Inland Revenue
Te Tari Taake

POLICY ADVICE DIVISION

PAD report: Where to from here for tax reform? Rate alignment and the company tax rate

Date:	28 January 2010	**Priority:**	**High**
Security Level:		**Report No:**	PAD2010/6

Action sought

	Action Sought	Deadline
Minister of Revenue	**Note** the issues raised in this report and **discuss** its contents with officials. **Refer** this report to the Minister of Finance.	5 February 2010 5 February 2010

Contact for telephone discussion (if required)

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Minister of Revenue

Where to from here for tax reform? Rate alignment and the company tax rate

Executive summary

The purpose of this report is to set out officials' views on rate alignment and the company tax rate in order to establish a policy framework for the tax initiatives of the 2010 Budget. The important rates for this alignment are the top personal tax rate and its relationship to the trust and company tax rates. Issues with respect to the tax rate for PIEs are also raised. It draws on the work and recommendations of the Tax Working Group (TWG).

The report addresses issues raised in two reports sent by Treasury to the Minister of Finance on 18 December and which he has referred to you (T2009/2714 on "Where to from here on tax reform?" and T2009/2747 on "Why do foreign-owned firms perform better than New Zealand-owned firms?" refer).

The first of the Treasury reports raises a number of issues which are outside the matters to be considered in the Budget (including capital gains tax, land tax, a dual income tax and taxing real income only). We make no comment on these issues. However, a key Treasury conclusion that is relevant to Budget matters is that the goal of alignment of tax rates is unattainable as international pressures would force the company and top personal tax rates to diverge. It states, "We have moved away from supporting an aligned system. Although there are strong integrity and administrative benefits of alignment, we've been persuaded that the environment in which we now find ourselves leads to the conclusion that lower non-aligned rates would give us a better economic return." The second report questions the importance of location-specific rents.

We have serious reservations about the conclusions contained in those reports.

We consider that moving toward a more aligned rate structure should remain a goal of the New Zealand tax system. In particular, while we agree with Treasury that full alignment of the company tax rate and top personal rates may not be feasible, we believe that there are good structural reasons for keeping the rates as closely aligned as possible. Moreover, so long as the degree of misalignment is not too large, we believe that the main incoherency in the current tax system can be corrected in a relatively straightforward fashion.

We believe that New Zealand's unique economic situation and tax system substantially mitigate the arguments for a divergence in tax rates that may apply in other countries, and that a reasonably aligned tax system is both desirable and feasible in the New Zealand context. We consider that a 33/33/30 system would achieve a reasonable level of alignment and would be sustainable without the need for additional corrective mechanisms.

We have considerable reservations over whether reducing the company tax rate is currently in New Zealand's best interest because it may largely reduce taxes paid by foreign residents, at the expense of New Zealanders.

The Australian government is examining the possibility of cutting company tax rates as part of the Henry Review. We recognise that New Zealand's company tax rate should be broadly competitive with Australia's which means that our tax rates should not get too far out of line. However, it may be feasible for New Zealand to maintain a somewhat higher company tax rate than Australia, so even if there were a small cut in Australia's rate it might be viable for New Zealand to maintain its current company tax rate. In any event, we doubt whether it makes sense for New Zealand to decide upon any specific cut in its company tax rate until Australia has indicated what it will be doing.

Recommended action

We recommend that you:

(a) **Note** that officials have serious reservations about some of the conclusions contained in Treasury Reports T2009/2714 and T2009/2747 and, in particular, doubts that the benefits of cutting the company tax rate outweigh the costs.

Noted

(b) **Note** that officials consider that there are benefits in awaiting the outcome of the Henry Review before making any decisions on the company tax rate.

Noted

(c) **Discuss** this report with officials.

Discussed

(d) **Refer** a copy of the report to the Minister of Finance.

Referred

Matt Benge
Assistant Deputy Commissioner
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Hon Peter Dunne
Minister of Revenue

Background

1. The focus of this report is the alignment of the tax rates and the appropriate company tax rate. It provides officials' response to recent Treasury reports that have been forwarded to the Minister of Revenue, (T2009/2714,"Where to from here on tax reform?" and T2009/2747, "Why do foreign-owned firms perform better than New Zealand-owned firms?" refer).

Goals

2. The goals of the medium-term tax strategy should be to produce a tax system which:

- ensures sustainable revenues to fund government expenditure and provides a secure base to meet future revenue pressures;
- minimises, to the extent possible, distortions and economic inefficiencies;
- is perceived to be fair; and
- minimises compliance and administrative costs arising from the payment of taxes and tax planning.

3. The tax system must be able to respond to increased globalisation and various changes in the international taxation environment. New Zealand can draw from the experience and research results of tax systems in other jurisdictions. However, the New Zealand tax system must be designed to reflect New Zealand's unique characteristics.

Problems with the current system

4. The TWG emphasised three problems with the current tax system in its report;

- The tax system relies too heavily on income taxes, particularly on capital income, with the exception of income from property investments which is under-taxed. This leads to inefficiencies and may impede growth.
- Misalignment of tax rates across entities undermines the coherence, integrity and fairness of the tax system. This can distort business structures and can lead to under-taxation of income from wealth relative to income from labour.
- A perception of unfairness combined with international pressures on company and personal tax rates may make it difficult to sustain taxation revenues and respond to future revenue pressures.

5. In the light of these concerns, some commentators have concluded New Zealand's tax system is "broken" and in need of radical restructuring. This conclusion appears too extreme. The New Zealand tax system remains a relatively efficient collector of tax revenues compared with other tax systems.

6. Our GST is widely seen as being world's best practice and both the Capital Market Development Taskforce and the Tax Working Group endorsed retention of our full imputation system (a company tax system which is now relatively rare). Across the board we have reasonably broad bases (and with the exception of the company tax rate which is now somewhat higher than the average in the OECD) relatively low rates. We believe that our general broad-based, low-rate approach is an attractive way of structuring a tax system. We also believe that the Generic Tax Policy Process (GTPP) normally leads to very high levels of consultation and good policy reforms.

7. Much has been made of New Zealand's high reliance on company tax and personal tax and that these are among the most growth retarding of taxes. This is based on work in a considerable number of studies (including OECD studies) that have concluded that this appears to be true drawing on data from a cross-section of countries. However, whether it is true for any particular country depends on the particular circumstances a country faces. As discussed later, if companies owned by non-residents generate economic rents from investing in New Zealand, cutting the company rate has the potential to provide a windfall to non-residents and lower GNP. Moreover, taxes may be badly distorting without necessarily affecting GDP or GNP. Thus, the efficiency of taxes cannot be measured merely in terms of their effects on these measures.

8. It is important to recognise that we do not have taxes such as payroll taxes and social policy taxes which some studies include (along with company tax and personal income tax) as the most growth retarding. A recent draft working paper from the OECD ranks New Zealand as 7th best in the OECD in terms of its percentage of tax take from the most growth retarding taxes. (It includes in this measure company tax, personal income tax, payroll and social policy taxes).

9. In our view, a review of the work undertaken so far does not warrant abandoning the underlying principles of the New Zealand tax system. Nevertheless, there are some important concerns, such as the taxation of property. We share concerns raised in the TWG that the rental property sector is significantly undertaxed. In our view, the most critical concern relates to pressures that have arisen from the misalignment of tax rates.

The key question – alignment of the company and personal tax rates

10. The key policy question at issue, which will underpin much of the tax policy development work towards the 2010 Budget, is the relationship between the company tax rate and the top personal tax rate. The rates of tax applied to trustee income relative to the top personal tax rate are also important. The rate of tax to be applied to PIEs will also need to be considered, depending upon changes to the other rates.

11. The Tax Working Group has stated that "The company, top personal and trust tax rates should be aligned to improve the system's integrity. If at any time this is no longer feasible due, for example, to global pressure causing the company rate to reduce, at the very least the trustee rate, top personal tax rate and top rate for portfolio investment entities (PIEs) and other

widely held savings vehicles need to be aligned, accompanied by the introduction of suitable fiscal integrity measures." We believe that this provides a coherent platform for reform.

12. Initially, the tax rates applying to companies, trusts and high-rate individuals were the same. Alignment of these rates conveyed significant benefits. Income generally faced the same rate of tax regardless of the form in which was earned, increasing economic efficiency and discouraging unproductive tax planning. Many complex features of other, less aligned tax systems were avoided.

13. However, subsequent deviations from that policy, increasing the top personal tax rate and lowering the company tax rate, have led to the integrity problems highlighted in Inland Revenue's Briefing to the Incoming Minister and the report of the TWG, in addition to distorting economic behaviour. There is a consensus that the degree of misalignment under the current system is unsustainable. The policy question is whether the problems should be addressed through changes that improve the alignment of tax rates, or should additional measures be introduced that provide scope for a substantial cut in the company tax rate and greater misalignment?

14. The former approach is clearly simpler and arguably more neutral. The question is whether there are other, over-riding, economic considerations that imply that the company tax rate should be significantly lower than the top personal tax rate.

15. Treasury has concluded that the balance of arguments is in favour of a divergent path between the company and personal tax rates and that, as a consequence, measures will need to be introduced to deal with the integrity problems this divergence entails.

We do not share this view. We believe that the New Zealand's unique economic situation and tax system substantially mitigate the arguments for a divergence in tax rates that may apply in other countries, and that a reasonably aligned tax system is both desirable and feasible in the New Zealand context.

Reasonably aligned tax system

16. The New Zealand tax rate structure originally had complete alignment of the company, trust and top personal tax rates. Complete alignment is may not be feasible as it would require either reversing the recent reduction in the company tax rate or making 30% the top personal tax rate in New Zealand. However, complete alignment is not necessary to substantially eliminate the integrity problems of the current system and avoid the need for complex anti-deferral measures.

17. The current misalignment of tax rates confers two types of benefits on taxpayers:

- *permanent benefits* are conveyed by the trust tax rate at 33%, and top PIE tax rate of 30%, compared with the 38% personal tax rate; and

- *deferral benefits* are conveyed by the company tax rate at 30%, as the difference between the company tax rate and the 38% top personal tax rate is clawed back by the imputation system when dividends are paid out of the company income.

18. Permanent benefits lead to greater integrity problems since, unlike deferral benefits, they do not have to be paid back when funds are paid out to the owners of the entity. The following table compares the increase in after-tax return on an investment in a bond, relative to the situation when the investment is held directly by an individual taxpayer, in four circumstances:

- a trust holds the investment;
- a trust owns a company which holds the investment and retains the earnings until distributed as a dividend subject to imputation;
- a company holds the investment and retains the earnings until distributed as a dividend to an individual subject to imputation; and
- a PIE holds the investment, the earnings of which are taxed at the capped tax rate equal to the company tax rate.

19. In each case it is assumed that the person ultimately owning the investment is an individual on the top marginal tax rate.

20. Consider a $100 investment in a bond earning a six percent rate of interest. If this bond were held directly by an individual on the top tax rate, they would earn $6 before tax, pay tax of 38% of $6 which is $2.28 for an after-tax return of $3.72. If, on the other hand, they placed the bond in a trust and the income was taxed at the trust rate of 33%, they would pay $1.98 of tax for an after-tax return of $4.02. The net increase of $.30 is 8% of $3.72 as reported in the first cell of the table.

Table 1

Percentage increase in after-tax return 38/33/30 rate structure				
	Year			
	1	**10**	**20**	**40**
Trust	8%	10%	11%	16%
Company owned by trust	8%	10%	14%	21%
Company owned by individual	0%	2%	5%	12%
PIE	13%	15%	19%	26%

21. Line 1: Holding an investment in a trust applies the 33% trust rate as a final tax on the income from an investment.[1]. A substantial benefit is obtained even for income which is distributed the year after it is earned. The benefit increases for retained earnings as the associated investment income faces the lower trust tax rate. This level of distortion has been sufficient to lead to considerable levels of tax planning on the part of taxpayers, evidenced by the rapid growth in trustee income relative to beneficiary income.

22. Line 2: The use of a company owned by a trust allows the investment income to be taxed at the 30% company tax rate until it is distributed, at which time it is effectively taxed at a final tax rate equal to the trust tax rate of 33%. This results, over time, in a distortion that is somewhat greater than an investment held directly by a trust.[2]

23. Line 3: The benefit of making the investment through a company is considerably less than in the previous two cases as the tax benefit is a deferral benefit only. The investment income is taxed at the 30% tax rate only as long as it is held in the company. Upon distribution, the imputation system ensures that the personal tax rate of 38% applies.

24. In many cases, individuals will wish to have immediate access to their income for consumption purposes. In that case, there is no benefit from earning investment income through a company, since the lower company tax rate is immediately clawed back through imputation. This result is reported in column 1 of Table 1. However, both of the trust structures provided benefits even if the income is immediately distributed because they provide reduced final tax rates that convey permanent benefits. The income is permanently sheltered from the higher 38% personal tax rate.

25. This suggests that the focus of tax rate changes to reduce misalignment pressures should be on eliminating the permanent differences provided by the trust rate. If increases in the trustee tax rate are ruled out, this would require returning the top personal tax rate to 33%.

26. Line 4: The table also demonstrates that the greatest distortion results from the use of a PIE to hold the investment. All income is taxed at the 30% company tax rate and is a final tax rate. The appropriate taxation of PIEs raises a number of issues that need to be discussed in the context of potential changes to other rates. It should be noted that in practice this distortion will be limited by the fact that PIEs can only be used to shelter certain forms of income, namely passive capital income.

27. Table 2 shows the distortions that would arise if a rate structure of 33/33/30 were applied; that is, the trust rate was aligned with the top personal tax rate of 33% and the company tax rate remained at 30%. PIE rates of 33 and 30% are also shown.

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[1] Trusts may also convey income splitting advantages, and can be of benefit if personal service income is earned through one.

[2] Until 2007/08 there was no tax advantage in this structure relative to direct ownership of the investment through a trust as the company and trustee tax rates were aligned at 33 percent. It is too soon to see in the data how structuring of investments into companies owned by trusts will have resulted from the reduction in the company rate to 30 percent. However anecdotal reports suggest that such restructuring is occurring.

Table 2

Percentage increase in after-tax return 33/33/30 rate structure	Year			
	1	**10**	**20**	**40**
Trust	0%	0%	0%	0%
Company owned by trust	0%	1%	3%	4%
Company owned by individual	0%	1%	3%	4%
PIE @ 33%	0%	0%	0%	0%
PIE @ 30%	4%	5%	6%	9%

28. A move to a 33/33/30 rate structure largely eliminates the problems associated with misalignment. Importantly, the benefits from flowing income through entities are entirely eliminated for funds that are distributed rather than being accumulated. If PIEs continue to be taxed at the 30% company tax rate, a benefit would remain for them, but would be greatly reduced, since the top personal tax rate would be reduced to 33%.

29. The TWG recommended that PIEs be taxed at the top rate. This would be necessary to remove artificial biases for people to use PIEs ahead of direct investments and to earn interest through PIE structures rather than normal bank accounts. This would provide a strong argument in favour of increasing the PIE tax rate as well as the tax rate on other widely held savings vehicles. However, this would mean higher tax rates on those on the top tax rate who invest in those KiwiSaver accounts that operate as PIEs.

30. This degree of misalignment is very small compared with levels of misalignment in many other countries. These countries have found it necessary to introduce a number of special measures to prevent individuals from sheltering personal income in companies, which include:

- different systems of company tax with higher taxes on shareholders when dividends are paid;
- taxing passive income such as interest, dividends and possibly rents received by either all companies or at least certain companies at the top personal marginal rate;
- taxing gains on selling shares in a company; and
- excess retention taxes whereby extra taxes would be levied on either all companies or at least certain companies which distribute too few dividends.

31. We believe it is possible and attractive to have a simple tax system without these additional base protection rules. None would be necessary with a 33/33/30 tax rate structure.

We consider that a 33/33/30 system would achieve a reasonable level of alignment and would be sustainable without the need for additional corrective mechanisms.

Should there be further company tax rate cuts?

32. Among OECD countries there has been a continuing trend toward lower company tax rates, although the aggregate share of company taxes in the economy has not fallen. Even with the recent reduction in the company tax rate, New Zealand has moved from having one of the lowest company tax rates in the world to one that is above the average tax rate internationally.

33. International trends have been driven by a number of factors:

- Most OECD countries implemented a change in approach to company taxation away from imposing high tax rates to a relatively narrow base, often riddled with incentives, to one of low rates applied to a broad base – this factor dominated until the mid-90s.
- The change toward lower rates and broad bases also was seen in the taxation of personal income.
- There has been some shift from taxation of income toward taxation of consumption.
- Competition for investment in an increasingly globalised world.
- Concerns about income shifting between countries at the expense of countries with relatively high tax rates.

34. The key questions are whether these factors should drive New Zealand to further reduce its company tax rate and, in particular, to abandon alignment as a goal and allow an increasing divergence of the company and personal tax rates.

Economic issues

35. There are a number of pros and cons in reducing the company tax rate.

36. Reasons to reduce the company tax rate include the following:

- Any positive company tax rate can reduce efficient inbound investment. The size of this distortion will increase with the company tax rate. By reducing investment and New Zealand’s capital stock, the tax can reduce the number of machines such as tractors, buildings and computers and make labour less productive and lower wage rate. Under some strong but unrealistic assumptions, including the absence of any economic rents, this tax can be shown to fall on domestic residents (predominantly workers) but in a less efficient way than if they were taxed directly. This issue has been important in the Henry Review’s consideration of tax reform options.

- Reduce incentives for profit streaming. The higher New Zealand's company tax rate is relative to company tax rates in other countries, the greater will be incentives for multinational firms to stream profits away from New Zealand.

- Problems in measuring economic income perfectly (including the difficulty of measuring how assets actually depreciate) means there will inevitably be distortions to investment decisions. These will rise with the company tax rate.

37. Perhaps for the reasons outlined above, studies have concluded that high levels of company taxes can impede efficiency and growth.

38. On the other hand, there are a number of reasons against cutting the company tax rate:

- Foreign inbound investment may often generate economic rents (that is, returns that are higher than the minimum that would be required to justify the investment). In this case if the economic rents are location-specific (that is associated with operating in New Zealand), this can be a very efficient tax. This is particularly true from a New Zealand perspective when the tax is borne by non-resident firms investing in New Zealand.

- 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, reducing the company tax rate can provide a transfer from New Zealand to foreign treasuries rather than encouraging additional inbound investment.

- Integrity of the personal income tax system. As we have discussed, the closer the company tax rate is to higher rates of personal income tax, the less can companies be used to shelter income from these higher rates of personal tax.

39. In our view, a key reason against cutting the company tax rate is the possibility of location-specific economic rents. If these are important, cutting the company tax rate has the potential to provide a windfall to foreign parent companies without necessarily affecting domestic activity very much. If replacement taxes need to be levied on New Zealanders, this has the potential to make New Zealand as a whole worse off.

40. It should be noted that there are two quite different types of economic rents: firm-specific economic rents and location-specific economic rents. A firm with a superior process or product (for example IBM) may earn firm-specific economic rents. It may be looking around the world for the best place to locate a plant to produce goods to export into third countries. It will not generally be possible for a small open economy to be able to levy high taxes on these rents. If it attempts to do so, the firm can always choose to locate its plant elsewhere. Location-specific economic rents are rents associated with locating in a specific country. Location-specific rents are likely to be particularly important if a firm must locate in an economy to sell its goods or services to people living in that economy. Location-specific rents can also arise through proximity to natural resources or well-developed infrastructure.

41. A critical issue for New Zealand in assessing how best it should tax companies is the importance of location-specific economic rents. If firms such as New Zealand subsidiaries of foreign parent companies need to be in New Zealand to serve the New Zealand market, these firms may be quite insensitive to New Zealand's company tax rate.

42. Location-specific rents are likely to be a bigger issue for an island economy like New Zealand than for a land-locked country in Europe. For example, a firm that is deciding to set up a plant either in Germany, the Czech Republic or Slovakia may be able to supply much the same market from a plant located in any of these countries. This means that none of these countries might have much ability to tax any economic rents without the danger of the plant relocating to the other country. This is likely to be less of an issue for an island economy such as New Zealand if the bulk of foreign investment is in New Zealand to provide goods and services for the New Zealand market. Evidence on economic rents is provided in the Appendix.

43. Thus, care must be taken in importing international experience into New Zealand. New Zealand has a unique economic situation given its geographical isolation, which distinguishes it in particular from the European experience.

44. A substantial part of the New Zealand company tax base for non-resident owned companies involves location-specific activities, that is, the activity must be carried out in New Zealand. Location-specific industries are those which must be carried out in New Zealand either to access raw materials (forestry, mining and oil and gas) or to supply New Zealand markets (retail banking, telecoms and merchandising).

45. It is important to note that some firm-specific rents are still location-specific in this sense, if the production of the goods or services cannot be sourced from offshore or if it is uneconomic to do so.

46. The Treasury in its report T2009/2747 argued that there are a number of reasons for the data reported in our Appendix other than location-specific economic rents. These are:

- foreign firms invest in high performing local firms; and
- foreign firms bring new techniques and skills to improve productivity.

47. However, if foreign firms invest in high performing local firms there would appear to be two possibilities. Either the high performance is captured in the price that the foreign firm pays for shares in the domestic firms. In this case there would be no evidence of the above normal returns reported in the Appendix. The other is that they are able to acquire shares at a price that is less than they would be prepared to pay and that as a result they earn economic rents. However, in this case these are rents we can tax. Similarly if foreign firms generate economic rents by bringing new techniques and skills to improve productivity but are doing so to access the domestic market, these will again be economic rents that we can tax. To this extent they will be in part location-specific and able to be taxed.

48. There is little evidence of non-resident businesses using New Zealand to supply world markets (where rents would be likely to be firm-specific and location decisions sensitive to company tax rates). It might possibly be argued that a reason that New Zealand is not used as a hub by international firms for establishing plants which export into other markets in our region is its relatively high company tax rate. However, New Zealand was not chosen for these activities when its company rate was lower than average and so is unlikely to be losing substantial amounts of such activity if its current rate is somewhat higher than average.

49. When there are substantial location-specific rents, reducing company taxes on non-resident companies has the potential to provide a windfall to foreign-owned companies and lower GNP. To the extent that these taxes need to be replaced by taxes on New Zealand taxpayers, this has the potential to make New Zealand as a whole worse off. This would be true even if the replacement taxes were perfectly efficient and non-distorting. In practice, replacement taxes are likely to be distorting which makes the equation even worse for New Zealand. When considering the benefits to New Zealand of cutting the company tax rate it is worth noting that roughly a quarter of our company tax base comes from taxes on foreign-owned banks and oil companies.

50. Moreover, personal tax rates may matter more in New Zealand than in other countries. New Zealand's skilled labour market appears to be particularly internationally mobile and potentially sensitive to personal tax rates. A substantial part of New Zealand business activity is carried out by closely held companies where the top personal tax rate could have an impact on residency and investment decisions, although trust structures have mitigated their impact.

51. This is closely associated with another reason why cutting the company tax rate in New Zealand may have a very different effect from doing so in the average OECD country. Our imputation system means that for companies owned by domestic residents, there is only a deferral effect when the company tax rate is cut. Lower company tax payments are balanced by higher shareholder taxes when dividends are paid. Cutting the company rate may have a muted effect on investment and productivity for such firms. By contrast, foreign-owned firms will often receive the full benefit of any company rate cut.

52. A substantial part of the move toward lower company tax rates has been driven by trends in Europe. However, the European situation is in stark contrast to New Zealand's position:

- Different jurisdictions are embedded in a geographical contiguous economic market.
- Firms can choose among jurisdictions to supply the broader market, with few institutional or physical barriers to trade, so that activities are less likely to be location-specific. In this case, tax rates are more likely to affect location decisions.
- Language and cultural barriers mean that labour mobility lags behind the mobility of capital.

53. It might be expected that these considerations would mean that countries which are geographically isolated would tend to have higher company tax rates. Indeed there is some empirical evidence of a distance effect – that the pressures of tax rate differentials fall as the distance between two countries increases. No country is further from the rest of the world than New Zealand.

54. Given these substantial differences, we are concerned that the costs to New Zealand of shifting the tax burden from non-resident companies to domestic residents are likely to be more substantial in New Zealand than other countries. At the same time, the benefits of reducing company taxes in generating increased activity and growth by attracting higher levels of FDI are likely to be smaller.

Accordingly, we do not believe that the net economic benefits of cutting the company tax rate would outweigh the complexity and inefficiencies that arise when there is significant divergence between the top personal tax rate and the company tax rate.

Tax structural issues

55. The tax structural issues can be divided between international issues, in particular the effect of the company tax rate on the allocation of taxable income among jurisdictions and the role the company tax system plays in maintaining the integrity of the tax system, particularly in acting as a backstop in protecting personal tax revenues.

56. International evidence suggests that higher company tax rates engender more international tax planning. Losses sustained to planning can cause tax rates on other taxpayers to rise, but may not encourage greater investment to compensate.

57. Up to now, New Zealand has been able to maintain its relatively high reliance on company taxes, even when its rate was greater than Australia's. In contrast, the experience in other countries, such as the US, is that non-resident firms report lower profit levels than domestic firms, potentially indicating profit shifting.

58. New Zealand has robust anti-tax base shifting rules compared with other countries. Its interest allocation rules are much more robust than most and have been enhanced by the recent reform of the international tax rules. Anti-arbitrage rules introduced in the international tax review and the repeal of the grey list provide enhanced protection against international arbitrage transactions.

59. While obviously there are limits to how out-of-line a country's company tax rate can be, there is little evidence that New Zealand's current rate raises undue risks for the New Zealand tax base.

60. Domestically, the company tax system plays a critical role as a backstop to the personal tax system. Problems of misalignment, that arise when tax rates diverge, are essentially a failure of the company tax system to fulfil that role.

61. The foregoing analysis suggests that with a 33/33/30 rate structure, problems from misalignment are minimal. The rates are close enough that the company tax system does in fact support the personal income tax rates.

62. The questions arises, at what level of difference in tax rates are the problems from misalignment sufficient to imply that corrective mechanisms such as changes to the company tax system, taxes on gains in shares, surtaxes on passive investment income earned by companies or excess retention taxes are needed. As noted above, the critical tax rates to have aligned are the trust and top personal tax rates. Divergences between the company rate and the personal rate of tax are mitigated by the imputation system, since benefits can be obtained only to the extent that funds are actually retained in the company. A divergence of three percentage points appears sustainable. As the divergence in tax rates increases beyond three percentage points, pressure will increase. It is a matter of judgement how much divergence is sustainable without requiring complex rules to buttress the personal income tax system.

63. Table 3 shows the increase in distortions that would arise from a further reduction of the company tax rate to 28%, while the top personal and trust rates are aligned at 33%.

Table 3

Percentage increase in after-tax return 33/33/28 rate structure				
	Year			
	1	**10**	**20**	**40**
Trust	0%	0%	0%	0%
Company owned by trust	0%	1%	3%	7%
Company owned by individual	0%	1%	3%	7%
PIE @ 33%	0%	0%	0%	0%
PIE @ 30%	4%	5%	6%	9%
PIE @ 28%	7%	9%	11%	15%

64. The table shows that, provided the PIE rate is aligned with the company rate, distortions for investments held in companies remain reasonably small, except for very long holding periods. Reducing PIE rates along with the company rate would lead to substantial distortions in favour of such vehicles.

65. Divergences in tax rates can also cause pressures for individuals to try to extract retained earnings from companies without paying taxes on dividends, (so-called dividend stripping). Capital gains taxes are sometimes used to mitigate these pressures. The amount of pressure depends upon the divergence of company and personal tax rates. The pressure for dividend stripping that arises from misalignment can be seen by looking at the results for PIEs reported in the previous tables. Dividend stripping turns the company tax rate into a final tax, the same situation as with a PIE taxed at the company rate. The tables indicate that the

incentive for dividend stripping would be reduced compared with the current system. At the level of rate divergence under discussion, our view is that current anti-dividend stripping rules in New Zealand appear to be adequate without the structural recourse of a capital gains tax.

More analysis is required before determining the extent and nature of integrity measures that would be required if the company tax rate were to be reduced below 30%.

What about Australia?

66. It is commonly expected that Australia will announce in its budget some limited company tax rate cuts, arising from the Henry Review. However, there remains uncertainty about the size of the cuts. In our view it would be sensible to wait to see Australia's decision in this area before deciding if or how much to cut our company rate.

67. Should New Zealand necessarily follow Australia in this area? Are the arguments made above for maintaining a 30% rate overturned by a reduction in the Australian rate?

68. The New Zealand rate was three percentage points higher than Australia's between 2001 and 2008 without significant problems. Moreover, Australia's imputation system provides a significant incentive for Australian-owned firms to pay Australian rather than New Zealand tax. This effect would swamp the impact of any small rate differential. Moving to mutual recognition is the most effective way to reduce pressures on the New Zealand tax base with respect to Australian-owned companies.

69. Nevertheless we recognise that Australia's proximity and relationship with New Zealand means that a reduction in Australia's rate would increase pressure for a reduction of the New Zealand company tax rate.

70. While clearly New Zealand's company tax rate cannot be substantially out of line with Australia's, our experience does not suggest that we must exactly match Australia to maintain a competitive tax system.

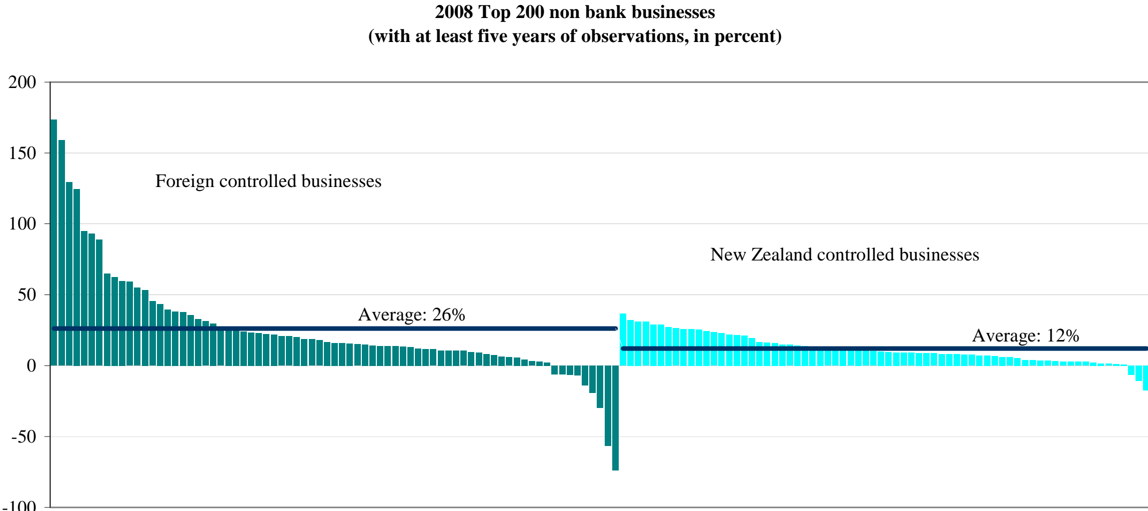
We believe that uncertainty about Australia's future rate announcements is consistent with delaying making decisions to reduce company tax rates at this time.

Appendix: Economic rents

As far as we are aware, there are no international studies that attempt to quantify the likely size of economic rents. Economic rents may be hard to find. For example, rents may be captured by one firm when it sells assets to another. In this case the firm acquiring the assets may generate a normal after-tax return on capital even though there are important economic rents.

Nevertheless, to attempt to look at the question of economic rents, officials have examined data for New Zealand's top 200 non-bank businesses from the NZ Management database.[3] Data is reported in Figure 1. These are the average returns over a 10-year period for firms with at least five years of observations. The average after-tax return on total equity for foreign controlled firms is about 26% compared with around 12% for New Zealand-controlled businesses.

Figure 1: After-tax returns on equity



The top 200 businesses are identified as follows. Each year the NZ Management magazine writes to 1000 of New Zealand's top businesses to collect annual reports, which are reviewed in a process overseen by Deloitte.
Return on total equity is calculated by profit after-tax divided by average total equity over the past two years.

Source: NZ Management and Inland Revenue

Whether or not this is evidence of economic rents is an open question. A high average rate of return on equity may be feasible for highly-geared firms and foreign-owned firms may often be more highly geared than domestic firms. Thus, we endeavoured to estimate an after-tax return on total assets. Here we found an after-tax return for foreign-owned firms of 1 %and for domestic-owned firms of 10%.

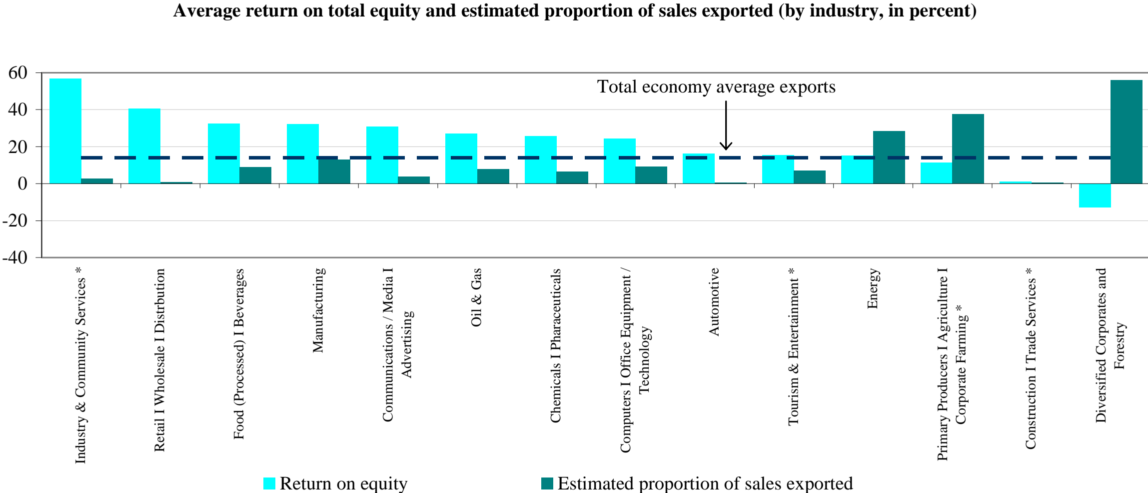
It is possible that economic rents exist but these are firm-specific rather than location-specific. Rents could exist because firms have established plants in New Zealand from which to sell goods into our region rather than to sell goods to New Zealanders only. It might be expected

[3] http://www.management.co.nz/top200/

that if there were important amounts of firm-specific economic rents from New Zealand subsidiaries of foreign parents, these would tend to be associated with high levels of exports.

To test this, officials attempted to estimate exports as a percentage of total sales for the foreign-controlled firms included in the top-200 survey. Results are reported in Figure 2. Interestingly, there appears to be no evidence that high after-tax rates of return are associated with high levels of export performance. This suggests that any rents may be more likely to be location-specific than firm-specific.

Figure 2: Foreign-controlled businesses operation in New Zealand



Businesses with at least five years of data are included.
The proportion of sales exported is measured by the average zero GST rated sales to total sales for 2007 to 2009.
* The industry average is reported due to data confidentiality. It is measured by exports as a proportion of gross output using 2005/06 input-output data from http://www.motu.org.nz/files/datasets/IO2005-06.xls.

Source: NZ Management, Inland Revenue and Motu Economic and Public Policy Research