Company Taxation in New Zealand

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New Zealand tax reform - where to next?

Introduction

- In late 1980s NZ adopted clear and simple tax paradigm.
- Broad base and low rate income tax.
- Supported by full imputation classical company tax system with rate alignment.
- Broad-based and low-rate GST.
- Since then external pressures (especially worldwide reductions in company rate) and policy decisions have created pressures on this paradigm.

Introduction

- The government has announced longer term goal of 30:30:30.
- Is this achievable or will goal posts keep moving?
- If this goal is to be achieved, what do we do in the interim if getting there takes time?
- What are key alternatives?
- Pros and cons.

Key facts

- NZ highly reliant on corporate tax base (5.8% of GDP cf OECD average of 3.9%).
- NZ geographically isolated but open economy with mobile capital and labour:
  - inbound FDI 52% of GDP (of which 28% of GDP equity);
  - inbound portfolio equity 8% of GDP;
  - in 2000 approx 16% of NZers and 24% of skilled NZers lived abroad. Highest ratio for OECD.
- Highly integrated economy with Australia:
  - approx 55% of inbound and outbound FDI;
  - free labour market.

1980s NZ Policy Paradigm

- Alignment of company and top personal marginal tax rates.
- Reasonably flat personal tax system:
  - top marginal rate 33% and no tax free threshold.
- Broad tax base.
- Imputation system:
  - with alignment, aim was to get reasonable proxy for fully integrated tax system.
  - but taxation of unimputed dividends: base protection.
- International taxation:
  - company tax is used to tax non-resident on NZ source income;
  - imputation taxes foreign-source income on distribution to domestic shareholders. This reduces incentives for multinationals to avoid NZ tax and likely step towards encouraging NZ firms to invest to maximise national welfare

Where are we in 2009?

- NZ done reasonably well in avoiding base-eroding tax incentives.
- International: at company level move from taxing foreign income on accrual with tax credits to exemption of active income.
- Tax rates:
  - company rate 33% to 30%;
  - top personal rate 33% to 39% going to 37%;
  - trust tax rate remained at 33%;
  - PIE rate capped at company rate.

Effects of Current Rules

- Changes to tax rates have made it very easy for people to shelter incomes from higher personal marginal tax rates:
  - accumulation of profits in companies;
  - growth in income of trusts (in 2006, 12.5% of imputation credits flowed to individuals while 24.6% flowed to trusts);
  - PIEs: heavily marketed to lower tax rates on interest.
- This undermines basic paradigm.

Aggregate Taxable Income of individuals by $1,000 bands of taxable income

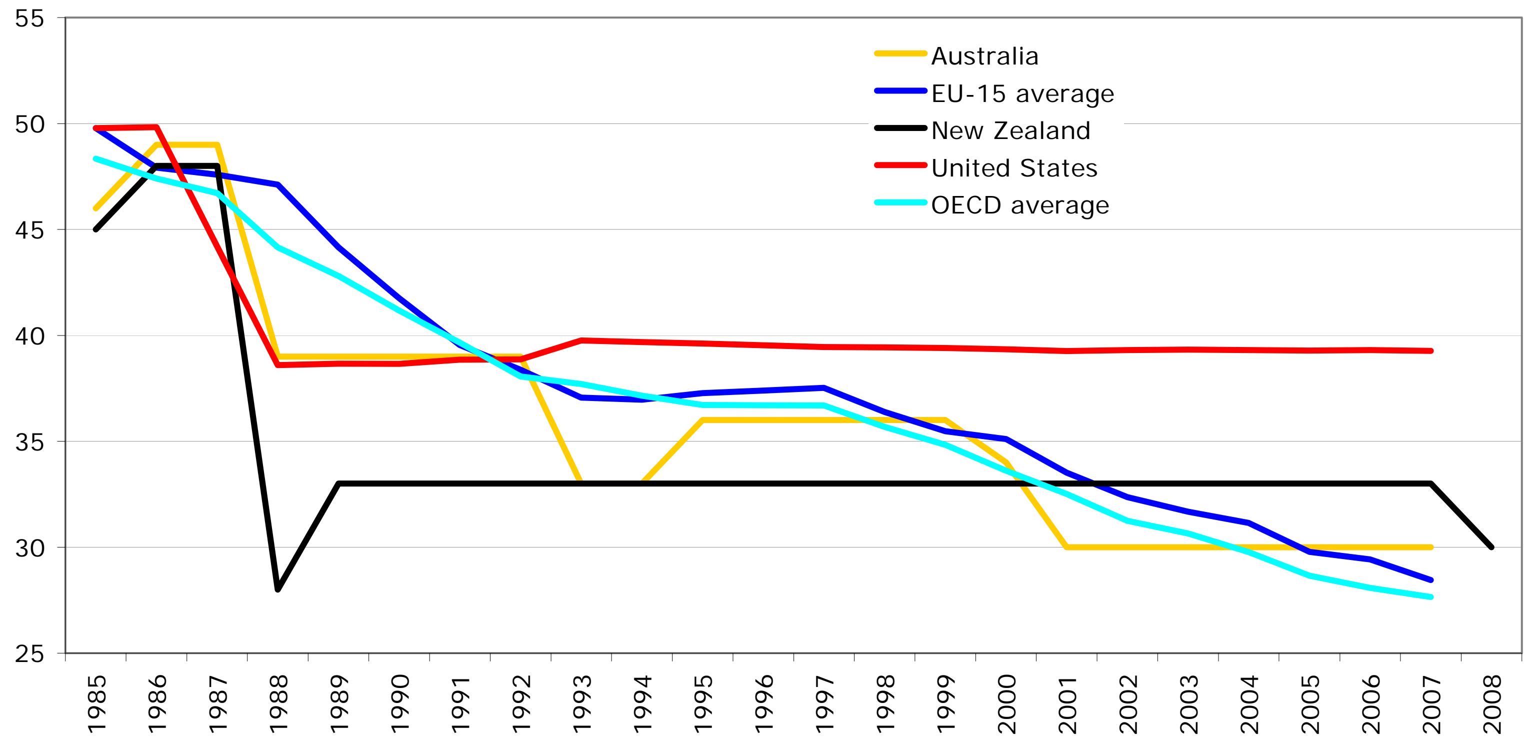
Determining policy choices

- Arguably, necessary condition for current paradigm is reasonable alignment between company and top personal rate.
- Does policy of alignment still make sense?
- Is alignment achievable and will it continue to be so with international pressures on company rates?
- Would a shift from income taxation to increased taxation under GST be a way to achieve and maintain alignment?
- If not, or if achieving alignment takes time what is the second best (possibly temporary?) alternative?

Whither the company tax rate?

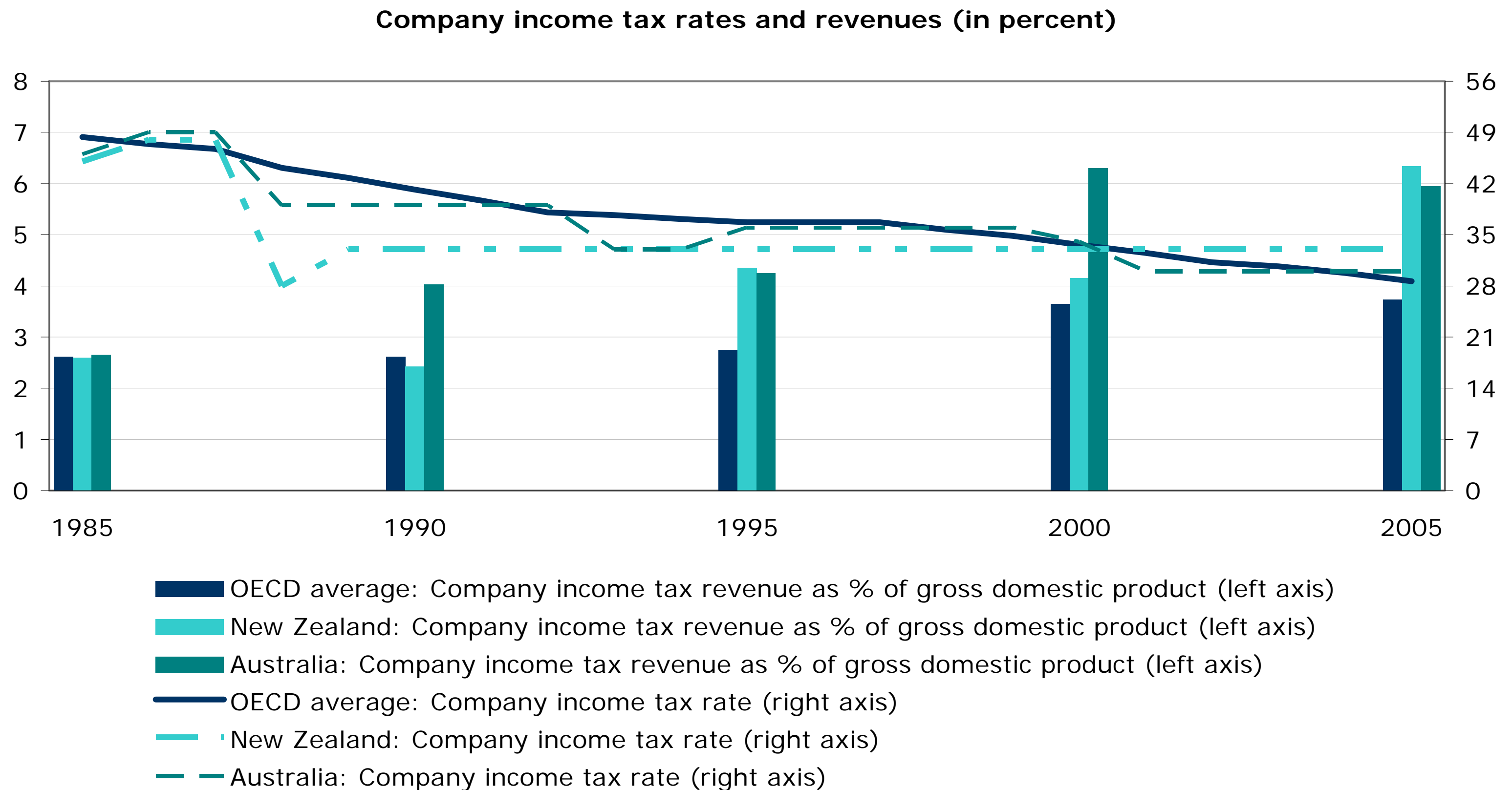
- In late 1980s, NZ company tax rate was low relative to other OECD countries;
- Since then, rates have decline in OECD whereas no change in NZ until 2008/09.
- Even given NZ rate reduction, NZ has relatively high company tax rate.
- Within OECD company tax rate reductions have been accompanied by base broadening and company tax as % of GDP has not declined.
- What will happen in future?

Whither the company tax rate?



Source: OECD

Whither the company tax rate?



Source: OECD

Irish system – go for broke!

- One possibility would be a deep cut in NZ's company tax rate;
- Encourage capital formation (boosting labour productivity and growth), FDI (possible technological spillovers), reduce investment distortions, make NZ a more attractive place in which to do business.
- Ireland cut its rate to promote FDI.
- Could NZ emulate Ireland?

Irish system – go for broke!

Ireland	New Zealand
Small Island	Small Island
Educated English-speaking workforce	Educated English-speaking workforce
Member of EU (GDP $19.2 trillion)	Member of CER (GDP $1.2 trillion)
EU subsidies	No subsidies
On EU's doorstep	Middle of nowhere
Competing against high wage EU countries for FDI	Competing against low wage SE Asian countries for FDI

Irish system?

- Major reduction in company tax rates could boost investment and also TFP growth.
- OECD has suggested a cut in company rate from 35% to 30% could boost TFP by 0.4% per annum over 10-year period (OECD, 2008).
- Are these results necessarily relevant for NZ?
- Would a cut in company rate increase integrity problems and create a windfall for foreign shareholders requiring higher taxes on NZers?
- Extensive other modifications likely to be required.
- General conclusion to date has been not to introduce deep company rate cut but should this be reconsidered?

Addressing integrity problems

- Three key alternatives:
- i. alignment approach:
  - 30:30:30 option;
- mind-the-gap approach
  - accept a company tax rate that is lower than higher rates of personal tax;
  - integrity measures to prevent diversion of personal income to companies;
- Nordic approach:
  - split-rate system with lower flat rate on capital income.

Alignment approach

- Most direct return to original paradigm and arguably preferred approach:
  - biases in ways income earned removed;
  - marginal tax rates reduced;
  - complex distinctions necessary for other approaches eliminated.
- Can 30% rate be sustained?
- Revenue raisers? Increase in GST and reduction in all marginal rates?
- Increasing GST at same time as reducing marginal income tax rates may not improve incentives to work but would reduce savings biases.

Mind the gap approach

- Allows for a lower company rate than top personal marginal rate.
- Backed up by rules to prevent deferral of tax on personal wage and investment income earned through companies.
  - active/passive distinction in domestic context;
  - beefed up attribution rules.
- Allows flexibility and independence of company and personal tax rates.

Mind the gap approach

- Biggest disadvantage is effects on economic efficiency.
  - Biases between company and non-company income;
  - Encouragement to active income over potentially higher return passive income.
- Operational issues:
  - Difficulties in policing borderlines between active and passive income (e.g., real estate).
  - Would a CGT be necessary?

Nordic approach

- Would apply lower company tax rate to all capital income.
- Are we almost there already?
- Norway leading proponent but very large gaps between rates of tax on labour and on capital income.
- NZ has lower differences between company rate and top personal rate.
- Also no payroll tax to fund social security contributions.
- Alignment more feasible for NZ.

Simplified Nordic

- Would a possible temporary measure be to extend current PIE capped rate to all capital income using list approach.
- Interest and dividend income subject to cap.
- Attribution rules to prevent salary-like income being sheltered in closely-held companies.
- But no other attempt to prevent labour component of closely-held company's income from benefiting from company rate.
- Capital component of unincorporated business income taxed at personal rates.

Simplified Nordic

- Biases would remain.
- Different tax rates on business income of companies and unincorporated enterprises.
- Passive investment income all subject to cap.
- Arbitrage issues?
- Reduction in tax rates on capital income would tend to be regressive.
- Inefficiencies could be reduced if seen as an intermediate step with more general personal tax rate reductions over time to restore alignment.

Issues for discussion

- Paper suggests deep company rate cut is unlikely to be preferred option for NZ.
  - Is there a best company tax rate?
  - Is investment more sensitive to high company rates than to low company rates?
  - Is there a significant tax base risk from high company rates?

Issues for discussion

- The paper suggests alignment as arguably the best approach.
  - Is this true or is there a case for reducing the company tax rate while keeping personal tax rates higher?
  - What is the future direction of the company tax rate? Is alignment sustainable?
  - Could an increase in the rate of GST be used to fund across-the-board personal rate cuts?

Issues for discussion

- If rate alignment cannot be achieved (or if it can only be achieved with a protracted delay), what is the second-best (possibly temporary) alternative?
  - Nordic?
  - Mind the gap?
- Would a simplified Nordic tax system be interim step towards alignment?
- Should investment income be subject to same progressive rates as labour income?
  - Fairness
  - Trade-offs
  - Efficiency.