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The Chair
Finance and Expenditure Committee
Parliament Buildings

Our ref Submission to FEC - IRD LTIB Feb 2023

24 February 2023

Dear Sir or Madam

Inland Revenue's Long-Term Insights Briefing 2022

We are pleased to make a submission to the Committee on Inland Revenue's 2022 Long-Term Insights Briefing ("LTIB"), titled *Tax, foreign investment and productivity*, released in August 2022.

As a general comment, we welcome the focus of the LTIB. As a capital importing nation, which competes for investment on the world stage, we agree that there needs to be clear understanding of the impact of domestic taxes on the cost of capital for NZ firms.

We do not comment on the economic analysis, as that is not our area of expertise. We also do not have a preferred view on the different options to reduce the cost of capital for New Zealand firms or to make effective tax rates more neutral. We acknowledge there will be trade-offs.

Rather, what we have aimed to do in this letter is highlight some of the practical issues we have come across in our role as tax advisors, including based on our interactions with business and investors, for the Committee's further consideration.

The LTIB notes that New Zealand's statutory company tax rate is above both the OECD average and the cohort of small open economies that New Zealand benchmarks itself against. The headline company rate was last reduced in 2010/11 and is now higher than most of our trading partners (Australia being an exception). This can present challenges, from a signalling perspective, when investors are looking at different jurisdictions. While this may seem overly simplistic/superficial, and we acknowledge there will be other factors international investors will consider as well as undertaking detailed due diligence of a country's tax regime prior to investing, in our experience it can be an initial filter. So, the effect of a high company tax rate on investment decisions cannot simply be discounted (for example, if the foreign investor is tax exempt in its home jurisdiction, as is typically the case with sovereign wealth and pension fund-type investors, NZ tax will not be creditable at all so will be an absolute cost of the investment).

In addition to the rate, other tax settings for capital investment that are markedly different from the global norm and/or create tax barriers to repatriation of profits will make New Zealand less attractive to foreign direct investment. New Zealand tax settings that are an outlier – for example, New Zealand's Restricted Transfer Pricing (interest deductibility limitation) rule – are difficult to explain (and are particularly problematic where their effects run counter to tax settings in the investor's home country). On repatriation, the timing of tax payments, availability of deductions for non-cash expenses (such as tax deprecation) or untaxed capital gains can all result in mismatches between the cash available to distribute and the amount able to be paid as a "fully imputed" dividend (that is, without further withholding tax impost) which will be less. While some tax treaties (those with a 0% dividend withholding rate) will assist here, these are a minority. These are not immaterial practical considerations.

We note that the global trend has been to lower statutory corporate tax rates, although it appears this momentum has ceased. At the same time, there has been international adoption of a range of so-called Base Erosion and Profit Shifting ("BEPS") measures, including by New Zealand, with more to come[1]. The effect of BEPS measures is to generally increase effective tax rates, by expanding tax bases (e.g. through disallowing deductions or bringing more profits to tax). So, internationally, reductions in headline rates should be viewed in combination with higher effective rates through adoption of BEPS measures. New Zealand's approach has been the latter, but not the former. It is also worth highlighting that New Zealand's approach to BEPS implementation has been relatively comprehensive, whereas certain other jurisdictions have been more selective in their application, often applying an overall national interest perspective or lens.

Some of the complexity with reducing the statutory company tax rate is the impact on overall tax system integrity. This is because New Zealand's company tax rate tends to be inextricably tied with the personal income tax system, due to imputation (a link which most other countries have severed). As a result, any change to the company tax rate is typically viewed by Officials through the lens of potential misalignment with personal tax rates. The consequence of misalignment can be the introduction of complicated "backstop" measures to preserve integrity (to stop the perceived risk of company structures being used to avoid the top marginal tax rate) – we reference the 2022 discussion document on *Dividend integrity and personal services attribution*, as an example. The impact on the ease and cost of compliance, from introduction of such integrity measures, also needs to be kept in mind when looking at potential reform options. This may inform preferences around the different options in the LTIB.

The focus of the LTIB is the impact of taxes on inbound investment. In our discussions with clients, we are seeing concerns expressed around New Zealand's outbound tax settings – specifically the application of the Fair Dividend Rate ("FDR") method to foreign investments, which can tax unrealised income. This is increasingly a barrier for highly-skilled individuals looking to relocate to New Zealand (or staying in New Zealand). Their concern is not paying New Zealand tax on offshore investments but paying tax without accompanying cash-flow (we note the FDR regime is unique to New Zealand) and also the risk of "double tax" (as tax on unrealised FDR income is unlikely to be creditable in other jurisdictions, if they also tax these investments). In addition to filling much needed skill-gaps, these individuals are also a valuable source of capital and entrepreneurship.

[1] The OECD's ongoing work to address the tax challenges arising from the digitalisation of the global economy, which includes an effective global minimum tax rate proposal (Pillar 2).

We are conscious that choices around tax settings will ultimately be dictated by the current and future Governments' fiscal requirements. Recent events will no doubt have an impact on this. What investors will typically value most is certainty. Therefore, any changes to tax policy settings (including the corporate tax rate, base or other features) need to be well considered, signalled and most importantly sustainable over time[2].

Further information

Please do not hesitate to contact us if you would like further information on our submission.

Yours sincerely

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[2] We note the 2010 removal and 2020 reinstatement of non-residential building depreciation as an example of an ad hoc tax policy change that created considerable uncertainty.