Tax Tips Alert

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The Tax Working Group – release of the Interim Report

The Tax Working Group has released its [Interim Report.] The report covers a broad spectrum of issues, including those that were identified in *Future of Tax – Submissions Background Paper*. The report provides the TWG's interim conclusions on those issues, therefore shedding light on the general direction of travel of the TWG's final recommendations to the Government.

Key highlights include:

- a relatively detailed design for extending the taxation of capital income (a capital gains tax) but not going as far as a recommendation at this stage
- categorically ruling out the introduction of a land tax or wealth taxes
- a strong desire to retain the current GST regime meaning no further exemptions would be introduced, and
- largely maintaining the current framework for taxing businesses.

While not opening up another full consultation process, the TWG welcomes comments from the public on the interim report. Furthermore, the TWG will continue to work with specific industry and special interest groups in formulating its final report, which is expected to be issued to the Ministers of Finance and Revenue in February 2019.

The Interim Report – what does it cover?

The report provides good insight into the TWG's general direction of travel as well as providing clarity to the frameworks that form the basis of how the group has approached its review of New Zealand's current tax system.

The report is divided into 4 parts - Part I: Purposes and Frameworks, Part II: Issues and challenges, Part III: Interim conclusions, and Part IV: Summary. The report is also supplemented by appendices, including a relatively fulsome appendix on potential design features that should be considered for extending the taxation of capital gains.

In our latest Tax Tips Alert, we provide a detailed summary of the key aspects of the report.

Part I: Purposes and frameworks

Part I of the report provides the context in which the TWG is undertaking its review by setting out the purpose of New Zealand's tax system - that is, while it is essential as a source of revenue to the Government, it is also *an important tool that can be used positively to pursue distributional goals, shape behaviour, improve living standards, and develop sustainability*.

The TWG has taken this rounded purpose of the tax system into consideration in developing its recommendations. This is evident in the issues that have been identified and addressed in the report.

The report also sets out the frameworks (as outlined in *Future of Tax*) used by the TWG in assessing tax policy - The Living Standards Framework and Te Ao Māori, which are brought together to form a single framework. It also reaffirms the validity of the established principles of tax policy design (efficiency, equity and fairness, revenue integrity, fiscal adequacy, compliance and administration costs, and coherence) and notes two further important principles - predictability and certainty.

We agree with the TWG's view that the tax system has a wider purpose than just collecting revenue for the Government. We are supportive of the approach of adopting more rounded frameworks to ensure our tax system has a focus on the well being of New Zealand more generally.

Part II: Issues and challenges

The New Zealand tax system has some distinctive features, the first being that it relies on a narrow range of taxes - personal income tax, company tax, and GST. These three taxes raise about 90% of the Government's total tax revenues. Further, the tax system is not particularly progressive (the majority of the progressivity is delivered by the transfer system but, even taking that into consideration, it is still less than the OECD average) and the inconsistent taxation of capital income further exacerbates this.

With this in mind, as well as the issues that were identified in Future of Tax, the TWG assessed the structure, fairness, and balance of the tax system. The overall finding is that the inconsistent taxation of capital income raised concerns for the TWG including a question on the fairness of such treatment, the distributional impact as it is the wealthiest citizens who have the most untaxed capital gains, and tax revenue sustainability when considered against New Zealand's aging population.

The issues and challenges identified in the report are not surprising. In fact, a number of them were identified in Future of Tax. However, the report provides further insight as it outlines some key themes that came through from the almost 7,000 submissions made. It is useful to have these captured succinctly in the report to provide a backdrop for the interim conclusions reached.

Part III & IV: Interim conclusions

The report outlines the TWG's interim conclusions on 12 specific areas:

- Capital and wealth
- Retirement savings
- Housing affordability
- Environmental and ecological outcomes
- Corrective taxes
- International income tax
- GST and financial transaction taxes
- Personal income and the future of work
- The taxation of business
- The integrity of the tax system
- Charities
- The administration of the tax system

Capital and wealth

The report discusses the taxation of capital and wealth in some detail. It sets out the case for extending the taxation of capital mainly on the grounds of fairness. However, the interim conclusion is that the TWG is still forming its view on whether or not to recommend the introduction of a capital gains tax on the basis that the design of the approach (which the TWG is still working on) will be critical in helping them reach their final recommendation.

Rather, the TWG sets out the main policy considerations it will apply in forming its overall judgement as well as views on certain options and design features for extending the taxation of certain capital income.

The TWG's general view is that there are two main options:

- taxing realised gains that are not already taxed, or
- taxing certain assets on a deemed return basis e.g. a risk-free rate of return method

The report includes detailed discussion on more specific design features under both of the methods including the application to different types of assets (e.g. livestock, personal assets, and business assets), rollover relief, inflation adjustments, treatment of capital expenditure and losses and application to different entity types.

The TWG does, however, categorically rule out the introduction of a land tax and wealth taxes. On a land tax, the TWG is concerned with the social acceptability of a land tax given it will apply in addition to local government rates as well as the complexity of not having it apply to owner-occupied housing. On wealth taxes, they are generally complex to administer as the tax is levied on the value of the taxpayer's assets periodically (usually annually) and they also generally suffer from high levels of avoidance and evasion, which can reduce the integrity of the tax system.

The report highlights the complexity that surrounds the taxation of capital income. We are pleased to see that the TWG is taking a balanced and considered approach in forming its views on the taxation of capital income, including recognising that complexity may outweigh any advantages.

Retirement savings

The report notes the relevance of retirement savings especially in the light of New Zealand's changing demographics but cautions any change to the tax treatment must be considered from a national savings perspective. That is, the overall impact should be an increase in national saving (public saving and private saving) as opposed to shifting the saving from public to private or vice versa.

The TWG believes that there is a case to consider additional concessions for retirement saving but is mindful of the fiscal and distributional impact of poorly-designed concessions. With this in mind, the TWG recommends three key changes which are generally targeted at lower and middle income earners:

- remove ESCT on the employer's matching contribution of 3% of salary to KiwiSaver for members earning up to $48,000 per year
- reduce the lower PIE rates for KiwiSaver funds by five percent points each (passing the 5% reduction to all individuals)
- consider ways to simplify the determination of the PIE rates (which would apply to KiwiSaver).

Housing affordability

The report notes that the tax system is an influence on the demand for housing. However, the interim conclusion notes that, in simple terms, the cause of unaffordable housing is largely due to a shortage of supply to meet demand.

The TWG will have particular regard to housing market impacts as it finalises its recommendations regarding capital income.

Environmental or ecological outcomes

The TWG's interim conclusion is that there is significant scope for New Zealand's tax system to play a greater role in delivering positive environmental and ecological outcomes in New Zealand, recognising that tax can be a power tool in ensuring people and businesses better understand and account for the impact of their actions on the environment.

However, the report notes that tax is not a suitable tool for all environmental issues and, in those cases, regulation may be a better approach. The TWG outlines a framework that identifies a range of criteria and design principles for environmental taxes to be effective.

It is also interesting to note that the TWG sees a strong case to recycle some or all of the revenue from environmental taxes into measures that support the transition to a more sustainable economy. The use of revenue in this way to support the transition journeys of affected industries will be key to the political sustainability of such taxes.

In the short term, the TWG recommends:

- extending the coverage of the Waste Disposal Levy and for reassessing waste and landfill disposal externalities to see if higher rates are warranted
- strengthening the emissions trading scheme including the pricing of the units
- advancing congestion charging.

Over the medium term, the TWG considers there may be benefits from greater use of tax to address challenges in both water pollution and water abstractions but notes that Māori rights and interest in freshwater should be central to any changes.

In the longer term, the TWG recommends the development of new tools that expand the role of environmental taxes to address other challenges such as biodiversity loss and impacts on ecosystem services.

Corrective taxes

The TWG cautioned that the Government should be clear on the desired goals when considering the use of corrective taxes and also noted that regulatory changes may be more appropriate.

As such, the TWG recommends the following:

- reviewing the rate structure of alcohol excise with the intention of rationalising and simplifying it
- prioritising other measures to help stop smoking before considering further large increases in the tobacco excise rate
- developing a clearer articulation of its goals with regard to sugar consumption and gambling activity

International income tax

The report recognises that the taxation of multinationals is an area of concern for New Zealanders and specifically notes the challenges associated with digital services involving user value creation. The TWG sees two options for New Zealand - to change the current international tax frameworks e.g. expanding the definition of permanent establishment or the way profits are attributed or to apply a separate tax to certain digital supplies.

The TWG generally supports New Zealand's participation in OECD discussions on the future of the international tax frameworks but recommends being ready to implement an equalisation tax (a separate tax to certain digital supplies) if critical mass of other countries (including Australia) move in that direction.

The TWG also recommends that the Government ensures, to the extent possible, New Zealand's double tax agreements and trade agreements do not restrict New Zealand's taxation options in these matters.

GST

The TWG recognises the significant public concerns about GST but does not recommend a reduction in the rate of GST or removing GST from certain products such as food and drink. Such measures will be poorly targeted, and there are other more effective ways to achieve the desired goals of providing assistance to low and middle income families either through welfare transfers or personal income tax changes.

The interim conclusions also consider changing the GST treatment of financial services and the introduction of a financial transaction tax but does not recommend either.

Personal income and the future of work

The TWG recognises the importance of personal income tax as it is currently the largest source of revenue for the Government. It also recognises the need to test the current structure in the light of changes in the world of work.

The TWG notes that a large number of submissions were received on the rates and thresholds of income tax. However, the final recommendations on this will be addressed in the final report in February 2019.

The TWG's other interim conclusions in this area include:

- general support for Inland Revenue's efforts to increase compliance of the self-employed by using withholding tax as far as possible, including to platform providers such as ride sharing companies
- support for the facilitation of technology platforms to assist the self-employed with their tax obligations
- reviewing the current GST requirements for contractors who are akin to employees
- aligning employee and dependent contractors for tax and employment purposes.

The taxation of business

The TWG reviewed some of the key features of New Zealand's taxation of business, with a focus on company tax given its significance to New Zealand's revenue base. The TWG's interim conclusion is to largely maintain the current company tax regime, including retaining the imputation system and not reducing the company tax rate at the present time.

The TWG does not recommend introducing a progressive company tax (arguably achievable under look-through company structures already) or an alternative basis of taxation for smaller businesses (e.g. cashflow or turnover taxes). In particular, the TWG's view is that support for smaller business can be better achieved through reducing compliance costs including:

- increasing the $2,500 threshold for paying provisional tax to $5,000-$10,000
- increasing the $10,000 year-end closing stock adjustment to $20,000-$30,000
- increasing the $10,000 limit for automatic deduction for legal fees and potentially extending it to other expenses

The TWG also makes a number of recommendations in relation to the taxation of Māori authorities, including retaining the 17.5% rate and extending that rate to subsidiaries of Māori authorities.

The integrity of the tax system

The TWG recognises the importance of maintaining the integrity of the tax system and identifies four broad principles which it has applied in formulating its interim conclusion in this area. The four principles are:

- Income should be treated the same regardless of structure.
- All income should be reported.
- Inland Revenue has the capability to find and address integrity issues.
- Tax must be collected.

With those in mind, the TWG's recommendations include the following:

- reviewing the loss trading, potentially in tandem with a review of loss continuity rules for companies
- giving Inland Revenue the ability to pierce the corporate veil in relation to certain tax debts
- further actions in relation to the hidden economy including removing deductibility if a taxpayer has not followed labour income withholding or reporting rules
- Inland Revenue continues to invest in technical and investigative skills of staff
- establishing a centralised Crown debt collection agency to achieve economies of scale and more equitable outcomes across all Crown debtors.

Charities

The TWG believes that how the charitable sector is using what would otherwise be tax revenue available to the Government should be subject to review from time to time in order to verify that the social outcomes are being achieved. This is further supported by the fact that contributions to the charitable sector have increased over time. As such, the TWG supports the Government's inclusion of a review of the tax treatment of the charitable sector on its tax policy programme.

The report also notes that the income tax exemption for charitable entities' trading operations was perceived by some submitters to provide an unfair advantage over commercial entities' trading operations. However, the TWG notes that the underlying issue is the ability for charitable entities to accumulate surpluses rather than distributing or applying those surpluses for the benefit of their charitable activities. The TWG recommends that these issues be addressed.

In addition to the above, the TWG also recommends the following:

- consider whether to apply a distinction between privately-controlled foundations and other charitable organisations
- consider if amendments are required to the deregistration rules to make it more effective in keeping assets in the sector or to ensure there is no deferral benefits
- review the GST treatment of not-for profits, including considering if it is appropriate to treat some not-for-profits as final consumers or limit the GST concessions.

The administration of the tax system

The TWG focused on four key areas of tax administration that affects the public's perceptions of the tax system:

- the approach to tax secrecy and transparency
- the resolution of tax disputes
- the process for development of tax policy, and
- the way in which participants in the system perceive the purpose of the legislation.

The TWG's interim conclusions encourage Inland Revenue to publish and make available more data on the basis that it does not reveal information about individuals or confidential information about companies as well as collecting information associated with environmental outcomes.

The TWG also made a number of recommendations on tax administration, including:

- expanding the resources available to the Ombudsman including additional tax expertise to deal with complaints (including dealing with increased volumes due to the establishment of the new Crown debt collection agency)
- establishing a taxpayer advocate service to assist with the resolution of tax disputes.

Where to from here?

Labour has committed that any major change recommended by the TWG would not take effect until 1 April 2021 at the earliest. In thinking about how to respond to the TWG's interim report, it is important to understand the process from here.

There is a long and complicated journey to travel before any tax reform recommended by the TWG might actually be implemented. There are also multiple consultation points and potential political tipping points along the way. Take, for example, the proposed design of the capital gains tax discussed in the interim report. For that to actually apply in 1 April 2021, the following steps will need to be completed:

Step 1: the TWG completes its work and makes a firm recommendation for a CGT in its final report in February 2019.

Step 2: In March 2019, the parties of the coalition government, Labour, NZ First and the Greens, agree to take the recommended CGT forward as government policy.

Step 3: Around May 2019, detailed design is released in a discussion document and feedback sought.

Step 4: As a result of that feedback, the coalition government determines to continue with the proposed CGT and introduces a tax bill to Parliament around November 2019.

Step 5: That bill is worked through the select committee process and, after taking into account any changes that emerge in that process, by July 2020 the coalition government agrees to pass the legislation so that it comes into effect on 1 April 2021.

Step 6: The CGT will then become a key issue for the 2020 general election. Any coalition government formed after that election would likely need to involve Labour and the Greens in order for the CGT to remain on the statute books.

If one of the coalition parties withdraws support for the CGT at any stage along the way, it will be unlikely to eventuate. It is likely to be an interesting couple of years for tax policy watchers!

Please get in touch with your usual PwC adviser if you have any concerns or would like to discuss the potential impact of the interim conclusions.

Get in touch

Elly Ward
Partner
T: +64 4 462 7242
E: eleanor.x.ward@pwc.com

Sandy Lau
Director
T: +64 4 462 7523
E: sandy.m.lau@pwc.com