere, because of the OECD work cited. Both elements—especially (1)—may merit some elaboration. In turn:

What about the effective <u>average</u> rate of tax?

One strand in the literature has highlighted the potential importance of the effective *average* tax rate (EATR),[2] rather than the EMTR, in driving cross-border location decisions. The classic example is of a case in which some lumpy investment must be located in either of two countries: if pre-tax profitability is the same, it will be located wherever total tax is the lowest; and that total tax will reflect not just the EMTR but also, independently, the statutory rate (because the latter influences the rate at which intra-marginal earnings (rent) are taxed). And of course EATRs and EMTRs, while linked, do not necessarily track each other, in the sense that a high (or low) EATR can go with a low (or high) EMTR.

The authors are of course fully aware of this, and mention the EATR in MR ¶3.2. So it seems to be a conscious decision not to pursue the EATR aspect—it would be helpful to know the reason! Some working in this area do appear to see the arbitrariness of the assumptions needed to calculate

[1] I have just one observation on this below.

[2] Following in particular Devereux and Griffiths (2003).

forward-looking EATRs as a major weakness (this not the first paper I have noted to be quietly reluctant to use EATRs)—but they are arguably not much more so than those needed to calculate EMTRs. Or perhaps the view is that a comparison of EMTRs and statutory rates is just as informative—though then perhaps the report might linger a little more on the statutory rate aspects and their significance not just for transfer pricing issues but also for location decisions.

In any case, the reader may wonder if available EATR numbers tell much the same story as the OECD's EMTRs. Table A below reports two such readily available sets of numbers for OECD members: one is from the Oxford University Center of Business Taxation (CBT), the other from one column (chosen more of less randomly) in Table 3 of Hannapi (cited in the report). These do show New Zealand as being on the high side in terms of the EATR, though not dramatically so: New Zealand has the 9th or 13th (respectively) highest EATR. In both sets of figures, moreover, this is not far off the mean:[3] less than one standard deviation in each case.

What about other estimates of the EMTR?

The OECD estimates of EMTRs naturally come with some stamp of authority. But they are not the only estimates, and one might wonder if others—not necessarily better, but also not necessarily worse—tell the same story. The last two columns of Table A report estimates from CBT and Bazel and Mintz (2021). These leave rather different impressions: New Zealand is 5th in the CBT numbers, which us reassuringly similar to the OECD, but noticeably lower, at 13th, in Barzel-Mintz. If one looks beyond the ranking, however, to the likely significance of New Zealand's difference from others, even in the CBT case the EMTR is only a little more than one standard deviation from the mean.[4]

So,,,,

One takeaway from all this may be that New Zealand may not be quite such an outlier as the Table in MR Figure 3.1 Panel B may suggest, at least in terms of the EATR that arguably most matters for Inward investment.

Perhaps more important, however, it may be worth highlighting earlies the health warnings around the use of METRs: that they provide "no more than a partial insight" (MR ¶3.2) and that " Small changes in assumptions can lead to large differences in reported EMTRs. Moreover, as will be discussed in later chapters, they can affect conclusions." (TA ¶2.72)—not least, it might be added, they can also change rankings; and rankings themselves can mislead if they reflect very small differences. Indeed one

[3] The mean turns out to be much the same as the median.

[4] What also stands out from the table is how different can be the estimated EMTRs, for the same country, under the different methodologies: for Japan, for instance, CBT has an EMTR of 19.2 while Bazel-Mintz has 28.7. (Strikingly, however, those for New Zealand are very similar: though not much can be read into that, given the apparent differences in methodologies, reflected in a very different means). This also implied that the ordering of countries—not just the position of New Zealand—can be very different: for instance, the 4 countries with the highest EMTRs are entirely different in the CBT and Bazel and Mintz (2021) numbers.

The differences (beyond levels) between the estimates are much smaller for the EATR, though other columns in Hannapi might give a different conclusion.

lesson of the report—implicit, but perhaps worth making explicitly—is that one needs to look much deeper than the kinds of rankings of "the" METR that so naturally attract attention.

2. What significance of the Inclusive Framework agreement?

While there a few references to developments in the Inclusive Framework, this is such a major development in cross-border international taxation, that it might be useful to consider explicitly its implications for New Zealand and for thinking about the various reform options. These implications may be limited—and I imagine much work on this is underway!—but if so it would be helpful to understand if and why that is the view taken in the Report.

Two aspects come to mind in relation to Pillar 2 (the minimum tax):

a. It may very well be that the moderately high rate and broad base mean that few entities in New Zealand will currently have effective rates below 15 percent and so be subject to the top up. Is that a basic assumption of the analysis? Even if that is so, one could imagine that some of the incentives discussed in general terms in Chapter 11 might bring effective rates for affected entities below 15 percent, so that their effect would be to some degree (though not wholly) diluted—this may be worth noting as potentially limiting their effectiveness. (Perhaps too, as noted below, mention might be made of non-refundable tax credits as one way to get an entity's total tax below the otherwise absolute minimum of 15 percent of excess profit).

   The Pillar 2 rules of course will only apply, however, for multinational groups large enough to be in-scope of the minimum: is the presumption that there are or will be no such multinationals large enough to be likely affected by any incentives that New Zealand might consider, or an implication that they would/ought to be designed not to apply to such entities?

b. Even if New Zealand is not directly affected by the minimum, its application elsewhere will have indirect effects that might be significant:

   - Outward profit shifting will presumably be less of a concern, as, with global adoption, the lowest rate achievable elsewhere would be in the region of 15 percent. That may reduce pressures on the level of the statutory rate. (This is mentioned briefly in MR ¶6.13).

   - In relative terms, higher taxation elsewhere may make New Zealand a more attractive location even with unchanged policies there (because EA/MTRs rise elsewhere).

   - Less positively, a reduced ability to shift profits out of New Zealand makes investing there less attractive: in effect, it raises the EMTR.[5] The importance of this effect is likely to remain largely imponderable, but: to get a broad sense: Is there any readily available information on the likely extent of outward profit shifting from New Zealand?

[5] This point goes back (I think) to Hines and Rice (1994). It may be worth noting in the Report that the calculated EMTRs do not include a profit shifting-induced reduction.

Also:

c. Any reflections to offer on Pillar 1? Perhaps this is more a matter of revenue than of incentives for inward investment?

3. Another option: Cash flow taxation?

The selection of reform options for consideration in the LTIB is well done, and wholly appropriate. There is just one other alternative that it might be useful to mention (or indicate why it is not pursued): cash flow taxation. This has been so prominent in the debate on corporate tax reform—and with interest revived by elements of the 2017 Tax Cuts and Jobs Act in the US—that the absence of any mention is striking.

If felt worthwhile, it may be that offering some remarks on this option would not seem to require additional simulation work, since, as with the ACE (and is indeed hinted in MR ¶10.), the key feature is that the EMTR would be zero. Much of the discussion of the ACE might apply here too: e.g. the implications for integration with personal taxation if the normal return is excluded from tax at corporate level. But perhaps the transition problems (MR 10.24) would be less with a cash flow tax?

3. Mix and match?

It might be worth addressing in the MR the question of whether the various reform options considered could be combined. My sense is that a health warning may be appropriate on this: for example, I don't think one would want to *both* provide more accelerated depreciation *and* loosen thin cap rules.

4. Scene-setting

It might be helpful to set out at the start of—or in an Appendix to—the MR a short summary description of core aspects of the New Zealand tax system that will come into play in the discussion (corporate and personal tax rates, imputation, typical treatment of depreciation, NRWT, AIL—and the perhaps the quite striking numbers in MR footnote 9 and on the share of profits accruing to foreign companies.) Most readers will of course be more familiar with all this than I am—but I imagine that even for them, as well as for the wider international readership the LTIB will deserve, it may be useful to have all this set out clearly in one place.

C. More specific comments

These are (more or less) in the order they arise in the MR and TA respectively, rather than by possible significance.

Main report:

1. ¶2.3: Are there also property taxes in New Zealand that might be relevant?

2. Perhaps use the same color for NZ in Figures 1.1-1.4?

3. Perhaps, in the discussion following ¶2.7, spell out that the argument points to a low EMTR but a high EATR on location-specific rents? The text nearly does this, but not quite—and being explicit here might help the reader understand some of the later discussion

4. It might be helpful too if were possible to give some sense of the extent to which major inward investors into New Zealand may in fact be able to credit taxes paid there (e.g. under GILTI), nuancing the zero-tax argument. The implicit assumption here appears to be that generally they will not be able to—is there good reason to suppose that the be the case?

5. Five lines from end of ¶2.11: specify *pre-tax* interest rate?

6. In ¶2.20, does the 8.3 percent number reflect/assume no distribution of profits?

7. In ¶2:40, presumably the evidence cited includes effects through domestic investment, not just inward real FDI?

8. P.33, first bullet: I always find counter-intuitive the (perfectly correct, I think)[6] claim that, with historic cost depreciation, higher inflation favors longer-lived assets. My (bad) intuition is that with higher inflation you really value near-term allowances, so that favors short-lived assets. Is the (good, or at least correct) intuition rather that with longer-lived assets the allowances are so far away that in present value they are worth very little even with zero inflation, so further erosion by inflation makes little difference? In any case, a brief explanation would be helpful for the puzzled likes of me.

9. ¶4.7 Explain that *b* indicates the debt ratio?

10. Footnotes 18-19 dealing with inflation effects are a bit cryptic: a few words explaining how these equations are derived might be helpful (or perhaps that would be best done in the TA).

11. In ¶4.20:

    (a) I found the argument initially hard to follow: I take it that the key point here is the reference to "cost…to New Zealand" the point being that the actual borrower pays 3 but now the government also collects some tax? Perhaps state this more explicitly? (The point is made much more clearly in the TA than in the MR).

    (b) I'm not sure why it would be inappropriate to calculate the EMR using the rate actually paid by the borrower—the concept is after all related to private incentives. But I may misunderstand.

[6] Perhaps wrongly, I think of this as coming, intuitively, from: The present value of depreciation allowances is $D = \delta/(r + \pi + \delta)$; so $\frac{\partial^2 D}{\partial \pi \partial \delta} < 0$. But this may be wrong.

12. In ¶4.23:

    (a) Is there a reason to support focusing on this case rather than the other? It seems from the TA that this is because they lead to much the same results, but as noted below my initial suspicion (hence maybe also that of other readers) when reading the MR was that the absence of a CGT would make them quite different.

    (b) Why 33 percent? (I now presume this is because that is the trust rate—but did not learn for several pages more—the summary suggested above would have helped me!)

13. I also struggled with intuiting the point in ¶4.25 that "There will be small positive EMTRs for very short-lived PME and inventories, but significantly negative EMTRs for…assets where capital expenditure can be expensed": this is because I would think of expensing as the ultimate short-lived case.

14. In ¶5.19:

    (a) first bullet: and also reduce transfer pricing concerns?

    (b) (b) 5th bullet; the ACE might though forego revenue on non-location specific rents (depending on the rate at which it is set—an EATR issue).

15. In ¶6.24: why now 39 percent?! (Only in the next para do I learn that it's the top personal marginal rate).

16. The important point in ¶6.23 about the being signs of movement to higher CIT rates may risk being buried away here: perhaps mention at the start of the chapter, or perhaps around Figure 1?

17. In ¶7.5, I didn't understand the: "An alternative might be to allow some level of partial expensing in lieu of depreciation loading for those for which $d = d^* = 100\%$." Does that not also mean deducting more than 100%? I am missing something here!

18. In ¶7.13: Isn't though another (reasonable) reason to give accelerated depreciation as rough compensation for inflation, which might, I think, sensibly also be done for 'old' investment?

19. In ¶7.15: very good point, but perhaps "no benefit" is a bit strong as presumably there will be an effect when losses carried forward are used?

20. In ¶7.17, I am struck by the unqualified: "assets that depreciate more slowly tend to face lower costs of capital and EMTRs" I thought that, at inflation of zero, historic cost depreciation 'gets it right' (as indeed some tables in the MR seem to neatly show). Or does this statement have in mind situations of non-zero inflation?

21. In ¶7.18: Might it be helpful to refer to the evidence on the impact of bonus deprecation in the US? I am not expert on this, but there seem to be some indications that it was at least good for employment; I have in mind e.g. Garrett et al. (2020).

22. Table 7.2: Explain "m" in the title?

23. Example 8.1: Might this usefully be extended to show the 'right' tax treatment of interest income?

24. Last bullet after Table 8.1, first sentence: since the table does show negative EMTRs for full expensing, is the point being made here an "even without full expensing" one?

25. In ¶8.18: Why not the actual change in the CPI, which is what the previous arguments would seem to suggest? Is this to counter the risk that indexation will reduce determination to bring inflation back down? Or is it the argument in the next para that is in mind? Or something else?

26. In ¶9.25 (and elsewhere), perhaps clarify that the remark about tax being paid elsewhere is not to inherently devalue tax paid to any country other than New Zealand (which is how it might read) but (I think) to indicate that from the perspective of the investor the effectiveness of the measure is to some degree undermined.

27. On the ACE: Perhaps worth noting one other issue often remarked upon: the likely loss of tax revenue, and the risk of driving non-location specific rents elsewhere, if an attempt is made to recover this by raising the statutory rate. (Though against this, the increased efficiency in the allocation of capital should in itself generate some additional revenue).

28. Around ¶11.3: Perhaps now one should add the possibility of refundable tax credits envisaged under Pillar 2?

29. In Chapter 11: is there any experience with sector-specific incentives in New Zealand to draw on? Foreigners like me may wonder e.g. if the film tax credit (which there is/was?) is seen as a success—or as dissipating some potential revenue from location-specific rents. And on the R&D tax credit?

30. In ¶12.2: What is 'PIE'?

31. In ¶12.19, lines 3-4: It isn't clear to me if the claim here is that the capital income part of the dual income tax (i) inherently taxes only the risk-free return (by a portfolio adjustment story) or (ii) less subtly, (as it may later appear, with the Norwegian example) can be designed to do so. If (i), that may need some (not easy!) explanation for the reader.

32. In 12.31, near the end: It is not clear to mean how the Norwegian approach alleviates the lock-in problem: it may be worth elaborating.

Technical Appendices

33. In ¶2.9, in saying that no account is taken of inflation, does that mean inflation is taken to be zero? The reader may also wonder: Why the change of policy on accelerated deprecation in 2010?

34. Table A2,2: expositionally, might there a case for putting this before Table A2.1, so starting with the benchmark against which inflation effects can be assessed?

35. Footnote 11: This methodological difference is very interesting. Do we know if it is a general feature that the OECD approach will give a higher overall METR (some kind of convexity in calculating the METR) or is this just a chance feature of the particular example?

36. I puzzled over the distinction between immediate expensing and full depreciation over the first year (and similarly between full depreciation and expensing in MR ¶7.9) until I came upon footnote 12 in the TA ; it would be helpful to include this clarification where it first arises (MR ¶4.25?).

37. In ¶2.43, how it is that the AIL is (it seems) generally not creditable abroad when the NRWT is?

38. In ¶2.55, first bullet: I have lost the plot! Which of the cost of capital expressions derived earlier are being used (amended for the AIL) in Table A2.7 for "all companies" and "domestic companies with marginal foreign shareholder"?

39. In ¶2.64: This is a very interesting table. Could one not (at a bit of a stretch, admittedly) see some signs of clustering in that the 50-60% group has a higher number of groups than any other band? Of course fuller analysis would be required to tease out anything definite: I might be inclined to take a tone here of 'further research would be needed, but it seems…' rather than be quite so dismissive of the possibility.

40. In ¶2.75:

    (a) First bullet: I would find it helpful to have an explanation of why these EMTRs are so similar. Presumably part of it is that the assumed personal tax rate is not far off the CIT rate. But that still leaves me unclear why it is actually lower with full distribution (e.g. where does that come from in comparing (2') and (2'')?).

    (b) Penultimate bullet: I had trouble following the explanation of why there are no longer the high EMTRs: perhaps, for the likes of me, it would help to explicitly compare (2') or (2'') with (2)?

41. Table A2.11: I wasn't immediately clear of the purpose of this; but it seems to relate to the last bullet of ¶2.75, so may be worth referring to it there.

42. In ¶3.3, it wasn't clear to me how the point attributed to Bulow and Summers fits with what sounds like the quite different conclusion of Summers in ¶3.2.

Table A: Various Estimates of EATRs and EMTRs

	AETR		METR	
	CBT /1	OECD /2	CBT /1	Bazel and Mintz /3
Australia	26.6	24.8	19	28.3
Austria	21.5	29.2	13.1	20.6
Belgium	28.3	28.1	14.4	22.7
Canada	23.3	25.6	14.9	15.5
Chile	24.3	23.7	24.8	9.6
Czech	16.1	18.3	8.3	15.1
Denmark	19.7	22.9	14.1	13.7
Estonia	24	18	30.1	8.1
Finland	18	19.4	13	14.4
France	32.4	37.7	20	27.9
Germany	27	29.9	18.2	26.1
Greece	25.4	25.3	17.1	9.7
Hungary	9.7	19.3	6.2	10.6
Iceland	17.7	19.1	12	14.9
Ireland	11.3	12.2	8.1	16.3
Israel	21.3	27	12.1	19.5
Italy	21.3	26.2	-7.6	19.9
Japan	27.3	32	19.2	28.7
Korea	18		7.2	29.5
Luxembourg	24.2	28.4	11.4	15.7
Mexico	26.1	28.8	17.1	19.3
Netherlands	19.1	23	8.1	17.5
New Zealand	**25.8**	**26.3**	**21**	**19.7**
Norway	22.2	27.1	18.1	20
Poland	16.7	17.8	10.7	11.4
Portugal	25.2	28.4	14.9	21.9
Slovak	19.3	21.1	12.6	12.5
Slovenia	14.9	16.8	9.1	7.4
Spain	27.6	27.7	24	18.9
Sweden	19.4	21.4	13	17
Switzerland		20.4		10.2
Turkey	16.9	15.9	14.6	4.3
UK	18.5	23.1	17.1	20.5
US	34.8	38.4	23.2	22.6
Mean (unweighted)	21.9	24.3	14.5	17.4
Standard deviation	5.04	5.31	6.7	6.4

Notes: 1/ Data from CBT, at https://oxfordtax.sbs.ox.ac.uk/cbt-tax-database. These are for 2017, before the US Tax Cuts and Jobs Act. 2/ From Table 10 of Hannapi (authors' reference), first column ("Manufacturing plants") 3/ From Bazel and Mintz (2021).

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