Company Taxation in New Zealand

by

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The paper examines possible future directions for New Zealand's company tax system. It does not consider radical reform options, such as ACE or cashflow taxation, but concentrates on approaches with rates and structures within OECD norms. A cornerstone of New Zealand's tax paradigm has been the alignment of the company and top personal tax rates. The paper outlines the problems arising from the divergence of these rates in recent years. It examines a number of possible approaches drawn from international experience for resolving these problems for New Zealand.

The views expressed in this paper are not the views of the Inland Revenue Department. We are grateful to Sandra Watson and Iris Claus for the provision of much of the data referred to in this paper and to Norman Gemmell for helpful comments on the paper.

Introduction

The purpose of this paper is to examine the role of the company tax as a critical part of the New Zealand income tax system. It does not consider radical reforms such as ACE systems or cashflow taxes. Rather, it examines tax design issues within the context of a company tax with conventional rates and structure. Nor does it make a detailed examination of the imputation system which forms a key bridge between company and personal taxation.

The general features of New Zealand's company tax system were established in the reforms of 1989. Since that time, there has been an accumulation of specific policy changes and an evolution of New Zealand's economic context and the broader company tax environment. This has led to pressures on the current regime. This paper briefly outlines these pressures and considers a number of policy responses to them. Some of these pressures are external and arise from international considerations, in particular downward pressures on the company tax rate. Domestically, they arise principally from the gap between the company and personal tax rates leading to tax minimising behaviour by taxpayers; what has been termed the integrity issue, and how best to respond to it.

The appropriate response to these pressures must take into account a number of key facts that form the New Zealand context:

- Company taxation provides a higher level of government revenues than in most other OECD countries. In 2006 New Zealand collected 5.8 percent of GDP in company tax which was the third highest ratio for the OECD. The OECD average was 3.9 percent[1];
- Company taxation and the imputation system have two key roles in sustaining revenues from the New Zealand tax system:
    - Application of source base taxation for profits arising in New Zealand; and,
    - Backstop to personal taxation;
- New Zealand is a relatively open economy but it is geographically isolated;
- New Zealand has a very mobile labour force. In 2000 about 16 percent of New Zealanders lived abroad and about 24 percent of highly-skilled New Zealanders lived abroad. This was the highest ratio in the OECD for highly-skilled individuals living abroad.[2]
- The proximity and degree of integration with Australia. Almost 55 percent of foreign direct investment (FDI) into New Zealand is from Australia and just over 55 percent of outbound FDI from New Zealand is into Australia. [3] There is free labour mobility between Australia and New Zealand.

[1] Source: OECD.

[2] Source: Treasury (2009).

[3] Source: Statistics New Zealand.

The New Zealand Policy Paradigm

In the 1980s and 1990s many OECD countries implemented reforms of their tax systems that broadened their tax bases and lowered their tax rates. The attempts of the 1970s to use tax incentives to direct economic development and stimulate activity were largely seen to have failed. The promised increases in investment expenditures failed to materialise, tax systems became a miasma of complexity and government revenues were eroded as tax bases narrowed. New Zealand joined in the low rate / broad base reforms and went further than most countries.

The policy thrust of New Zealand's reforms of the late 1980s and subsequent adjustments was to apply a single level of tax on a broad-based definition of income. The major components of the system were:

1) <u>Alignment of top personal and company tax rates</u> – Alignment of the personal tax top rate and the company tax rate was arguably the cornerstone of the New Zealand system. In combination with the imputation system it eliminated most distortions which arise when income is earned through different entities and allowed New Zealand to avoid many of the complexities that arise in tax systems that apply different rates of tax to the same income earned in different forms. With aligned rates, the company tax provides a backstop to the personal tax system by preventing deferral of tax through shifting personal activity and assets to closely-held companies.

2) <u>Reasonably flat personal tax system</u> – Unlike most OECD countries, New Zealand taxed income from the first dollar earned; there was no tax free threshold. Coupled with a broad base of income, New Zealand's revenue objectives could be achieved by what was, at that time, a reasonably low rate of company tax by international standards, (33 percent), and a very low, (the same 33 percent), top personal tax rate. Low tax rates, in themselves, contribute to simplification, by reducing incentives to tax plan and consequent anti-avoidance rules, and reducing the tax distortions that inevitably arise from definitions of income that cannot fully reflect economic income, (inflation, measurement of depreciation rates etc.).

3) <u>Broad tax base</u> – New Zealand broadened its tax base, achieving a greater broadening than most other countries. A welter of tax concessions were removed including export and export marketing tax incentives, accelerated depreciation and numerous special incentives for farming, forestry and other industries. Under the income tax there were few explicit incentives and a comprehensive definition of income was implemented, e.g. the Financial Arrangement rules that impose comprehensive accrual taxation of interest and similar income. The major departure from international norms was that many capital gains are not subject to tax. (Gains earned on revenue account are subject to full tax rates). New Zealand's GST also stands out as very comprehensive, applying a single rate to a broad base of goods and services. In practice, broad-based taxes that enable low rates are likely to reduce the economic costs of taxation and the opportunity and incentives for avoidance.

4) <u>Imputation system</u> – New Zealand's imputation system was designed as a practical way to implement an integrated tax system. It ensures that income earned through companies bears a single level of tax. Income retained in the company is subject to the company tax rate, originally equal to the top personal tax rate. This meant that companies could not be used to defer tax for

shareholders on the top marginal rate. At the same time, firms could distribute profits and have them taxed at the marginal rates of shareholders if they wished. This was to prevent the over-taxation of company profits where this was material. As a result, New Zealand, (and Australia which also has an imputation system), has internationally high distribution ratios of company income and most income ends up being subject to tax at the tax rate of the shareholder[4]. By design, imputation provides a back up to the company tax since unimputed dividends are subject to full taxation at the personal level, reducing the incentives for tax minimisation for companies that wish to pay imputed dividends.

5) International taxation – With some provisos, the basic model underlying the taxation of resident individuals is taxation of worldwide income (i.e., on both their domestic-source and their foreign-source income).

   There is considerable controversy over how best to tax outbound investment income. In principle, it can be in a capital exporting country's interest to fully tax such income as it accrues, allowing a deduction rather than a credit for any foreign taxes. This would equalise the pre-tax rate of return on domestic investments with the net-of-foreign tax return on offshore investments. This can be justified on the grounds that the benefit that New Zealand as a whole gets on its domestic investments is the total pre-tax rate of return, which includes taxes paid to fund government expenditures. For offshore investments, the benefit to New Zealand is the post-foreign tax return, since foreign taxes do not provide any benefit to New Zealand. Thus, taxing individuals on their net of foreign tax offshore income (allowing a deduction rather than a credit for any foreign taxes) will cause individuals to invest in ways which maximise the welfare of New Zealand as a whole.[5]

   In practice, at the company level, international tax conventions prevent countries from only allowing a deduction for foreign taxes paid when taxing income from outbound investments. Instead countries, including New Zealand, are constrained to allow either a credit for foreign taxes or to exempt such income at the company level. However, the imputation system is a step in the direction of reinstating a deduction for foreign taxes. Because not all profits are distributed each year, there will normally be a deferral benefit. Overall, the imputation system is likely to increase the efficiency of offshore investment from a New Zealand perspective. Importantly it also provides a base protection role in reducing incentives for New Zealand companies to transfer price profits to lower taxed jurisdictions.

   Under existing rules, New Zealand is the only country to tax the offshore active income earned by subsidiaries of its resident companies as it accrues. Other countries typically defer taxation until dividends are paid, allowing credits at that

[4] Self-integration is facilitated by New Zealand's rules allowing taxable bonus issues to be imputed.

[5] There are some possible qualifications to the simple national welfare maximisation story. If offshore investment by a New Zealand resident creates scope for additional inbound investment and this inbound investment generates taxable income, this can create a case for a lighter taxation of outbound investment than full taxation with a deduction for foreign taxes. This is the so-called "seesaw effect", see Slemrod et al (1997). However, offshore investment by domestic firms is unlikely to be matched dollar for dollar with inbound investment. Moreover, equity investment is only about one third of inbound investment and debt is normally subject to only very low rates of tax. This means that for New Zealand the simple national welfare maximisation story is not likely to be qualified much by allowing for the possibility of inbound investment flows.

time, or exempt the income[6]. Under legislation currently before Parliament, New Zealand's system of international taxation of the offshore income of companies will be brought into line with international practice, and active offshore income earned by offshore subsidiaries will be exempted from company tax.

New Zealand taxes non-residents on their New Zealand sourced income. In contrast to the taxation of residents, in principle, New Zealand does not seek to tax non-residents on income not sourced in New Zealand.[7] The main way that non-residents are taxed on their New Zealand source income is through our company tax.

There are theoretical arguments that can be advanced against taxing non-residents on their New Zealand-source income. Taxing this income will tend to drive up the pre-tax rates of return that companies need to make. This has the potential to reduce inbound investment and lower productivity and wage rates. Under certain strong assumptions including the absence of any 'economic rents' from investment in New Zealand, this tax could end up being borne by New Zealand residents but in a less efficient way than if they were taxed directly.

But there are at least two opposing considerations. First, if investment flows into the economy from countries with foreign tax credit systems, lower taxes on income in New Zealand may be offset by higher taxes abroad. In this case, New Zealand taxes need not discourage inbound investment. Second, and much more importantly, foreign investment into New Zealand will often generate economic rents (i.e., returns that are higher than the minimum that would be required to justify the investment). In this case the arguments against taxing non-residents on their New Zealand source income break down. The main effect of taxing this income may be to generate tax revenue and allow lower taxes to be imposed on New Zealanders rather than discouraging investment.

No developed country exempts foreign residents on their domestic-source income, although Ireland has moved in that direction with its low company tax rate and Belgium has an allowance for company equity which exempts foreign residents on domestic source income up to the level of a risk free return. On balance, taxation of location-specific returns has led New Zealand to retain full source taxation.

Where are we in 2009?

Tax systems, like other complex systems, are subject to deterioration over time. Economic and political cycles come and go. Changes accumulate in response to those cycles. Moreover, changing circumstances can imply that old solutions may no longer address current challenges.

In a review chaired by Robert McLeod, New Zealand undertook a comprehensive review of its system early this decade, (see Tax Review 2001). While the review made a number of suggestions for change, it reaffirmed the basic paradigm of the New Zealand tax system. Outside commentators commented on the essential soundness of New Zealand tax policy. However since that time there have been a

[6] New Zealand also has a grey list of eight countries with comparable tax systems which allows income to be accrued tax free and an exemption for dividends from affiliates.

[7] An exception is that there may sometimes be a non-resident withholding tax (NRWT) impost. Foreign-source income passing through a New Zealand company and then to non-resident shareholders as dividends is currently subject to NRWT. This is under review.

number of developments in New Zealand taxation and it is appropriate to reassess the state of the tax system.

New Zealand has done well in avoiding base-eroding tax incentives. The openness of the New Zealand tax policy process and the memory of the chaos of the incentive riddled tax system of the mid-1980s have led to a consensus among policy makers and most private sector commentators against tax incentives.

In international taxation there has been a further, deliberate, retreat from accrual taxation of offshore income. The government has recently proposed to introduce an exemption for offshore active income exemption. This will bring New Zealand's practice more in line with international norms. The exemption responds to concerns that New Zealand-based firms suffer a disadvantage compared to competitors when operating offshore. This could have discouraged otherwise profitable expansion into offshore markets and could have led to migration of firms to other countries (including Australia) to take advantage of more liberal international tax regimes. The policy of allowing only a deduction for foreign taxes remains for dividends distributed to domestic shareholders out of offshore profits. The imputation system effectively taxes back the active income exemption. However, as noted above, deferral can significantly reduce the impact of personal level taxation.

It is the policy of rate alignment that has seen the greatest challenge. Recent tax rate changes include:

- i) Company rate, since 2008/09 reduced from 33 to 30 percent;
- ii) Top personal tax rate, since 2000/01 increased from 33 to39 percent, will fall to 38 percent in 2009/10 and 37 percent in 2010/11;
- iii) Trust tax rate, has remained at 33 percent;
- iv) Portfolio Investment Entity (PIE), tax rate capped at company tax rate since 2007, (reduced to 30 percent from 2008/09); and,
- v) Life insurance policy holder income, taxed at 30 percent since 2008/09.

Policy pressures arise from this diversity of tax rates because individuals can shelter personal income from higher effective marginal rates using companies, trusts, PIEs and other savings vehicles. Information derived from tax collection data since the introduction of the higher top rate indicates that there has been considerable rearrangement by taxpayers to minimise tax and avoid the full application of the apparent progressivity of the tax system[8].

There are a number of ways of escaping higher marginal and effective marginal tax rates by diverting income to lower-taxed companies or trusts. For example, by earning income through a company, an individual can ensure that income is taxed at a 30 percent rate so long as profits are retained within the company. While income may eventually be taxed at the shareholders' marginal rate when dividends are paid, there can be substantial benefits from tax deferral if income is retained for a number of years in a company before it is distributed as dividends. A sharp increase in the amount of imputation credits held by closely-held companies indicates that there is significant deferral of dividend payouts for such companies in order to avoid the higher personal marginal tax rates.

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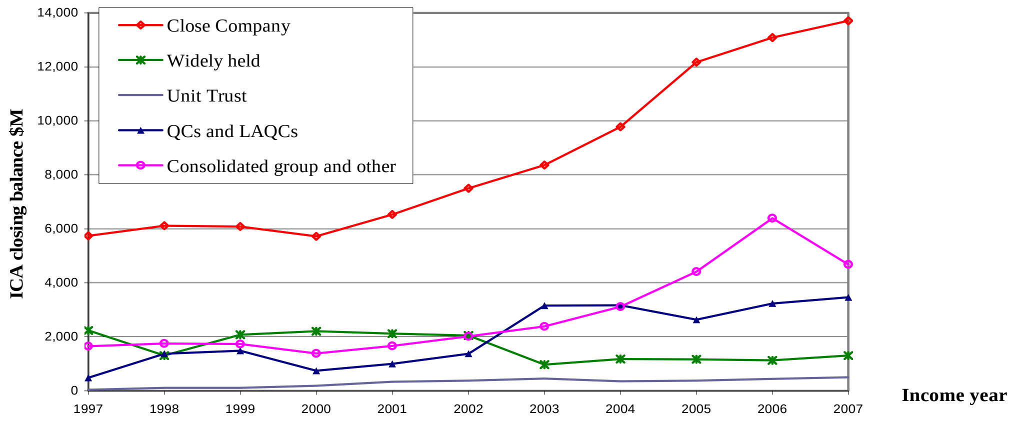
[8] This information is presented in the Briefing to the Incoming Minister, Inland Revenue Department, November 2008

Who has excess imputation credits?

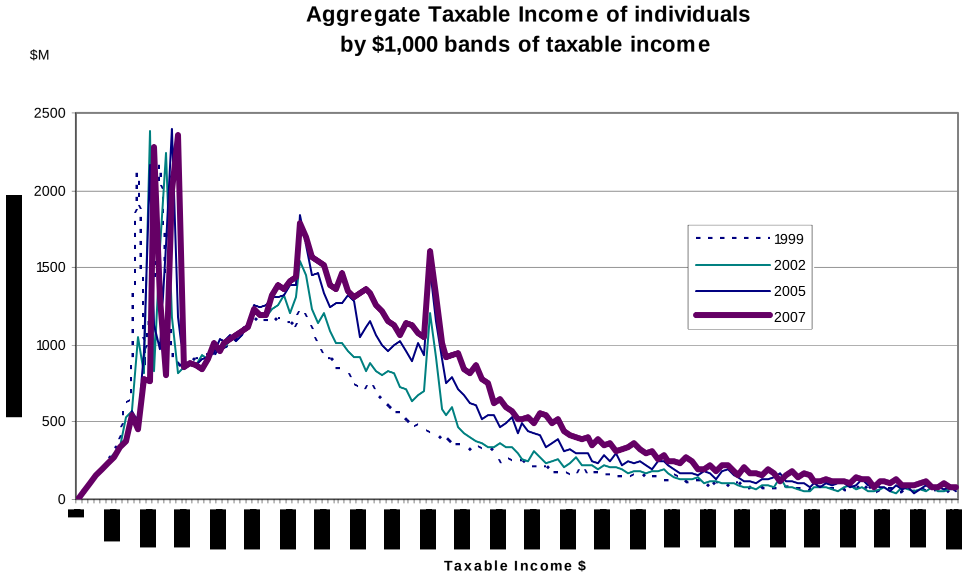


Trusts can be used to shelter income by having it taxed as trustee income (at a rate of 33 percent) rather than having it distributed to beneficiaries and taxed as their income. There is continuing evidence of trustee income growing much more quickly than beneficiaries' income.[9]

The effect of these various strategies is illustrated in the table below which shows aggregate income of individuals in different income bands for the years 1999, 2002, 2005, and 2007. The year 1999 was before the introduction of the 39 percent top marginal rate for incomes above $60,000 and at that stage there was no spike of taxpayers clustered at the $60,000 threshold. Since then, an obvious spike has developed. For example, in 2007 there is much more income attributable to people earning between $59,000 and $60,000 than for other $1,000 bands of income on either side. This suggests that those who would otherwise be facing the top marginal rate may be using companies, trusts and other savings vehicles to shelter income from higher rates of personal tax.

The sheltering raises concerns about whether it is fair for some taxpayers to be able to escape higher personal rates while others, such as salary and wage earners, face the top statutory tax rate. It also raises efficiency concerns. It is not costless for people to set up tax-efficient entities. From the perspective of the nation as a whole, the money spent doing so is a source of economic waste. Savings and investment can also be allocated inefficiently to take advantage of lower tax rates.

[9] For fuller details, see Inland Revenue (2008). Greater tax benefits can be arranged by having companies taxed at 30 percent held by trusts. Accumulated earnings obtain a deferral advantage by being taxed at 30 percent, with a final tax of 33 percent applied when they are distributed to the trust.



The current tax provisions also raise questions about the achievement of the objectives underlying the current statutory personal tax rates and thresholds and other measures which also affect effective marginal tax rates (EMTRs) (such as abatement of Working for Families Tax Credits, Student Loans, and Child Support). These all apply if individual income is received and taxed as personal income, but not if earned in other ways such as through companies, trusts or PIEs.

There is considerable variety in the way that income is taxed depending on exactly how the income is earned.

Marginal Tax Rates by Entity[10]

	Accumulated	**Distribution/Attribution of income**			
Type of Entity	**Entity level**	**58% investor**	**38% investor**	**33% investor**	**21% investor**
Direct Investment	N.A.	58	38	33	21
Trust (a)	33	33	33	33	21
Company/Unit Trust	30	58	38	33	21
Company owned by trust	30	33	33	33	21
PIE	N.A.	30	30	30	21
Widely held super fund	30	30	30	30	30
Life insurance policyholder	30	30	30	30	30

[10] Inland Revenue (2008).

Determining policy choices

Arguably, a necessary condition for the viability of the current paradigm is maintaining a reasonable correspondence between the company rate and the top personal tax rate. Choosing the right tax structure depends upon predictions of future company tax rates and political choices about tax mix and progressivity. The government has announced a longer term goal of returning to a balanced set of rates, with the company tax, the trust tax and the top personal rates all aligned at 30 percent. The remainder of the paper examines the issues relevant to the achievement of this objective.

There are a number of broad questions the answers to which will inform the policy discussion.

- <u>Does policy of alignment of company and personal tax rates still make sense?</u>

  Are the perceived simplification and efficiency benefits of rate alignment still valid today? Or might growth and productivity considerations drive down the desired company tax rate to a rate that is lower than a government would want to levy on higher personal incomes?

- <u>Is alignment achievable with international pressures on company tax rates?</u>

  Even if alignment of rates remains an appropriate policy objective, is the company tax rate a moving target? Will international rates continue to fall? If so, would New Zealand be forced to follow suit with further reductions in the company tax rate?

- <u>Would a shift from income taxation to increased taxation under the GST be a viable way to achieve alignment even if company tax rates were to fall further?</u>

  Could fairness objectives be maintained by providing an across-the-board cut in personal tax rates to align the top personal rate with the reduced company tax rate? Would a shift toward consumption taxation enhance economic welfare in a manner that complements the efficiency benefits of rate alignment?

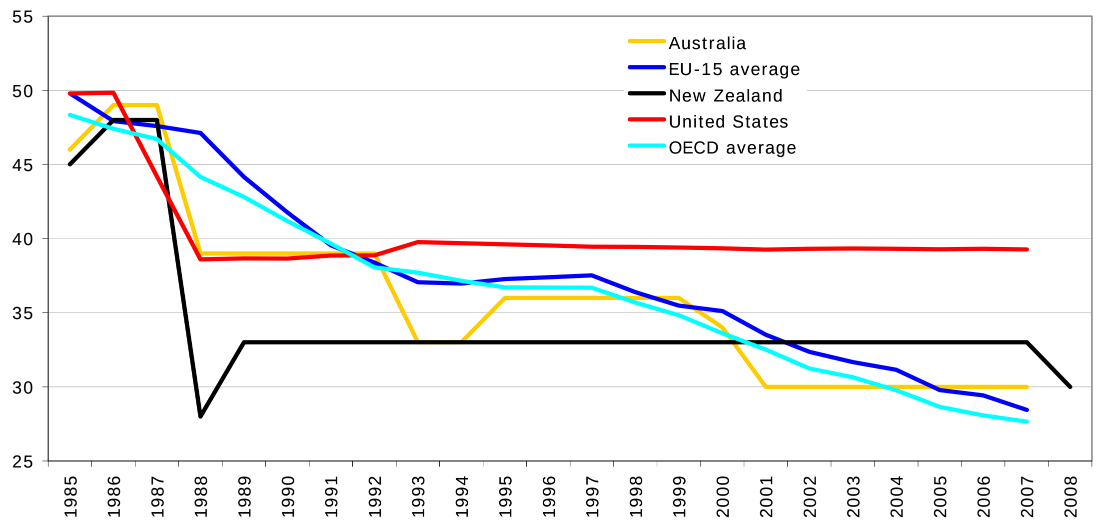
- <u>If not, or if achieving alignment may take a considerable time, what is the second best (possibly temporary) alternative?</u>

  Should measures be introduced, as in a number of OECD countries, to prevent certain types of personal income being sheltered in companies or should New Zealand align rates where possible, such as for capital income as in a Nordic approach?

Whither the company tax rate?

In the 1987/88, New Zealand's company tax rate was 48 percent which was around OECD norms. In 1988/89 the company tax rate fell to 28 percent and then was raised back to 33 percent a year later where it remained until 2007/08 with a reduction to 30 percent in 2008/09. The company tax rate was relatively low compared to rates in other OECD countries from the late 1980s until about 2000. However, since the mid-1980s there has been a downward trend in company tax rates around the world and, even given New Zealand recent cut in its company tax rate, New Zealand's rate is now above the average for OECD countries.

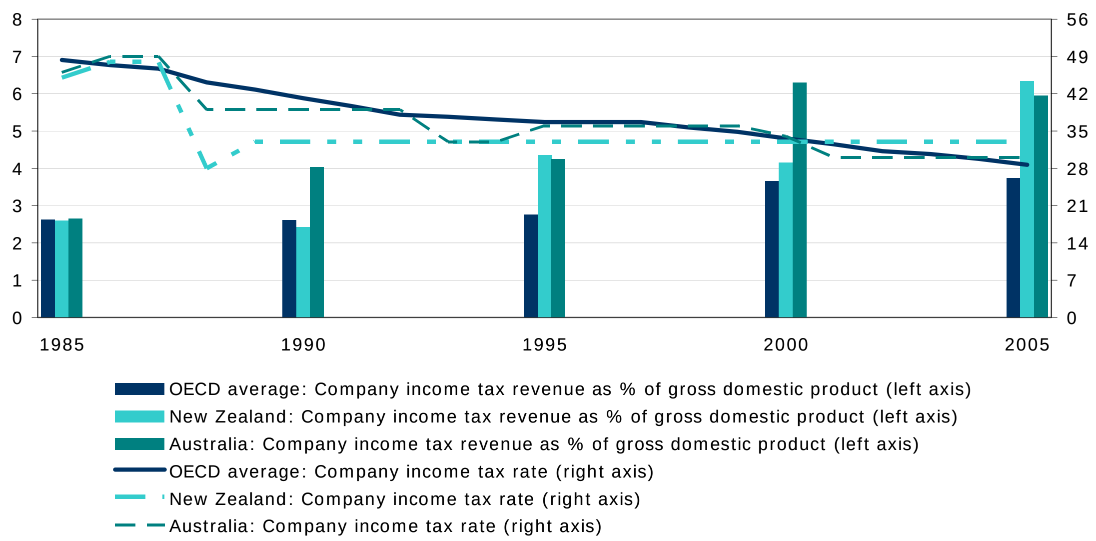
Historical trends in statutory corporate tax rates (in percent)



Source: OECD

Interestingly, however, as company tax rates have fallen across the world, company tax revenues have not declined as a proportion of GDP. Between 1985 and 2005 the average company tax rate fell from 49% to 28% but company tax collections increased from 2.6% to 3.7% of GDP. This is in large part because many countries have broadened their corporate income base while reducing their company tax rates to protect company taxation as a source of revenue.

Company income tax rates and revenues (in percent)



Source: OECD

So while reductions in company tax rates have been characterised by some as a "race to the bottom", perhaps a more accurate characterisation among OECD countries would be a structural improvement in tax systems towards low rates and broad bases in ways that, to date, have not impaired the company tax as a source of tax revenues, while reducing the distortionary impact of the tax.

This raises the question of the future path of company tax rates. Has reducing rates and broadening bases reached a natural limit. If so, from now on rate reductions would cost significant money. Will this slow the race to the bottom among developed economies?

Of particular interest to New Zealand is the future direction of Australia's company tax rate. Australia has announced a review of its tax system, concentrating on issues of competitiveness among others. Consultative documents suggest that it will maintain much of its current tax structure, including in particular its imputation system. For example, most submissions from businesses to the review have supported the retention of the imputation system. But the review may well lead to moderate company tax rate reductions in Australia. This raises the question; to what extent can New Zealand's rate be higher than Australia's?

This raises another important consideration. A relatively high company tax rate can make it attractive for multinational firms (especially from Australia with its imputation system) to stream profits away from New Zealand and into lower tax countries. This might be achieved by firms "thinly capitalising" the New Zealand operations (i.e., financing as much of their New Zealand activities as possible by using debt) or by transfer pricing arrangements where New Zealand entities pay as high as possible prices and charge as low as possible prices on transactions with associated companies overseas. There are measures to prevent transfer pricing and thin capitalisation but these are not perfectly effective. Incentives to stream profits from New Zealand overseas will tend to arise when the New Zealand company tax rate is higher than that in other countries.

Irish system – go for broke!

Independent of international developments, New Zealand could choose to abandon rate alignment and unilaterally reduce company tax rates similar to the Irish system.

A high company tax rate may discourage capital investment by increasing the user cost of capital and so have a direct negative effect on labour productivity and growth, (see OECD 2008). There are other ways in which an excessively high company tax rate could affect productivity and growth. It could reduce the level of FDI. This could be important if FDI brings new innovation to New Zealand.

There has been much study of the effects of taxes on FDI. A recent authoritative survey reported a median semielasticity of -3.3 suggesting that a 1 percentage point reduction in the company tax rate would increase FDI by 3.3 percent (see, de Mooij and Ederveen, 2003). However, there is substantial variation across studies. There is also some evidence that there may be a less elastic response in countries with relatively low tax rates than in countries with relatively high tax rates (Benassy-Quere et al, 2005). This suggests after a point, further cuts in the company tax rate may have limited effects in increasing FDI.

A high company tax rate can also increase investment distortions which lower capital productivity because, in practice, economic income can never be measured and taxed properly. It can make New Zealand an unattractive place to base a business. This has the potential to reduce labour productivity and growth.

The Tax Review proposed a deep cut in the company tax rate for non-resident owned companies to attract FDI[11]. A targeted reduction would, in principle, achieve the Irish

[11] This could potentially be achieved in a number of ways: either by trying to define income earned on behalf of non-residents or by providing refunds of imputation credits as dividends are paid. Either approach would present formidable technical difficulties.

objective of attracting FDI, without the added revenue cost of lowering taxes on domestic investment.

Could New Zealand, as a small island nation, hope to emulate Ireland? The answer depends greatly on the similarities and differences between New Zealand (today) and Ireland (in the 1980's at the beginning of the Irish miracle). Some similarities and differences are highlighted in the following table.

Ireland	New Zealand
Small Island	Small Island
Educated English-speaking workforce	Educated English-speaking workforce
Member of EU (GDP $19.2 trillion)	Member of CER (GDP $1.2 trillion)
EU subsidies	No subsidies
On EU's doorstep	Middle of nowhere
Competing against high wage EU countries for FDI	Competing against low wage SE Asian countries for FDI

A short perusal of the list suggests that New Zealand differences outweigh its similarities with Ireland.

Moreover, taxing company income is a way of taxing foreign residents on the profits they make through investing in New Zealand. Where foreign-owned firms are making economic rents from their investments in New Zealand, reducing the company tax rate could potentially lead to higher economic profits for their shareholders with little effect on investment. In this case, much of the benefit of a company tax cut could go to foreign residents.

A recent OECD study has estimated some very large effects of cutting company tax rates on growth of total factor productivity, (TFP) (OECD, 2008). The study suggests a reduction in corporate taxation from 35% to 30% would increase average growth of TFP by 0.4% per annum which they argue is likely to be an upper bound estimate. Trend TFP growth in OECD countries only averaged around 1.1% over the period 2000-2005. The paper notes that gains in growth are likely to be smaller for lower starting tax rates. That is, reducing company tax rates that are higher than average may have a greater impact than further reductions below the average rate. This latter effect has been reported in other studies.

But it would be wrong to conclude that these results are necessarily applicable to New Zealand because some of the reasons identified by the OECD why company tax may reduce TFP growth are already substantially mitigated by our full imputation system. Moreover there may be other factors in New Zealand's situation which make a substantial rate cut less likely to be welfare enhancing.

An interesting question is whether location-specific economic rents are likely to be a bigger issue for a small isolated economy like New Zealand's than, say, a country in Europe adjacent to other similar economies. Typically FDI into New Zealand seems to be focussed on servicing the New Zealand market, (e.g. banks), where location-specific rents are likely to arise. These rents may be greater in New Zealand than other countries that are more integrated into regional markets. Therefore the foregone tax on rents from a cut in tax rates may weigh more heavily on New Zealand than other economies.

The increase in FDI that New Zealand might expect to gain from a cut in tax rates may also be smaller than for countries that are competing within a regional market for FDI. Consider the choice of whether to establish a new plant in Germany or right across the border in Austria. The choice of country may have relatively little effect on the productivity of the plant or its ability to service the regional market. In that case, it might be expected that the decision of where to invest might be significantly affected by taxes. As the bulk of FDI into New Zealand services the domestic market, inbound FDI into New Zealand may be less sensitive to tax. For example, in competing for footloose manufacturing, it is questionable whether New Zealand would ever be used as a major manufacturing hub to supply the Asian market, irrespective of its tax system.

Company taxes are a high proportion of government revenues in New Zealand. As replacement taxes would need to be levied on New Zealanders, this may make New Zealanders as a whole worse off. Given the high degree of non-resident ownership in New Zealand reducing taxation on non-residents would be very expensive.

Finally, a tax preference for income earned by companies, but not other forms of income, leads to inefficiencies in choice of entity, type of investment and financial decisions, such as distribution of profits, which in themselves can impair productivity and growth.

A case would need to be made that increases in capital stock and productivity flowing from increases in FDI engendered by the low company tax rate would be of sufficient net benefit to New Zealand to overcome these various costs.

A deep general rate cut, as in Ireland, would have profound structural implications for the tax system.

- Integrity measures

  Measures to prevent deferral of taxes on personal income shifted to companies would be required. These are outlined in more detail in the section on the "Mind-the-gap" approach

- Role of imputation

  With deep cuts in company tax rates, imputation may no longer be considered appropriate. Ireland, for example, has a classical tax system.

- Capital gains taxation

  A classical tax system generally requires a capital gains tax to prevent avoidance or undue deferral of dividend taxation.

A deep cut in the company tax rate would alleviate transfer-pricing and thin-capitalisation concerns by making it attractive for multinational firms to move taxable profits into New Zealand rather than away from New Zealand. However, on balance we would support the general conclusion in New Zealand to date has been not to introduce a deep rate cut. Should this conclusion be reconsidered?

Addressing integrity problems

Integrity problems can be addressed by reducing the variation in tax rates facing taxpayers in different situations. There are a number different ways in which tax rate variation could be reduced.

The fundamental decision, which frames other decisions on the rate structure, is the level of the company tax rate relative to the tax rates (particularly the top rate) on personal income.

Choices by government on tax rates applied to the income of individuals will reflect views on the level of revenues required to fund governmental spending programmes, the appropriate progressivity of the tax system, and efficiency considerations related to the impact of taxation on economic behaviour. Choosing the appropriate company tax rate reflects a balance of revenue objectives, international considerations and the structure of taxation of domestic income. Finally, the tax system must be administratively feasible and should strive to minimise compliance costs to the extent possible.

Ideally, the tax system should be flexible so that it can evolve as New Zealand's needs change. For example, fiscal demands may change as there are economic or demographic changes, or particular tax parameters may need to be recalibrated due to external factors; for example, a lowering of the rate of the company tax in response to continued reductions in company tax rates internationally.

There is no one best way of balancing these considerations and different countries have chosen different routes to achieving their objectives. These are summarised below as a guide for possible approaches to lessening the current inconsistency in marginal tax rates.

Conceptually, tax rates could be made more consistent in three different ways:

- <u>Alignment approach</u>

  The top personal and company tax rates would be the same. Alignment would essentially return the tax structure to New Zealand's pre-2000 alignment of the company and top personal tax rates, presumably at the new company tax rate of 30 percent;

- <u>Mind-the-gap approach</u>

  Integrity measures would be introduced to prevent current tax deferral and diversion possibilities, while retaining a company tax rate lower than the top personal tax rate;

- <u>Nordic approach</u>

  A split rate system would be introduced with a lower tax rate applying to income from capital that aligns personal tax rates on investment income with the company tax rate, but continues to tax labour income at full personal tax rates. Variations of this approach have been adopted by the Nordic countries.

Alignment approach

The most direct return to the New Zealand paradigm would be to align the top personal tax rates with the company rate. The top personal tax rates of 33 and 38 percent would be set equal to the company tax rate of 30 percent. This is clearly the simplest way to eliminate the disparity of rates among different entities. It avoids the need to distinguish between active and passive income, as under the Mind-the-gap approach and avoids the practical complications of Nordic tax system.

Arguably alignment is the preferred option. An individual would be taxed on all forms of income earned through any entity at similar tax rates. Incentives to structure holdings of assets in artificial ways would be eliminated. Marginal tax rates would be reduced, reducing distortion from higher marginal tax rates on decisions to work and invest. Complex distinctions required to implement both the Mind-the-gap and Nordic approaches would be avoided. The Nordic approach would achieve the efficiency benefits with respect to capital income, but would continue to apply high rates of tax on labour income at the top end. New Zealand labour (and skilled labour in particular) appears to be particularly mobile, especially between New Zealand and Australia. The efficiency costs of high personal tax rates could be higher than other countries.

There are a number of questions that need to be addressed in assessing the feasibility of this option.

- Pressures on company rate

  Can a company tax rate of 30 percent be sustained – or will the question of alignment re-emerge if international pressure forces continuing cuts in the company rate. In other words is the system flexible enough to deal with changing circumstances?

- Revenue raisers

  Reducing the top marginal tax rates is expensive. This requires feasible, base-broadening measures to fill the revenue gap. The obvious candidate to fill the revenue hole, from an efficiency point of view would be to increase the rate of GST.

- Progressivity

  A sharp reduction in the top marginal tax rate would cause concern for those that believe progressivity in the personal tax rate structure is necessary to redistribute income and promote fairness.

These fairness issues should be put in context. Because of the scope that high income earners currently have to shelter their income in companies and trusts, many of the best off in New Zealand are not necessarily subject to the top personal marginal tax rate. Moreover, government spending programmes as well as the tax structure will determine the progressivity of the government's fiscal programme.

Nevertheless, if reduced progressivity of the tax system were of concern, one way to address this would be to make a more dramatic shift from taxes on income to taxes on consumption, i.e. the GST. The progressivity of the personal rate structure could be maintained by lowering all personal tax rates by enough to equalise top personal rate and company rates.

Even so, some may argue that this could be unfair because lower income families typically consume a higher proportion of their income than do higher income families and so are likely to be harder hit by an increase in the GST. Much of the apparent regressivity of a GST increase would disappear if incidence is measured over the lifetime of individuals. Differences in timing of income and consumption lead to variations of the ratio of consumption to income measured on an annual basis. However, many people consume most of their income over their lifetime, leaving little in the way of bequests. In any event, the poorest in society could be protected by compensating cost-of-living adjustments to low income benefits and New Zealand Superannuation.

A switch from income to consumption taxes also raises transitional fairness issues to the detriment of individuals with higher savings. Raising the GST effectively imposes a lump sum tax on existing wealth owners although, over a life cycle, reduced taxes on investment income would compensate. However, the current elderly, whose accumulated savings would have borne the previously higher income tax rates, and who do not plan to leave bequests, would be hit hardest. This is only one of a large number of factors which may affect the current elderly including the performance of the share market and interest rates. Nevertheless, this may constrain the size of any increase in GST that might be feasible or provide a case for some other form of compensation to the elderly.

Across-the-board income tax rate reductions would reduce these effective tax rates on income. To the extent that lower marginal income tax rates are offset by a higher rate of GST, theory would suggest that the would not be increased incentives to work. However, the lower marginal income tax rates would be likely to increase the incentive to save and to reduce tax biases between different forms of saving.

Finally reliance on increases in the GST would provide an avenue to maintain alignment in the future if there are further reductions in the company tax rate in response to international pressures.

Mind-the-gap approach

Under this system New Zealand's company tax rate would remain less than the top personal tax rate, with perhaps a modest reduction from current levels.

Most OECD countries have a company tax rate which is considerably less than the top personal tax rate. Some countries have introduced integrity measures to prevent deferral of personal wage and investment income by shifting it to lower taxed closely-held companies. While the concepts behind these measures are reasonably straight-forward, their application can be complex in some situations. For example, the rules to maintain personal taxation of investment income on assets shifted to closely-held companies would require an active-passive distinction in the domestic context. The distinction is necessary to allow business income of the companies to benefit from the low company tax rate while preventing tax on income from personal savings to be deferred by transferring passive assets to a closely-held company. Similarly, measures are required to ensure that personal income earned through collective investment vehicles is taxed at the marginal tax rates of individuals. Finally, rules are required to prevent certain personal services being provided through a company from benefitting from the low tax rate.

- <u>Rationale and economic incentives</u>

  The major rationale for a "Mind-the-gap" system is that it preserves flexibility and independence of the company and personal tax rates. The company tax rate can be set to respond to international tax pressures and growth concerns, while the personal rate structure would be targeted at the redistributive goals of the government. It would reflect a judgement that the company tax rate would not be a stable platform on which to base the personal rate structure. It would represent a major departure from the New Zealand paradigm, as it would allow for a permanent de-linking of the company and personal tax rates.

For non-resident owned companies, it would represent a permanent reduction in tax. There would be greater flexibility in setting the rate to take account of goals for attracting FDI and minimising international transfer pricing pressures.

For domestically owned companies, the incentives depend upon the taxation of dividends at the personal level. If imputation were maintained, the lower company tax rate would provide an explicit tax incentive by allowing deferral of taxation for reinvested income.

The biggest disadvantage of this option is likely to be its effects on economic efficiency. Different rates of tax would be levied on active income earned through companies and by unincorporated businesses, biasing the choice of legal form. Lower tax rates on retained active income would bias high tax rate individuals towards investing in active businesses and away from possibly higher return passive investments.

Maintaining a rate gap also moves away from some of the neutrality goals of an imputation system. Maintaining imputation would avoid double taxation of income passed through companies. This might be considered a particular advantage for closely-held companies versus widely-held. On the other hand, there would be differential tax imposts across companies according to the period that elapses until income is distributed[12].

Other solutions are possible. For example:

i) Exempt imputed dividends to pass through the active income tax reduction; or,

ii) Classical tax system, which double taxes company income and may further discourage distributions.

- Other structural issues

  A number of other issues are raised, some of which are quite complex.

  First, there are borderlines problems in distinguishing active from passive investment businesses, for example, with rental of real estate. Secondly, most countries with dividend taxation and a gap between company and personal tax rates have found it necessary to introduce taxation of capital gains. For widely-held companies there is the concern that lack of a capital gains tax could bias the decision to retain or distribute income. For closely-held companies, well known dividend stripping strategies can be used to side-step the taxation of dividends. Thus far New Zealand has avoided introducing taxation of capital gains other than gains that occur on revenue account. Imputation and the relative alignment of company and personal tax rates reduce the structural reasons for having a capital gains tax. If a permanent, perhaps wider, rate differential were expected, this would raise the question: at what rate gap is there a sufficient structural reason to tax capital gains to limit deferral and preserve effective dividend taxation?

[12] This deferral effect happens whenever there is net taxation of the dividend.

Nordic approach

A Nordic system would apply the lower company rate of tax to all capital income, whether the assets are held by individuals, companies or other entities. Labour income would continue to be taxed at marginal personal tax rates. The Nordic countries introduced their systems for a number of reasons.

Norway has been the leading proponent of split rate systems. In 1992 Norway undertook a reform of its tax system that followed the pattern of tax reforms in the OECD. They replaced a tax system characterised by high tax rates and a distorted base with one with lower tax rates and a broad base. However, unlike most other reforms at that time, they decided to introduce a split rate system with a flat tax rate of 28 percent on company income and personal income from capital; with a progressive system with higher rates of tax and social security contributions on income from labour. At the time of introduction the top combined (including employers' contributions) rate of tax on labour income was about 50 percent; by 2003 it had risen to a combined total of 64.7 percent.

The basic motivation for the reform was to preserve rates of tax on labour income that were high by international standards, while responding to international pressures which made sustaining such high tax rates on capital income impossible. The system also addressed other structural problems such as arbitrage between rates of tax on capital and labour.

The traditional Nordic system requires splitting labour and capital income for unincorporated businesses and closely-held companies. This proved to be the Achilles heel of the system. More recently Norway has replaced its system to fix problems in the traditional split rate model and to respond to ECJ determinations that imputation systems cannot discriminate among EU countries.

The new Norwegian system incorporates a capital gains tax and double taxation of dividends above a standard rate of return. Tax rates on capital and labour are aligned rather ingeniously to prevent deferral of tax on labour income earned through companies and to apply the higher rate of tax to economic rents and not marginal investments. This system obviates the need for rules to distinguish between capital and labour for companies, but such rules are still required for unincorporated businesses.

The New Zealand tax system differs from the Nordic system as it has lower personal tax rates overall and a smaller difference between the top personal tax rate and the company tax rate. Moreover, New Zealand has no payroll tax to fund social security contributions and this makes it more feasible than would otherwise be the case to achieve alignment. Norway's reduced tax rate on capital income is close to the current New Zealand company tax rate. Alignment is a potential policy for New Zealand, but clearly out of reach for Norway. New Zealand does not have a general tax on capital gains, and historically there has never been a political consensus in favour of such a tax. On the other hand, a number of recent policy decisions, such as the capped tax rate for PIEs, have moved New Zealand's system in the direction of a split rate for capital and labour, (at least for taxpayers on higher rates of personal tax).

Given these measures, one option would be to adopt a simplified alignment of capital tax rates. PIE income is currently subject to a capped tax rate. It is taxed at the lesser of the company tax rate and the statutory tax rate of the individual. A capped tax rate could be extended to all investment income (using a list approach, not active-passive), wherever it is earned. The system would not adopt the Nordic separation of labour and capital income for unincorporated businesses and closely-held companies. The capital component of unincorporated business income would face personal marginal tax rates and the labour component of closely-held company income would enjoy the company tax rate. (There would need to be rules to prevent sheltering of salary and wages and perhaps certain forms of personal service income.) Imputation could be maintained, but a capped capital tax rate would apply to dividends. This approach would have much in common with a number of European schedular tax systems which apply lower rates of tax on certain forms of investment income.

Biases would remain because of different rates of tax on business income of companies and unincorporated businesses. Many of the efficiency issues of the Mind-the-gap approach would also arise with this simplified Nordic approach. However investment income would be taxed equally in different entities and so the incentive to hold investments artificially in tax efficient ways would be removed.

The change would exacerbate fairness issues between labour and capital income arising from the current tax minimising strategies. Capital income is concentrated with higher income earners, and so overall progressivity would be reduced. On the other hand, as is well known, the absence of inflation adjustments implies that capital income of individuals is often over-taxed, even at current low inflation rates. A capped tax rate could be seen as a partial ad hoc recognition of this over-taxation.

Finally, efficiency and fairness concerns could be lessened if applying a lower tax rate to investment income is seen as a halfway house to eventual full alignment of the company and personal tax rates.

Preliminary Conclusions and Questions for On-Going Debate

This paper has sought to discuss possible options rather than driving to definitive conclusions in this complex area. However, we would venture some preliminary conclusions and raise questions for further debate. These are:

1. In our view a deep company rate cut is unlikely to be a preferred option for New Zealand in the present international context. There are some important issues that need to be debated in firming up these conclusions:
   - 1.1. Is there a best rate of company tax rate for New Zealand which trades off the efficiency benefits of lower company rates against the loss of tax on rents?
   - 1.2. Is investment more sensitive to relatively high tax rates rather than low rates?
   - 1.3. Is there significant tax base risk from high company tax rates, to justify reducing rates to save revenue leakage?
2. In our view so long as it is viable (given any reductions in company tax rates abroad), the preferred option for personal and company income tax rates is the alignment approach, with the company and top personal tax rate equalised, and applied to a broad-based definition of income. But questions for further debate include:
   - 2.1. Is alignment the best alternative, or is there a case for reducing company tax rates while keeping personal tax rates higher?
   - 2.2. What is the future direction of the company tax rate in response to international developments? Is alignment sustainable?

2.3. Could an increase in the rate of GST be used to fund across-the-board personal tax rate cuts to maintain alignment?

3. If rate alignment cannot be achieved, two second best options were outlined: a mind-the-gap approach and a simplified Nordic approach. In our view the choice between the two approaches is less clear-cut. Questions for further debate include:

   3.1. Given that New Zealand already has a capped rate of tax for some investment income, could a simplified Nordic system be a way station toward full alignment?

   3.2. A fundamental policy question distinguishing these approaches is, whether investment income should be subject to the same progressive tax rates as labour income? This has a number of specific aspects:

      3.2.1. Fairness – Should all types of personal income face the same rate of tax, or is there a case for lower taxation of savings?

      3.2.2. Trade-offs – Do the intertemporal efficiency gains of lower tax rates on savings of the Nordic system out-weigh possible fairness concerns?

      3.2.3. Efficiency – In a small open economy, is it better to target the incentive of a lower tax rate at investment (Mind-the-gap) or extend the incentive to savings (Nordic)?

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