VICTORIA UNIVERSITY TAX WORKING GROUP

Fourth Session: Corporate Taxation 9 October 2009

The fourth session included:

- Presentations from Inland Revenue and Treasury followed by discussion on:
  - Tax on companies, and their impacts in a small open economy
  - Challenges in the current tax system
  - Alternatives to the current tax system: alignment of rates at 30%; a classical (Irish) system; a dual tax (Nordic) system, and an Allowance for Corporate Equity-Dual Income Tax model (the ACE-DIT model proposed for Australia by Sørensen and Johnson)[1]
  - Interim options for reform; and
  - Possible changes to the thin capitalisation rules.

Company tax - *presentations*

Corporate tax policy needs to choose the appropriate corporate tax base, the rate applied to this base, and the system for taxing the base. Interactions with personal tax systems are also an important part of corporate tax policy. Internationally, there is a trend towards the extension of corporate tax bases, and to lower the rate applied to these bases. This has seen the corporate tax take increase as a proportion of total taxation revenue, even where rates have been reduced. There has been no prominent international trend in the type of corporate tax system applied.

NZ corporate taxes raise 15% of our total tax revenue, compared to 11% across the OECD. If we want to maintain this level of tax revenue, we should consider whether it is possible to do so while reducing the deadweight costs associated with raising this revenue.

There are a number of challenges in the current corporate tax system:

- In the last decade, we have moved away from a broad base low rate strategy, and the corporate, personal, and trust tax rates are no longer aligned.
- The misalignment of the tax rates means that differing rates can apply to businesses, and provides incentives to hold income in companies. This has flow on implications for social assistance measures, and efficiency and equity.
- The company tax rate is relatively high. This undermines international competitiveness and inbound investment, and provides incentives for companies to stream profits overseas.
- New Zealand may need to change the corporate tax rate or system to respond to the Australian review and to maintain NZ's tax base and international competitiveness.

An economic framework for considering the taxation of inbound equity investment was presented. It was suggested that, under this framework (assuming that capital is highly mobile), it can be economically inefficient to impose company tax on non-resident equity investment. This is because imposing tax on the normal returns to capital that foreigners receive from New Zealand companies can result in less foreign equity investment and the New Zealand companies being required to provide a higher return to offset the company tax that is levied. When a higher return is required the company tax is ultimately borne by New Zealand residents (such as workers) through reduced productivity and wage rates. It was noted that the inefficiency that can result from taxing non-residents on normal returns to

[1] Peter Birch Sørensen and Shane Matthew Johnson, 'Taxing Capital Income - Options for Reform in Australia' available at http://taxreview.treasury.gov.au/content/Content.aspx?doc=html/conference.htm.

capital was the key factor prompting the Sorenson/Johnson ACE-DIT proposal that was being considered as part of the Australian Review.

It was emphasised that this framework relies on a number of important assumptions – including highly mobile capital, no economic rents (i.e. returns in excess of normal returns to capital) and foreign investors' not being able to use credits for New Zealand company tax paid in their own jurisdiction, and that capital is perfectly mobile. Evidence was presented suggesting that foreign-owned companies may be earning substantial location specific economic rents in New Zealand and, therefore, it may make sense to maintain the company tax rate.

Discussion

The group expressed concern about the lack of coherency of the tax system at present. This was due to the misalignment of rates and the differing rates applicable to savings through different entities. This influences investment decisions, provides incentives to shelter income in corporate or trust structures, and allows avoidance. It also questioned the sustainability of the status quo, and whether it was possible to strengthen the current system to remove some of these problems; or whether the only or best way to address these problems is to change the system.

It noted the key benefit of cutting the company tax rate is that company tax discourages investment, and particularly inbound foreign investment. The primary negatives associated with cutting the rate were the existence of location specific economic rents, as there are fewer costs associated with taxing company profits based on location-specific economic rents. Cutting taxation on these rents reduces revenue without the full efficiency benefits otherwise associated with lowering company tax rates. In addition, cutting the corporate tax rate further below that of the personal income tax rate would further undermine the integrity of the personal tax system.

The group felt that imputation was a good system; there was strong support for retaining imputation, particularly if company and personal tax rates were to be aligned. The fact that imputation is unusual to NZ, Australia and Mexico in the OECD is not, in itself, a reason to remove it.

The TWG agreed that the NZ company tax system needs to be able to respond to the changes made in the systems of our major investment partners, particularly any changes to the Australian company tax system that may result from the Australian tax review. Although changes to the company tax systems of our investment partners would not prescribe change here, the impacts of any changes on our tax base and international competitiveness need to be considered seriously.

Alternative company tax systems - *presentation*

Officials presented the impacts of different tax systems against a range of criteria:

- Efficiency and the impact on: savings; non-resident investment and productivity; treatment of economic rents; and labour supply
- Neutrality with respect to: investment decisions; and financing decisions
- Simplicity
- Coherence

The current system, with alignment – this would align the top rates of the personal tax scale and the company and trust tax rates. This would strengthen the imputation system; and is consistent with the Government's medium term objective of aligning rates at 30% although

alignment would also be possible at lower rates. The mobility of capital imposes a constraint on the scope to align at higher rates. If alignment is not possible, the group discussed the degree of misalignment that could be sustained with minimal distortions to avoidance incentives, and considered that misalignment of less than 3-6% between top personal and corporate/trust rates, may, with some strengthening measures, be sustainable.

Dual income taxes (Nordic system)
A dual income tax system would tax capital income at a lower rate than labour income, with the aim of promoting capital imports and reducing the deadweight loss associated with taxing capital income. This would mean that company tax was taxed at the capital income tax rate, and labour income at the personal income tax rate.

Classical (Irish system)
The classical (Irish) tax system would apply a low rate of tax on non-residents to attract capital imports. In practice, this would set a low company tax rate (e.g. 20%) for active company income, and a higher tax rate (e.g. 30%) for passive income. A measure would also be needed to discourage excess retention in companies.

Allowance for Corporate Equity and Dual Income Tax model (Sørenson-Johnson)
The Sørenson-Johnson ACE-DIT proposal has been suggested in the Australian tax review. This tax system would allow companies a deduction for the normal return on their equity, and would tax income in excess of the normal return. Shareholders would be taxed on their dividends, and also their accrued capital gains on shares in listed companies. Unlisted companies would be subject to excess retention tax. Individuals would be subject to a dual income tax rate with a progressive income tax schedule and a low capital income tax rate.

Discussion

The TWG agreed that there was considerable attraction in an imputation tax system with aligned rates, and that it was better than the status quo. But it had concerns about the feasibility of sustaining alignment if New Zealand has to significantly reduce the company tax rate (for example, in response to a move by Australia). The group considered that alignment above 30% is not desirable, as this would entail raising the corporate tax rate, and this would have negative efficiency implications.

The group considered that the dual income tax (Nordic) system was not a good option for New Zealand, primarily due to its bias against risky investments and entrepreneurship. Other concerns with dual income taxes included the treatment of employee shareholders (for example, in closely held companies), and the differences between NZ and other tax systems that have implemented dual income taxes (in particular, NZ’s high labour mobility). The group also noted the complexity of the system for administration.

The TWG generally agreed that the classical (Irish) system should be considered as an option if alignment were not considered possible or desirable; and should be particularly considered if a significant company tax rate cut is needed to help improve productivity and competitiveness. However, the group noted concerns around a classical system in relation to the distortions it could create, including: the incentives it provides to do some business through a company structure and to retain earnings but the incentive against doing business through a company in other cases; it’s “back to the future” nature; and its effects on savings, through double taxation at the personal level.

The Sørensen-Johnson ACE-DIT model was seen by the group as an interesting proposal in principle, as it reduces tax on investments but maintains tax on economic rents. For this reason the TWG felt that it should be kept under consideration, particularly if adopted elsewhere. However the group also noted that there were considerable concerns around

implementation and compliance with such a system, and several unknown factors, given that it has not been implemented in any country.

The TWG also discussed a scenario under which NZ domestic investment would be tax preferred, in order to retain companies in New Zealand that would otherwise relocate offshore. The group considered that targeting this would be difficult, and that the system would reduce efficiency by reducing the tax on economic rents. This would also have negative implications for investment, and would be difficult to enforce without a range of measures to support coherence.

Interim options for reform - *presentation*

If the options listed above were not possible in the short-term, two possible interim measures were considered:

1. Maintain and strengthen the current system. This would allow the personal and company tax rates to respond individually to international pressures or to redistribute income. Measures would include:
    - steps to prevent deferral of wage and investment income by sheltering in companies and trusts (38% trust rate, passive income at higher rates, excess retention tax).
    - steps to ensure that collective investment vehicles were taxed closer to individuals' marginal rates (PIEs/other saving entities/LAQCs).
2. Formalise dual rates for capital and labour. Treatment of investment at 30% under the PIE regime could be extended to other investment income, to remove distortions between choices of entity structures. There would continue to be fairness problems between labour and capital income and between incorporated and unincorporated businesses.

Both interim options would require further measures to ensure that all forms of income were included in the definition of income for social assistance targeting.

Discussion

The TWG group preferred option 2 as an interim measure if other systems cannot be aligned, but discussed how big an issue rate misalignment was. The group agreed that a gap of 3% to 6% between the corporate, top personal, and trust tax rates could cause problems. The group considered that option 1 was not a medium-long -term option, but was "repairs" and "maintenance" that need to be considered for our current system. The group concluded that a few changes would not significantly improve the current system, and that many things would need to be done to improve the system.

Thin cap rules - *presentation*

The purpose of the interest allocation (thin cap) rules is to prevent multinational groups over-allocating debt to New Zealand. As interest is deductible, high levels of debt can be used to lower taxable profits in New Zealand, and thus a company's effective rate of NZ tax. Further, Australia is our main source of foreign direct investment, and their imputation system provides a significant incentive to shift profits to Australia.

The interest allocation rules work by reference to two thresholds:

- A "safe harbour" threshold, which applies if the debt percentage of a New Zealand group does not exceed 75%. If it does, the second threshold applies.
- A New Zealand group should not have a debt percentage (debt-equity ratio) greater than 110% of the debt percentage of the worldwide group.

Changing the 75% safe harbour threshold would restrict the ability of foreign multinationals to over-allocate debt to New Zealand. Reducing this to 60% is estimated to increase revenue by $177 million.

There are also other trade-offs to be considered in determining the optimal threshold. If a lower safe harbour threshold may increase compliance costs due to the need for firms to monitor and adjust debt levels.

Discussion

The TWG noted that it is important to consider these thresholds in the context of international regimes, and particularly Australia's. At present, Australia applies the same thresholds as New Zealand. The group asked officials to undertake further work and to report back with details of the level of the thin capitalisation thresholds, and the application of these thresholds, in other countries.