Submission

By

BusinessNZ

To

Inland Revenue Department

On

Taxation of Investment Income

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TAXATION OF INVESTMENT INCOME
SUBMISSION BY BUSINESS NEW ZEALAND
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1. INTRODUCTION

1.1 The taxation system has a critical role to play in attracting investment and fostering a dynamic, productive and innovative economy. High tax rates and complex compliance requirements impose significant costs on the community, including lower investment, output, incomes, and employment as well as distortions in behaviour.

1.2 Business New Zealand welcomes the opportunity to comment on the Taxation of Investment Income Discussion Document (referred to as 'the document') that the Government has released. While Business New Zealand supports some measures contained in the document, we believe the general direction of the document is not in the best interests of investment, and may have a negative impact on the savings and investment patterns of New Zealanders. We believe the Government should effectively re-examine the issue with further consultation with key stakeholders.

2. SUMMARY OF RECOMMENDATIONS

2.1 Overall, Business New Zealand makes the following recommendations:

(a) The option to exempt from tax most realised equity gains derived via a QCIV should proceed (see page 3);

(b) The introduction of a capital gains tax on offshore portfolio investment income should not proceed (see page 3);

(c) Scenarios and/or examples included in future discussion documents are provided in a rational and unbiased manner (see page 6);

(d) The current grey list for offshore investment remains (see page 7);

(e) The Government seriously consider lowering both personal and company tax rates to help boost savings and investment for New Zealanders (see page 9); and

(f) The Government instigates another round of consultation with key stakeholders regarding the treatment of taxation on investment income (see page 9).

3. BACKGROUND

3.1 The document represents the culmination of an extensive period of consultation and evaluation with various groups regarding New Zealand's savings taxation system. The release of the Stobo report and subsequent consultative meetings has culminated in recommendations to attempt to eliminate distortions between direct and indirect investment (both onshore and offshore). While we agree that some of these distortions that require rectifying have been long overdue, we are deeply concerned that some key recommendations may actually increase distortions, particularly those related to taxation on investment offshore.

3.2 The document covers many complex issues, which the Government have requested views on. Rather than follow the list of points for submission format provided in the document, Business New Zealand would like to take the opportunity to comment on the overall implications of the key recommendations outlined.

4. TREATMENT OF TAXATION OF EQUITY GAINS ON INDIRECT INVESTMENT

4.1 Business New Zealand agreed with the conclusions in the Stobo report that recommended alignment of taxation of direct investments by individuals compared with indirect investments through managed funds. The current situation is an anomaly and clearly distortionary, whereby in most cases a direct investment in a New Zealand company will be treated as being held on the capital account, therefore only dividends, not increases in share value are taxable. In contrast, if the investment were made via an investment manager, the investment would typically be held on the revenue account, with tax payable on both realised gains and dividends. This tax treatment overwhelmingly favors direct investment as opposed to investments through Qualifying Collective Investment Vehicles (QCIVs).

4.2 To eradicate the equity and efficiency issues with this issue, we support the recommendations in both the Stobo report and the Government's discussion document to exempt from tax most realised equity gains derived via a QCIV.

Recommendation: That the option to exempt from tax most realised equity gains derived via a QCIV should proceed.

5. INTRODUCTION OF A CAPITAL GAINS TAX ON OFFSHORE PORTFOLIO INVESTMENT IN SHARES

5.1 While efforts to remove a capital gains tax on domestically managed funds is supported, Business New Zealand holds an opposing view on the recommendations to effectively introduce a capital gains tax on foreign investment when discussing new tax rules for offshore portfolio investment in shares.

5.2 The document outlines the broad justifications for the introduction of a capital gains tax on offshore portfolio investment in shares, which simply put are the extension of the revenue base and rectifying issues involving tax avoidance. Business New Zealand believes the implementation of such a tax on foreign investments is simultaneously removing one distortion and replacing it with another. There is a strong likelihood for an overheated domestic market by the implementation of such a tax, as it is highly probable many investors would divert their investments towards the domestic market to choose the best possible tax outcome. If investments are diverted inwards, there are two broad options available: the New Zealand share market and the New Zealand property market.

5.3 It is interesting to evaluate New Zealand's share market with similar Western style countries. Currently, the total New Zealand Stock Exchange (NZX) is estimated to be worth around NZ$77 billion[1]. The NZX has recently taken steps to try and increase the number of listings available to investors, especially through entry-level markets such as the New Zealand Alternative Market (NZAX), with 23 companies currently listed. However, progress towards expanding this list has been slow.

5.4 Competition in New Zealand's share market has recently been established with the introduction of Unlisted, which is an unregistered securities exchange with 24 market listings, and total capitalisation of around NZ$1 billion. This puts New Zealand's total capitalisation at around NZ$78 billion.

5.5 However, by international standards New Zealand's overall share market is extremely small. Total stock market capitalisation in Australia currently stands at NZ$751 billion. The New York Stock Exchange (NYSE) has a staggering capitalisation of NZ$21.3 trillion. To put things in perspective even further, the largest single company listed at the NYSE is worth more than the entire New Zealand and Australian markets combined.

5.6 The minimal number of options available for investors to invest in also exemplifies the smallness of New Zealand's share market. The NZX currently has 185 listed companies. Although this seems a reasonable number, historically 98-99% of the market value is contained within the top 50 largest companies.

5.7 As well as having a small domestic share market by international standards, New Zealand also differs when it comes to its preference for obtaining international shares. Investors in Australia tend to have around 40% of their shareholdings outside their domestic market. In Britain it is 35%, while in the USA it is much less, at around 19%. In comparison, the average pension fund in New Zealand has 71% of its share portfolio in foreign investments. Australia is the main benefactor, currently receiving nearly 60% of New Zealand's offshore investment.

5.8 A small stock exchange, both in terms of total capitalisation and company listing means the opportunities available for New Zealanders to invest are certainly more limiting than overseas markets, with a highly likelihood of putting too many eggs in relatively few baskets. From a risk assessment point of view, a balance portfolio that encompasses a variety of investments from different sources tends to minimise risk. Changes in the tax investment rules that leads to a strong concentration of investments into the domestic market will leave many open to losses in wealth if specific shocks hit the New Zealand economy in the future.

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[1] NZX Website (www.nzx.co.nz)

5.9 Apart from shares, the other main option available to investors is the property market. New Zealand has recently experienced one of the strongest and sustained increases in property investment for decades. While this has generally followed overseas trends, New Zealand's relatively safe environment in a time of terrorism attacks and strong gains in net migration has caused property prices to increase dramatically. The latest real estate figures show that the medium house in New Zealand has increased from $173,000 in September 2001, to $289,000 in August 2005 – an increase of 67%[2].

5.10 Despite predictions of a fall in the property market over the last year, prices have generally continued to increase or at least hold in most areas. However, it is reasonable to assume that price gains of the like seen over recent years simply cannot continue in the long term, as the disparity between the cost and return through rental widens further. Already, apartments bought as property investments in Auckland typify the problem investors are now having, with rent levels coming down as an over-supply of apartments now exist. Some commentators are predicting a drop of up to 40% on the value of apartments in the region, representing a significant loss for investors whom are often buying property for capital gain, rather than a positive cash flow.

5.11 New Zealanders investors typically have a strong affiliation with property investment. Currently, New Zealand has a national portfolio of 90% investment in household assets, compared with 3% in equities. This heavy preference for property is generally not seen in most other countries. Given a possible lack of options in regards to investing domestically through the share market, there is a strong possibility that this will direct many New Zealanders to either increase their current portfolio or begin investing in property. Obviously, this would be somewhat of an ironic and undesired outcome given the public statements by the Minister of Finance in recent times that considered New Zealanders were investing too heavily in property.

5.12 If investors truly wish to diversify their investments, and are not keen to invest all their money into the domestic share market (or other more risky ventures), then the property market is the only other viable option in terms of passive investment. Obviously, the influx of more investors into the property market will cause both residential and commercial property prices to increase, rather than soften and stabilise as many commentators have predicted will eventually occur.

5.13 In addition to comments that New Zealanders were investing too heavily in property, the Minister of Finance has also called for New Zealanders to invest more in shares to have a more balance portfolio of investments. At the same time, the Minister has regularly raised concerns about the affordability of residential property for many New Zealand first time homebuyers, who are finding themselves rapidly becoming priced out of the market. The increased focus on domestic investment because of a capital gains tax on offshore investments may lead to further price hikes for properties, exacerbating the problem for potential new home owners, while at the same time leading to

[2] Market Statistics, REALENZ.

further portfolios that are heavily lopsided in favour of one particular investment vehicle.

5.14 Apart from the potential outcomes for domestic investment and risk, Business New Zealand also questions the rationalisation outlined of protecting the tax base and eliminating perceived tax avoidance. The former is somewhat hard to justify given the large-scale surpluses that have been evident in the Government's accounts for some time. If anything, a capital gains tax on offshore earnings would probably boost the surplus further, rather than acting as a neutral cover for any drop when the changes to domestic equity gains on indirect investment are implemented. The later would be better solved by retaining the existing rules and attempting to specifically target the investments and structures that are causing the problems. The current recommendation is simply too crude and has too many negative implications for it to provide a successful outcome for the overall economy.

5.15 Overall, Business New Zealand believes the introduction of a capital gains tax on offshore investments could potentially lead to the combination of a domestic share market that would have great difficulty coping with providing a balanced portfolio of share options, as well as a property market that continues to boom, leaving many unable to purchase property for personal use. Both outcomes would be an extremely adverse result for the somewhat debatable justifications of protecting the tax revenue base and addressing instances of tax avoidance. Therefore, we recommend that the potential costs heavily outweigh the potential benefits, and the recommendation outlined in the document should not proceed.

Recommendation: That the introduction of a capital gains tax on offshore portfolio investment income should not proceed.

6. MISLEADING ECONOMIC EFFICIENCY SCENARIOS

6.1 Business New Zealand is also disappointed at the use of certain scenarios within the document that are clearly biased to explain the justification for a capital gains tax on foreign portfolio investment in shares. Specifically, we refer to tables 1 and 2 below, which compare the investment returns for domestic and foreign situations that were used in the document, as well as a revised example with matching pre-all tax returns.

Table 1: Domestic and Foreign Investment Returns

	Discussion Document Example		**Revised Example**	
	Domestic	Foreign	Domestic	Foreign
Pre-all tax return	10%	12%	10%	10%
Foreign tax (33%)	-	(4%)	-	(3.3%)
Pre-NZ tax return	10%	8%	10%	6.7%
NZ tax (33%)	(3.3%)	Exempt	(3.3%)	Exempt
Return to investor	6.7%	8%	6.7%	6.7%
Return to NZ	10%	8%	10%	6%

Table 2: Tax on Foreign Investment Returns

	Discussion Document Example		Revised Example	
	Domestic	Foreign	Domestic	Foreign
Pre-all tax return	10%	12%	10%	10%
Foreign tax (33%)	-	(4%)	-	(3.3%)
Pre-NZ tax return	10%	8%	10%	6.7%
NZ tax (33%)	(3.3%)	(2.6%)	(3.3%)	(2.21%)
Return to investor	6.7%	5.4%	6.7%	4.49%
Return to NZ	10%	8%	10%	6.7%

6.2 Using the numbers outlined in the document, table 1 shows that the investor would choose the foreign investment because it yields a higher return than the domestic investment (8% versus 6.7%). However, the choice of figures is clearly not comparing apples with apples. The pre-all tax return in table 1 is 10% for the domestic example, and 12% for the foreign example. The document effectively assumes foreign returns would always be higher. An accurate example would have both pre-all tax return rates the same for both domestic and foreign investments (i.e. at 10%). By equalising the pre-all tax return for both domestic and foreign investments, the end return for the investor would be exactly the same, and therefore indifferent between the domestic or overseas return.

6.3 Therefore, this eliminates the cause and effect argument that because the foreign return is always higher, investors would only seek returns offshore, with no domestic investment where the return to New Zealand includes the application of New Zealand tax. The main incentive for the investor would be to spread risk and have investments in both markets.

6.4 Table 2 shows the outcome of placing a tax on the post-foreign tax return. When the pre-all tax return is equalised for both domestic and foreign investments, a much larger gap between the end return for the investor between the two options becomes apparent, which heavily favours the domestic investment. As discussed above, the tax on the post-foreign tax return dramatically ‘screws the scrum’ in favour of domestic investments over foreign investments, which does little to ensure investors have a balanced portfolio to ensure a lower risk of loss.

6.5 Business New Zealand finds this sort of behaviour mischievous at best and extremely biased at worst to try and provide support for a recommendation. Any examples or scenarios provided in discussion documents by the Government need to be demonstrated in a rational and unprejudiced manner.

Recommendation: That scenarios and/or examples included in future discussion documents are provided in a rational and unbiased manner.

7. REMOVAL OF THE GREY LIST FOR PORTFOLIO INVESTMENTS

7.1 Underlying the issue of a capital gains tax on offshore portfolio investment in shares is the issue of the grey list countries, which the document recommends removing. The grey list exemption is the New Zealand tax exemption on income accumulated in companies resident in seven countries (Australia, Britain, the USA, Germany, Canada, Japan and Norway). The primary reason the exemption was initiated was to reduce compliance costs under the controlled foreign company (CFC) rules. The seven countries represent those with fairly robust tax rules, where the Government is satisfied that companies resident there will generally pay a broadly similar level of tax in that country as domestic companies do in New Zealand.

7.2 The document states that the rationale for the grey list exemption does not apply to Foreign Investment Funds (FIF), as FIFs generally do not qualify for an underlying foreign tax credit. Therefore, the Government believes investors have an incentive to invest in FIFs in grey list countries, even when that investment does not maximise the return to New Zealand. The document then reverts back to the incorrect economic efficiency examples discussed above, and view that investors investing in grey list countries face the incentives in table 1, while investors in non-grey list FIFs face the incentives illustrated in table 2. However, Business New Zealand opposes the abolishment of grey list countries. We believe the Government has not taken into serious consideration some key points about why the grey list was established in the first place.

7.3 The seven countries in this group represent a significant share of the countries in which New Zealanders invest (currently around 70%). They are also countries that have markets where information can be easily obtained and understood. While the existing mechanism for grey list countries means investments in these countries can be taxed more favorably than comparable investment in New Zealand or non-grey list countries, the countries in the grey list identifies those that typically have a sophisticated taxation regime that usually involves increased layers of regulation and compliance. Therefore, there is a legitimate reason they are treated differently in the first place.

7.4 The document states that the current treatment of grey list countries exposes the New Zealand tax base to loopholes in the tax bases of the world's largest economies. However, one would question whether the large proportion of investors who choose to invest in grey list countries are doing so for minimising tax. Typically, New Zealanders have had a more adventurous attitude to investing and as the statistics mentioned above show, are more likely to take a diversified approach and invest in countries we often compare ourselves with.

7.5 The removal of the grey list regime means investors may look elsewhere for sufficient returns, such as countries that have a lower tax jurisdiction. Investment in non-grey list companies may offer the possibility of bigger returns, but are also generally coupled with higher risk as not all jurisdictions have equally robust environments for investors' protection. Although it is up to the individual investor to weigh risk against return, if the Government is serious about increasing the number of New Zealanders investing to improve overall wealth, the grey list of countries provides a signal for a greater chance of wealth accumulation.

7.6 Lastly, the removal of grey lists countries has implications for New Zealand's movement towards the notion of a single economic market with Australia. If New Zealand wishes to continue down this path, then specific provisions for Australia should ideally be instigated so that investment patterns between New Zealand and Australia are not distorted.

Recommendation: That the current grey list for offshore investment remains.

8. RELATED ISSUES FOR NEW ZEALAND SAVINGS AND INVESTMENT

8.1 The Government has stated that the changes on taxing investment income complement the new KiwiSaver scheme recently announced, which is designed to encourage New Zealanders to save through work-based savings schemes. From the Governments point of view, it is therefore vital that their investments are taxed consistently and fairly.

8.2 If the Government is seriously concerned about raising standard of savings, which is found to be lower when compared with other countries[3], we believe a better way in which to provide all New Zealanders with the opportunity to save and invest more is through personal and company tax rate cuts.

8.3 Business New Zealand's recently published *Tax Perspectives*[4] outlines a direction in which both personal and company tax rates can be lowered without having to impede on funding for core Government expenditure. For instance, current projections show that two personal tax rates of 15% and 25%, combined with a company tax rate at 25% by 2010 is easily achievable. This would substantially change the take home pay of a significant proportion of the working population. By instigating a broad-base, low rate approach to taxes while containing Government spending to levels around 30% of GDP, most New Zealanders will have more cash in hand in which to repay debt, save for a house deposit or invest for retirement savings.

Recommendation: That the Government seriously consider lowering both personal and company tax rates to help boost savings and investment for New Zealanders.

9. CONCLUSION

9.1 Overall, Business New Zealand believes that the some key recommendations outlined in the document such as a capital gains tax on offshore portfolio investment in shares and the removal of the grey-list countries needs to be seriously re-considered by the Government. The rationale of addressing issues such as tax avoidance means the recommendations are tantamount to using a cannon to swat a fly. We believe the recommendations will steer New Zealanders disproportionately towards domestic investment, which brings about long-run capacity and risk concerns.

9.2 The document states that the Government has consulted various organisations and experts to find the best solution. However, from comments

[3] Whether this is a fundamental problem for New Zealand is debatable, as Business New Zealand has raised this issue in previous submissions and consultation relating to other issues.
[4] See http://www.businessnz.org.nz/doc/934/TAXPERSPECTIVES

already made by various groups, there is certainly the perception that there is a disconnect between what was suggested during consultation by key stakeholders and what has ended up as the key recommendations. The general perception by most interested parties is that the recommendations will make things worse, not better. At the very least, the recommendations require further consultation, and at most a clean slate to try and identify workable solutions that avoids any need for distortions to be introduced into the market. Therefore, in the interests of long-term success, we have no objection to the Government effectively going back to "the drawing board" and again consulting to try and find a workable solution that will grow, rather than inhibit or endanger investments New Zealanders enter into.

Recommendation: That the Government instigate another round of consultation with key stakeholders regarding the treatment of taxation on investment income.

APPENDIX

10.1 Encompassing four regional business organisations (Employers' & Manufacturers' Association (Northern), Employers' & Manufacturers' Association (Central), Canterbury Employers' Chamber of Commerce, and the Otago-Southland Employers' Association), Business New Zealand is New Zealand's largest business advocacy body. Together with its 57-member Affiliated Industries Group (AIG), which comprises most of New Zealand's national industry associations, Business New Zealand is able to tap into the views of over 76,000 employers and businesses, ranging from the smallest to the largest and reflecting the make-up of the New Zealand economy.

10.2 In addition to advocacy on behalf of enterprise, Business New Zealand contributes to Governmental and tripartite working parties and international bodies including the ILO, the International Organisation of Employers and the Business and Industry Advisory Council to the OECD.

10.3 Business New Zealand's key goal is the implementation of policies that would see New Zealand retain a first world national income and regain a place in the top ten of the OECD (a high comparative OECD growth ranking is the most robust indicator of a country's ability to deliver quality health, education, superannuation and other social services). It is widely acknowledged that consistent, sustainable growth well in excess of 4% per capita per year would be required to achieve this goal in the medium term.