Inland Revenue
Te Tari Taake

POLICY ADVICE DIVISION

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: The company tax rate

Date:	12 March 2010	Priority:	**High**
Security Level:		**Report No:**	T2010/373 PAD2010/43

Action sought

	Action Sought	Deadline
Minister of Finance	**Note** the issues raised in this report and **agree** to the recommendations. **Refer** report to Ministerial sub-group on tax.	22 March 2010
Minister of Revenue	**Note** the issues raised in this report and **agree** to the recommendations. **Refer** report to Ministerial sub-group on tax.	22 March 2010

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12 February 2010

Minister of Finance
Minister of Revenue

The company tax rate

Executive summary

The purpose of this report is to discuss whether the company tax rate should be reduced to 28 percent. Decisions about the level of company taxes will be made in the context of the wider tax package.

Key issues

The key issues to be addressed are:

- the extent to which company tax collections should be increased to fund personal tax rate reductions; and,

if the burden on companies is to be reduced relative to the base scenario, whether:

- to maintain the company tax rate at 30 percent and relax some base broadening measures affecting companies; or
- reduce the company tax rate to 28 percent.

Company tax in the overall package

The overall goals of the tax reform package are to improve efficiency and growth and deal with current integrity issues in a manner which is fair. The cornerstone of the tax reform is a shift in the balance of government tax revenues from income taxes to GST. This shift is expected to increase the growth potential of the New Zealand economy.

However, increasing consumption taxes raises concerns about fairness. The reform will therefore contain across the board reductions in personal income tax rates and other measures to ensure that most individual New Zealanders are no worse off.

Base-broadening measures will be required to achieve this goal. Base-broadening can be efficiency enhancing in its own right. For example, increasing taxation of the property sector is intended to reduce existing tax preferences and shift investment to more efficient uses.

Reductions in personal tax rates will increase the incentives for New Zealanders to work, save and invest and encourage productive skilled workers to remain in New Zealand. The alignment of the trust and top personal tax rates also deals with concerns about the integrity of the tax system expressed by the TWG and others.

However, the package is also to be broadly revenue neutral. Achieving the desired degree of fairness in the personal tax system will imply base-broadening that impacts the company sector and will have an impact on their incentive to invest.

The extent to which the burden of taxation should be shifted from individuals to companies focuses on the trade-off between supporting the fairness of the tax system with across the board personal tax rate reductions versus raising taxes on investment.

The package of reforms could be rebalanced either by finding additional base-broadening measures that affect individuals or by modifying the base scenario of personal tax rates. If sufficient funds can be released through these means, it would be possible to reduce the impact of the package on companies.

This relief, relative to the base scenario, could be accomplished by either reducing the company tax rate to 28 percent or by scaling back some of the base-broadening initiatives in the base scenario. The reduction in the company tax rate would have a fiscal cost of about $400 million per year.

The Treasury is of the view that this would be best accomplished by reducing the company tax rate to 28 percent. The IRD believes that the rate should remain at 30 percent and relief be provided by scaling back certain base-broadening measures. These two views are outlined below.

The Treasury position

The current package being considered by Ministers is broadly consistent with a growth, savings and investment theme, with a re-weighting from income tax to GST, reducing tax preferences on property, and integrity measures such as thin capitalisation and LAQC changes.

The stark potential inconsistency is the company tax rate. In the absence of a reduction in this rate, the base broadening measures will increase the total tax burden on companies, equivalent to returning to a 33% company tax rate.

The primary policy motivation for these base broadening measures is to reduce tax preferences for particular forms of investment. Reducing these preferences causes capital to flow to investments that are more productive for the economy as a whole. However, in the absence of rate reductions, these measures do push up average tax rates on investment. The solution is to use base-broadening revenues to lower tax rates. This redirects capital to more productive uses and reduces tax on fully-taxed activities. These two policy "wins" are the logic behind the "broad-base low-rate" approach.

Treasury also considers that a reduction in the company tax rate would encourage increased foreign investment in New Zealand, which is likely to deepen the capital stock and improve productivity. While foreign investment consists of a combination of inframarginal investments (economic rents) and marginal investments, clearly some new marginal investment would take place.

Concerns with distortions caused by a 5c gap between the company and top personal tax rates need to be kept in perspective. A 5c gap would be an improvement on the status quo. It is less than the current 8c gap, and less than the historic 6c gap between the 33c company and 39c personal tax rate.

From a strategic perspective, we see risks in New Zealand, as a capital-shallow investment-seeking economy, having a statutory tax rate for companies that is increasingly out of step with OECD comparators, then driving the effective tax rate even higher through base broadening measures without offsetting tax rate reductions.

The IRD position

Compared to other countries, New Zealand has unique economic, location and tax system features. Unlike countries in Europe and North America, New Zealand is not competing for tax sensitive investments as part of a large continental market, we have an imputation system and the small difference between our company and top personal tax rate means that we can capture the efficiency and simplification benefits of having alignment of tax rates. Taking these features into account, the IRD is of the view that reducing the company tax rate would be inconsistent with a number of the objectives of the tax reform.

To the extent that companies are earning rents, reducing tax rates provides windfall gains to investors. This is particularly costly from the point of view of New Zealand as a whole when such rents are earned by foreigners.

When considering the tradeoffs between reducing depreciation and reducing tax rates in a revenue neutral manner, the reduced taxes on rent earning sectors implies taxes are likely to increase in capital intensive sectors. Thus reducing the company tax rate, funded by less depreciation, is likely to have the perverse effect of reducing incentives to invest in New Zealand. Scaling back on depreciation measures is likely to be more cost-effective than reducing the company tax rate as a way of promoting investment.

Reducing the company tax rate will also reintroduce incoherence into the taxation of savings vehicles. Savings would be subject to a 33 percent rate if held directly, 30 percent if held by a PIE and 28 percent if held in a unit trust, life insurance plans and other special instruments. Resolving these issues would be very complex and would need intensive consultation. Such incoherence would move away from explicit recommendations of the TWG for greater coherence in the taxation of savings.

Aligning company and personal tax rates is itself efficiency enhancing as well as dealing with integrity issues in the simplest possible manner.

If Ministers wish to reduce the impact on companies as part of a rebalancing of the overall package, the IRD would recommend that this be accomplished by scaling back on the depreciation changes rather than reducing the company tax rate.

Recommended action

We recommend (subject to final decisions on a tax package for Budget 2010) that Ministers:

(a) **Note** that if the impact of reform on the corporate sector is to be rebalanced relative to the base scenario, relief could be provided by either reducing the company tax rate to 28 percent or scaling back base-broadening measures.

Noted Noted

If such relief is to be provided, either:

The Treasury's view

(b) **Agree** that, the company tax rate be reduced to 28 percent.

Agreed/Not Agreed Agreed/Not Agreed

Or,

The Inland Revenue's view

(c) **Agree** that, the company tax rate be maintained at 30 percent and relief provided by scaling back depreciation changes.

Agreed/Not Agreed Agreed/Not Agreed

(d) **Note** that the Treasury and Inland Revenue agree that a 33/33/30 tax rate structure would be sustainable without additional integrity protection measures. The Treasury

considers that a 33/33/28 tax rate structure may require integrity protection measures, while Inland Revenue considers that they would not be required.

Noted | Noted

(e) **Agree** that if Ministers agree to reduce the company tax rate, officials are to report back after Budget 2010 on possible integrity protection measures.

Agreed/Not Agreed | Agreed/Not Agreed

(f) **Agree** that if the company tax rate is to be reduced, the tax rate of Category A Group Investment Funds be aligned with the company tax rate.

Agreed/Not Agreed | Agreed/Not Agreed

(g) **Note** that if the company tax rate is to be reduced, the tax rate for the shareholder income base of a life insurance company would be aligned with the reduced company tax rate while the policyholder income base would remain at 30%. This would be reviewed as a matter of urgency after the Budget.

Noted | Noted

(h) **Agree** that the tax rate for various savings entities be reviewed as a matter or urgency after the Budget.

Agreed/Not Agreed | Agreed/Not Agreed

(i) **Agree** that if the company tax rate is reduced, decisions on the final package include consideration of permitting a two year transitional period during which pre-existing imputation credits can be attached to dividends at the current maximum 30:70 imputation ratio.

Agreed/Not Agreed | Agreed/Not Agreed

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Background

1. The purpose of this report is to discuss whether the company tax rate should be reduced as part the package of tax reforms to be announced in the Budget.

2. Fundamental questions of tax and economic policy are raised by the issues discussed in this report. Some of these have been addressed in reports sent previously to Ministers, (T2009/2714 on "Where to from here on tax reform?" and PAD2010/6 on "Where to from here for tax reform? Rate alignment and the company tax rate" refer).

Major decisions required

3. The key issues to be addressed are:

- the extent to which company tax collections should be increased to fund personal tax rate reductions; and,

if the burden on companies is to be reduced relative to the base scenario, whether:

- to maintain the company tax rate at 30 percent and relax some base broadening measures affecting companies; or
- reduce the company tax rate to 28 percent.

4. If company tax rate reductions are to be considered,

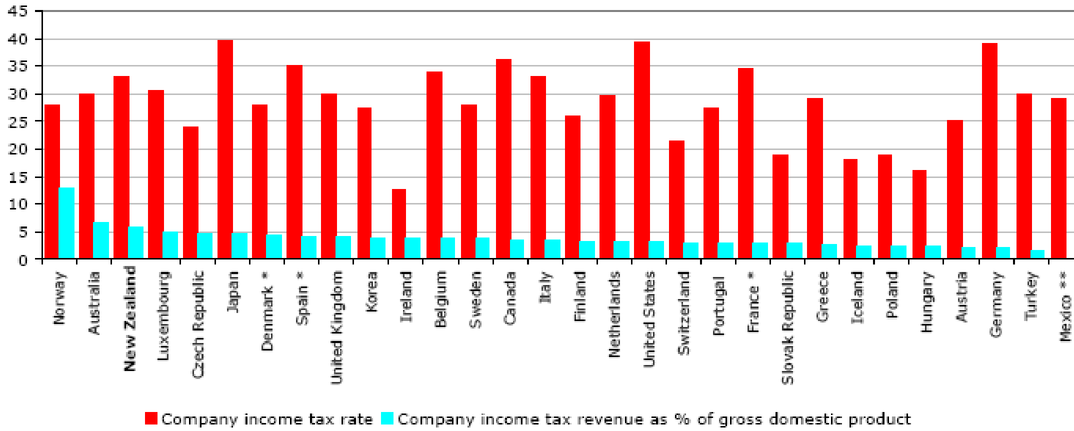
- should they be part of a Budget announcement or part of a post-Budget process; and,
- would special integrity measures need to be introduced; and, if so, which ones?

These issues were discussed in the report, Tax system integrity and the alignment of tax rates, (T2010/119, PAD2010/07 refers).

Context

5. New Zealand currently has an above average corporate tax rate by international standards, and in 2006 (prior to the company tax rate being reduced to 30%) had the third-highest company tax take as a share of GDP.

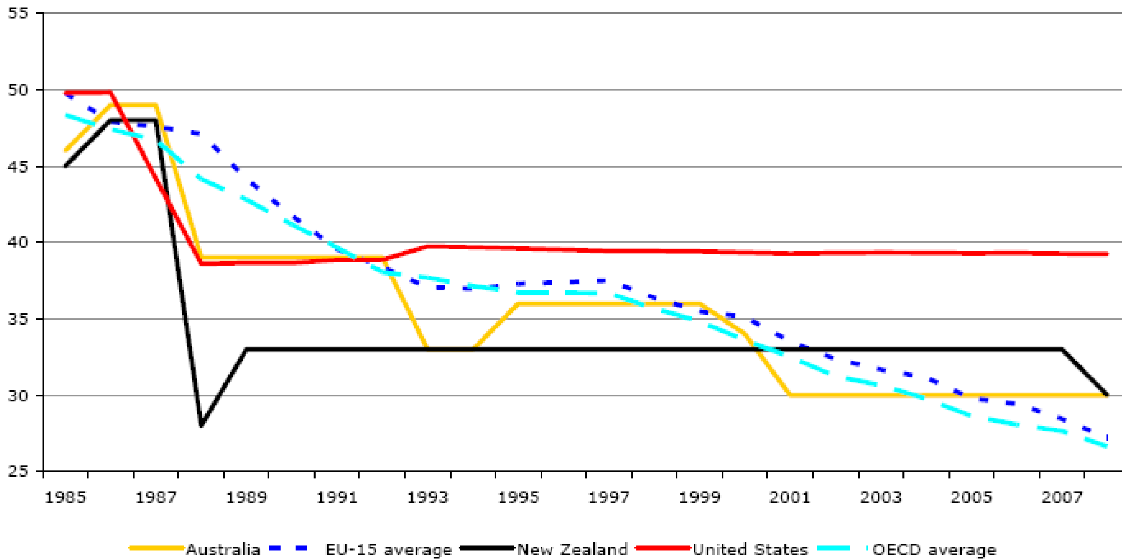
Figure 7: Company income tax rates and revenues (2006, in percent)



Note: Countries are ranked from highest company income tax revenue as % of gross domestic product to lowest. The comparisons include all levels of government.
* The total tax revenues have been reduced by the amount of capital transfer. The capital transfer has been allocated between tax headings in proportion to the reported tax revenue.
** Company income tax revenue not available.
Source: OECD

6. In the late 1980's, New Zealand had a very low company tax rate compared to other OECD countries. Since then company tax rates have fallen around the world. Despite New Zealand's recent reduction to 30 percent, it still is above average by OECD standards.

Figure 14: Historical trends in statutory company tax rates (in percent)



Source: OECD

7. At the same time there are a number of particular features of New Zealand that are noteworthy. New Zealand is a relatively isolated economy with not only mobile capital but also very mobile skilled labour. On a recent OECD review New Zealand was found to have 17 percent of skilled New Zealanders living abroad, (the third highest percentage after Ireland and Luxembourg). It also is one of the few OECD countries (along with Australia) with a full imputation company tax system.

How the company tax fits into the overall package

8. The overall goals of the tax reform package are to improve efficiency and growth and deal with current integrity issues in a manner which is fair. The cornerstone of the tax reform is a shift in the balance of government tax revenues from income taxes to GST. This shift is expected to increase the growth potential of the New Zealand economy.

9. However, increasing consumption taxes and lowering income taxes raises concerns about fairness. The reform will therefore contain across the board reductions in personal income tax rates as well as other measures to compensate vulnerable individuals for the increase in GST. Ensuring that most individual New Zealanders are no worse off implies that other base-broadening measures will be required to fund personal tax rate reductions and other compensatory measures.

10. Base-broadening can be efficiency enhancing in its own right to the extent that it brings taxation of particular activities more in line with their underlying economic returns. For example, increasing taxation of income from property, through reductions in depreciation and possibly other measures, is intended to reduce existing tax preferences and shift investment to more efficient uses.

11. By financing reductions in personal tax rates, the base broadening measures will have a second important impact on efficiency. This will increase the incentives for New Zealanders to work, save and invest and encourage productive skilled workers to remain in New Zealand.

12. However, the package is also to be broadly revenue neutral. Achieving the desired degree of fairness in the personal tax system will imply base-broadening that impacts the company sector and will have an impact on their incentive to invest. The extent to which the burden of taxation should be shifted from individuals to companies focuses on the trade-off between supporting the fairness of the tax system with across the board personal tax rate reductions versus raising taxes on investment.

13. An indicative impact on income earned through companies is given by the following:

- Commercial and industrial building depreciation $440 million
- Removal of depreciation loading $160 million
- Change to thin capitalisation safe-harbour $210 million
- Reduced taxation of dividends ($190 million)
- Total $620 million

14. Care must be taken in interpreting the impact on companies and the consequential impact on growth. Some of the burden of any increase in company tax is likely to fall on domestic shareholders of New Zealand firms. To that extent, the split between company tax and personal tax is somewhat artificial. Moreover some of the costs will be offset by

reductions in the personal taxes of such income. The impact on companies relying on domestic capital markets is offset somewhat by the reduced taxation of dividends received by individuals from companies. This reduces taxes paid by residents on profits distributed from companies.

15. A particular concern may arise that increases in taxes paid by non-resident owned companies could deter foreign portfolio investment (FPI) and foreign direct investment (FDI) into New Zealand. The depreciation measures will affect both FPI and FDI.

16. Other measures impacting non-resident-owned companies may involve New Zealand gaining more revenue at the expense of foreign Treasuries. For example, the thin capitalisation provisions will require foreign firms investing in New Zealand to displace debt with equity. While this will lead to higher tax payments in New Zealand it is also likely to lead to lower taxes being paid overseas. The net increase in worldwide tax payments is likely to be much smaller than the increase in New Zealand tax payments.

17. However as a result of Australia's imputation system, tighter thin capitalisation provisions will to some extent deter investment, even if the total of Australian and New Zealand company tax payments remain the same. Australian companies usually prefer to pay Australian tax in order to create franking credits that would offset tax in the hands of Australian shareholders (mutual recognition of imputation credits would address this, and New Zealand has long sought such an arrangement, most recently making submissions to the Henry Review on it).

18. If Ministers decide that the tax burden on the company sector under the base scenario is too high, relief could be provided by either reducing the company tax rate or scaling back on the base-broadening included in the base scenario. Either solution reduces funds available to finance tax cuts elsewhere.

Should the company tax rate be reduced?

19. Inland Revenue and Treasury have different views on whether or not the company tax rate should be reduced.

Treasury view

20. The advice provided by Treasury in our Briefing for Incoming Ministers, and largely endorsed by the Tax Working Group, is that growth potential will be improved by reducing the demands placed on relatively harmful tax bases and by reducing tax-induced distortions in taxpayer behaviour (both labour supply and investment and savings behaviours). The current package being considered by Ministers is consistent with this advice in most respects, with a re-weighting from income tax to GST, reducing tax preferences, particularly on depreciable property, and integrity measures such as thin capitalisation and LAQC changes.

21. The stark potential inconsistency is regarding the company tax rate. In the absence of a reduction in this rate, the base broadening measures will increase the total tax burden on companies, equivalent to returning to a 33% company tax rate. This appears inconsistent with the growth objectives of the package generally, and the particular objectives of improving our relatively poor savings and investment performance (the "capital shallowness problem").

22. The primary policy motivation for these base broadening measures is to reduce tax preferences for particular forms of investment. Reducing these preferences causes capital to flow to investments that are more productive for the economy as a whole. However, in the absence of rate reductions, these measures do push up average tax rates on investment.

23. The solution to this conundrum is to use base-broadening to reduce investment distortions, and use the revenues to lower tax rates. This redirects capital to more productive uses and reduces tax on fully-taxed activities. These two policy "wins" are the logic behind the "broad-base low-rate" approach. The alternative approach of less base broadening and an unchanged tax rate, achieves neither of these goals.

24. Treasury also considers that a reduction in the company tax rate would encourage increased foreign investment in New Zealand, which is likely to deepen the capital stock and improve productivity. While foreign investment consists of a combination of inframarginal investments (economic rents) and marginal investments, clearly some new marginal investment would take place.

25. Concerns with distortions caused by a 5c gap between the company and top personal tax rates need to be kept in perspective. A 5c gap would be an improvement on the status quo. It is less than the current 8c gap, and less than the historic 6c gap between the 33c company and 39c personal tax rate. Also, crucially, such a distortion affects *how* an investment is made (eg, through a company instead of individually) and not *what* investment is made (eg, in real property or in a debt instrument). The economic costs of the second type of distortion are much greater than the costs of the first type of distortion. The second type of distortion would be *reduced* by reducing the company tax rate.

26. Therefore our previous analysis and conclusions hold. From a strategic perspective, we see risks in New Zealand, as a capital-shallow investment-seeking economy, having a statutory tax rate for companies that is increasingly out of step with OECD comparators, then driving the effective tax rate even higher through base broadening measures without offsetting tax rate reductions.

27. In addition, if this opportunity to lower the company tax rate while broadening the company tax base is not taken, and international developments continue to increase pressure to lower the rate, Ministers may in future need to consider packages that reduce the company tax rate with no (or inadequate) base broadening measures, requiring reductions to be funded from elsewhere.

Inland Revenue view

28. If the government wishes to reduce company tax payments relative to the base scenario, Inland Revenue favours imposing less aggressive base-broadening rather than reducing the company tax rate. There are a number of reasons for Inland Revenue's position.

A. Economic rents

There is a strong prima facie case to expect greater location-specific economic rents in a small isolated economy like New Zealand than in land locked countries in Europe. Whether a firm sets up in Austria or Germany close to the border it can supply much the same market. This means that Austria and Germany are likely to have limited abilities to tax the economic rents of such firms because they always have the option of relocating across the border. Data provided in the Inland Revenue report "Where to from here for tax reform? Rate alignment and the company tax rate", (PAD2010/6 refers), is consistent with there being real and important economic rents. Major industries, such as banks and the resource sector, appear to earn economic rents and total about one-quarter of total company tax collections. Reducing tax rates on rent earning companies is costly, but provides relatively little increased incentive to invest in New Zealand.

B. Misalignment of tax rates introduces inefficiencies

29. New Zealand has a full imputation system that means unincorporated structures will not typically be favoured over company structures. This is in contrast to the situation in many other countries, and is efficiency-enhancing. Reducing the company tax rate, however, risks creating a bias *toward* company structures. This would reduce efficiency in itself and could also adversely affect the allocation of investment if different industries could take different advantage of the deferral benefits of the corporate form.

30. Reducing the company tax rate risks creating an opportunity for taxpayers to shelter income from higher personal tax rates – the integrity problem. The Treasury considers that a reduction in the company tax rate to 28 percent might require additional integrity measures. Alignment, or near-alignment, of company and top personal tax rates is clearly the simplest way to minimise these integrity pressures.

C. Reducing company tax rates introduces incoherence in the taxation of savings regimes

31. Reducing the company tax rate will also reintroduce incoherence into the taxation of savings vehicles. Savings would be subject to a 33 percent rate if held directly, 30 percent if held by a PIE and 28 percent if held in a unit trust, life insurance plans and other special instruments. Resolving these issues would be very complex and would need intensive consultation. Such incoherence would move away from explicit recommendations of the TWG for greater coherence in the taxation of savings.

D. Reducing rates and decreasing depreciation could reduce the level of investment

32. If the company tax rate and depreciation rates are reduced in a revenue neutral manner, there will be a reduction in taxes paid by sectors with high rents and little capital and an increase in taxes paid by capital intensive industries, (especially those not earning economic rents). This is likely to discourage investment. Scaling back on depreciation measures is likely to be more cost effective than company tax rate cuts as a way of promoting investment.

This effect would be reinforced by our full imputation system. Cutting the company rate may have little effect on investment for domestically-owned firms, while reducing depreciation will have strong negative effects on investment.

E. Some of the base-broadening necessary to sustain a company tax rate cut would create inefficiencies.

33. At the margin, a company tax rate reduction will be funded by reducing depreciation deductions for buildings. In our view, there is evidence that industrial and other special-purpose buildings actually decline in value over time. To deny a tax deduction for these declines would inefficiently create biases against activities that make heavy use of such buildings. Over time the distortion might be rectified by more industrial buildings applying for estimated useful life of less than 50 years. But this will obviously reduce estimated revenues from the change. In any event, all of the base-broadening is likely to be controversial and contestable.

F. New Zealand can sustain some gap between the New Zealand rate and international rates

34. The higher is New Zealand's tax rate compared to foreign rates, the greater is the incentive to shift profits out of New Zealand. However, New Zealand has relatively robust rules for preventing the shifting of taxable profits out of the country and as mentioned previously has sustained a higher company rate than Australia while maintaining strong company tax collections. Its interest allocation rules are much more robust than most and have been enhanced by the recent reform of the international tax rules. The international tax review introduced anti-arbitrage rules and repealed the grey list providing enhanced protection against international arbitrage transactions.

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

36. Moreover, there is considerable uncertainty whether the recent trends in reducing company tax rates internationally can continue. Up to now the falls in company tax rates have been offset by base-broadening, so that the share of company taxes as a percentage of GDP has risen. OECD tax systems generally have probably reached the limits of politically-possible base-broadening. Revenue pressures to pay back deficits arising from the recession and to cover increasing costs as populations age may constrain future rate reductions. The race to the bottom of company taxes predicted since the 1970's has yet to occur.

G. Unclear what Australia will do, and when

37. At this time it is not clear when Australia will release the results of the Henry Review and announce the government's reaction to it. It seems increasingly unclear whether Australia will be implementing company tax rate reductions. Inland Revenue believes that it would be prudent to await these results before making announcements of New Zealand's intentions in this area.

H. Possibility of firms being established in New Zealand as a result of a reduction in the company tax rate

38. It might be argued that one reason for dropping the company rate is that dropping this would make it more attractive for firms to be established in New Zealand. It should be noted that the company tax rate itself is likely to be a relatively minor factor in determining where firms locate. Closeness to markets may be much more important. It is clear that New Zealand had a lower company tax rate than Australia for many years without New Zealand becoming an obvious place for firms to locate to supply the regional market. Most importantly, however, it is likely to be average tax rates rather than the statutory tax rate that determine whether or not it is attractive for a firm to locate in New Zealand. It is not clear why for a given level of company tax collections a company rate cut should be more powerful than less aggressive base broadening as a way of enhancing the attractiveness for firms of establishing themselves in New Zealand.

Relieving the impact of base-broadening

39. If Ministers wish to relieve the impact on companies without reducing the company tax rate, the IRD would recommend:

- first, retaining depreciation for industrial buildings as recommended by the IRD in the report Changes to Depreciation – Budget 2010, (PAD2010/032, T2010/299 refers)
- second, scale back the reduction in depreciation loading or allow some depreciation to remain for commercial buildings.

40. The latter recommendation is contingent on the use to which the base-broadening is put. If the funds are used to fund personal tax rate reductions, which in turn are necessary to allow an increase in GST, then on balance the package would be efficiency and growth enhancing and the IRD would recommend the proposed base-broadening. However, if the funds were being used to fund a cut in the company tax rate, we believe that the serious negative impact of the rate cut would offset the beneficial aspects of the base broadening.

Consequential issues if company rate is reduced

Integrity protection measures

41. The analysis presented in the report to Ministers "Tax system integrity and the alignment of tax rates", (T2010/119 and PAD2010/07 refers), concluded that a 33/33/30 rate structure, would effectively eliminate problems from the current non-alignment of tax rates so that complex integrity measures are not necessary. The rates are close enough that the company tax system supports the personal income tax rates.

42. The question arises, at what level of difference in tax rates are the problems from non-alignment 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.

43. In the afore-mentioned report to Ministers, IRD officials concluded that the company tax rate could be reduced to 28 percent without requiring integrity protection measures, providing the trust and top personal tax rates were aligned at 33 percent. The Treasury concluded that such measures might be required with a company tax rate reduction to 28 percent.

Transitional issues if company tax rate reduced

44. There would be a number of consequential tax rate issues if the company tax rate is decreased, and two transitional issues. These issues all arose several years ago when the company tax rate was last cut. The consequential issues are mechanical and concern such things as the calculation of the foreign investor tax credit. We do not propose to further discuss these with Ministers here.

45. However, there are two transitional issues that should be considered. These concern a transitional period for imputation credits, and adjustments to provisional tax uplifts. The provisions affecting imputation credits are discussed below. Provisional tax uplifts are discussed in the report addressing the shape of the entire final package. Imputation credit transition was offered last time the company tax rate was cut and we recommend it be considered for inclusion in the final package.

Transitional period for imputation credits

46. If the company tax rate decreases there is a transitional imputation credit ratio issue that, in particular, has implications for resident shareholders of companies (company tax is often a final tax for non-resident shareholders and therefore not relevant to this discussion). From 1 April 2010 the maximum imputation credit ratio will be 30/70 (imputation credits to cash dividend), so if the company rate changes to say 28%, the ratio will automatically change to 28/72 from the date of the tax cut. Allowing this to happen automatically is the simplest solution from a compliance and administration perspective.

47. However, the claim could reasonably be made that this could result in double taxation. This will be more obvious where the shareholders' tax rate does not change (as will be likely for trusts and a number of widely held savings vehicles including PIEs to the extent they are taxed at 30%) because imputation tax credits representing tax previously paid on their behalf cannot be fully distributed. Allowing companies a transitional period to keep imputing at 30/70 to the extent they have imputation credits that arose from paying tax at 30% (or indeed 33%) mitigates this. Grandparenting the 30/70 ratio for two years has an estimated fiscal cost of a net $125 million over the forecast period, with a cost of $145m in 2012/13 and $20m saving in 2013/14.

48. While officials are relatively comfortable in principle with again providing a two year transitional period where companies can over-impute their dividends at the 30/70 ratio, in light of the significant cost we recommend that a final decision on this be made as part of the final package.

Appendix A

Tax rate for savings vehicles

A number of the issues concerning the tax rate for savings vehicles were canvassed in a recent report to Ministers – "Tax rate for savings vehicles – including PIEs" (PAD 2010/035; T2010/296 refers).

If the company tax rate were to be reduced to 28% as part of the 2010 Budget it is necessary to consider what the top PIE tax rate and the tax rate for widely-held superannuation funds should be. These rates are currently aligned to the company tax rate of 30%.

Officials recommended – on balance – to leave the top PIE tax rate at 30% as part of the 2010 Budget but review the issue post-Budget as a matter of urgency.

The tax rate for other forms of savings

In addition, there are a number of other forms of savings (e.g. life insurance, certain group investment funds and bonus bonds) that are presently linked to the company tax rate. If the company tax rate were to be reduced as part of Budget 2010 it would be necessary to consider whether the cut should flow through to these entities. As outlined below, it will be necessary that the rate for certain group investment funds is cut as part of Budget 2010.

The rate for certain other investment entities should remain at 30%, but should be reviewed – along with the tax rate for PIEs and widely-held superannuation funds – as a matter of urgency after the Budget. Until such time as these issues can be resolved, there will be a somewhat arbitrary tax treatment of savings and investment.

Investment entities that would follow the company tax rate

The tax rate for companies that are in economic terms savings or investment vehicles and unit trusts (which are taxed as companies) would change automatically as part of Budget 2010.

Category A GIFs (group investment funds) are currently taxed as companies. It would be necessary for the tax rate on Category A GIFs to follow the company rate down as part of the 2010 Budget. If it did not it would create major problems in respect of imputation.

Thus we are left with the following savings and investment entities that would be taxed at the company rate as part of the 2010 Budget:

- Companies that are savings and investment vehicles;
- Unit trusts; and
- Category A GIFs.

Under present tax law and practice this will often be a final tax.

Remain at 30%

The following rates/entities would remain at 30%:

- Maximum rate of PIEs (portfolio investment entities);
- An approved unit trust (Post Office Bonus Bonds which because of an exemption from the unit trust regime is taxed as a trust);
- Policyholder income of life insurance companies;
- A widely held (non-Category A) GIF; and
- A widely held super fund.

As noted above, these rates would be reviewed as a matter of urgency after the Budget.

Taxed at 33%

Savings income (dividends and interest) derived directly by individuals is taxed at their marginal rate (presuming a maximum of 33% after the budget cuts). Similar income derived by trusts is also taxed at this rate.