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Repairing Government Finances: Some taxing options?

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Setting the scene

The Government's response to COVID-19 will result in significant deficits and increases in net Crown debt. Thoughts will be turning to how to repay that borrowing. The role of the tax system in repairing the fiscal position and balance sheet is likely to be a feature of the upcoming election.

We've considered some options for tax changes. Bear in mind the following:

- Deficits and debt may alternatively be reduced by:
  - — Reducing Government expenditure.
  - — A growing economy increasing tax revenue.
- Refinancing rather than repaying debt is a choice.
- Governments have the luxury of a long-term view. For example, Great Britain repaid the last instalment of its World War 2 debt on 31 December 2006 – 61 years after the end of the war.

These may all play a part in managing the fiscal and debt position, but tax will also play a part in the Government finance story.

We have organised the tax options as follows:

Taxpayers

The current tax system makes choices about who tax is collected from. Additional persons might be included as taxpayers.

Income tax

Increasing tax rates or broadening the base will raise tax revenue. Tax reductions and incentives are also considered as potential options for repairing Government finances.

Indirect taxes

New Zealand's most efficient indirect tax is the Goods and Services Tax (GST). We consider changes to GST and several other possible indirect taxes.

Activity-based taxes*

These are considered separately. These are taxes targeted at activities and typically have the objective of raising revenue to fund the social costs of the activity and/or to make it less attractive and/or to make the cost of the activity more transparent.

Wealth taxes

Wealth taxes apply based on the value of an asset and not the return from it.

**Including environmental*

Some considerations

We do not recommend any particular tax option and we may have missed your favourite one. For example, beard taxes, which seems a likely candidate given the many seen on video calls recently, are not covered.

When considering a particular tax change, please remember the importance of trade-offs:

- Do the pros outweigh the cons? Do you agree with the pros and cons, as stated?
- What weight do you give to particular attributes such as efficiency, fairness and the cost of administration?
- What are the costs of compliance? A new tax may be efficient economically but if the same people are paying it, is it more sensible to just change the rate?
- There are whole of system considerations. Changes that don't take a system wide view can lead to incoherence which may cancel out the benefits.
- It is also important to consider whether behaviour will change as a result of the tax change. If taxpayers change their behaviour so a tax does not apply, no revenue will be raised. This may be the intended outcome, if aimed at decreasing a particular activity, but not if revenue raising is the objective.
- Finally, do keep in mind that while the tax system is only one lever, there are wider impacts from changing tax settings, including on the welfare system. Those impacts will need to be considered.

We're keen to know what you think. You can share your views and provide feedback on the options below. Alternatively, please contact your regular KPMG advisor or one of the authors should you wish to discuss in more detail.

We've also left white space in the available columns for notes in case you'd like to print a copy.

TELL US WHAT YOU THINK

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The taxpayer	Pros and cons	What do you think?
Citizenship (compared to tax residence)	**Pros:** More taxpayers but may be more suited to some taxes (e.g. inheritance or wealth taxes). **Cons:** Not the global norm and is difficult to enforce (New Zealand is not the United States). Increases risk of double taxation.	
Charities and other tax-exempts — Tightening restrictions for application of exemption	**Pros:** Better target exemption to those entities that actively apply funds for charitable purposes. (This is broadly consistent with the Tax Working Group ("TWG") view). **Cons:** Depending on design, this may impair genuine charitable work. As a result, Government may need to provide more funding to make up the shortfall. The "social" benefits from encouraging greater community involvement may be reduced/lost.	
Local Government businesses — Taxing local Government activities that are not currently subject to income tax	**Pros:** Base broadening by raising revenue from local Government activities. May provide an efficiency benefit, by equalising the position of local Government businesses with other businesses. **Cons:** May simply be a "money-go-round" if central Government needs to provide funding to local Government to meet their requirements. Any efficiency benefit may not be achieved.	

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Income tax	Pros and cons	What do you think?
Personal tax rate increases Changes to personal tax will need to balance: — Rates (scope to increase progressivity?) — Thresholds (currently less progressive due to low top rate threshold?) — Distributional impacts (top earners already contribute the majority of personal income tax revenue)	**Pros:** May improve progressivity of the personal income tax as the current top personal tax rate is low by international standards. **Cons:** New Zealand's top personal rate threshold is comparatively low by international standards – applies at around 1.5x median wage – so a consequential threshold change may be required. Would need to increase the trustee tax rate at the same time which would widen the gap with the company rate (if no commensurate increase).	
Company tax rate increase	**Pros:** Company tax rate increase should not reduce Foreign Direct Investment ("FDI") if non-residents are investing in New Zealand for economic rents. (Economic rents are returns above the normal rate of return that a foreign investor would expect to receive). **Cons:** Current "headline" company tax rate is already relatively high compared with other OECD countries, so increasing the company rate may have a further adverse signaling effect for FDI.	
Portfolio Investment Entity ("PIE") tax rate increases	**Pros:** Increasing the top PIE tax rate would better align with the top personal tax rate. **Cons:** PIE tax rates are now viewed as concessionary and, therefore, encouraging retirement savings (although arguably any benefit could be better targeted at lower income earners).	
Personal or company tax rate decreases	**Pros:** There may be a fiscal multiplier effect from decreasing tax rates leading to higher tax revenue over time. However, this may need to be targeted, e.g. at lower income earners as they are more likely to spend the tax saving. **Cons:** It's difficult to determine whether decreasing tax rates will increase revenue sufficiently in the longer term to make up for the immediate revenue drop. The evidence for increased investment, based on the last company tax rate decrease, is unclear.	
Tax incentives/tax expenditures Measures could include accelerated depreciation and further increasing the low value asset threshold, to encourage capital spending.	**Pros:** May improve capital investment and increase productivity leading to higher tax revenue over time. **Cons:** May be incentivising what would already happen anyway. Capital incentives, which in some cases can be expected to replace people with assets, may not help with increasing employment if that is an objective. Direct subsidies or grants may be better targeted and more transparent.	
Increase abatement rates for Working for Families ("WFF")	**Pros:** Depending on the design of WFF abatement rate changes, this may reduce the income levels at which high effective marginal tax rates apply. **Cons:** Tax rate "cliff" will increase with higher abatement rates. Marginal effective tax rates are already high. May result in an income shock for current WFF recipients.	

Income tax (continued)	Pros and cons	What do you think?
Broad Capital Gains Tax ("CGT") (per TWG majority)	**Pros:** This is an obvious option for base broadening as work on design of a CGT has largely been done as part of the TWG process. Potential to raise revenue if assets increase in value during the recovery. **Cons:** Implementation timing will be critical. Not likely to raise much revenue in the short term until the economy picks up again. It's likely that an acquisition rather than valuation date approach would be required. New Zealand's DTAs may limit revenue potential and advantage non-residents investing in NZ assets.	
Targeted CGT on — Land only (per TWG minority) - potentially achieved by extending "bright line" period. — "Speculative" investments	**Pros:** Easier to implement than a broad CGT as existing mechanisms available and potentially better meets political considerations. **Cons:** Perpetuates ad hoc changes to capture specific gains as income, which may contribute to system incoherence. Defining "speculative" investments is subjective. There may be scope for Inland Revenue to better enforce existing rules.	
New Zealand Superannuation Surcharge	**Pros:** May improve equity in retirement. **Cons:** May be politically difficult as effectively "means testing" by another name and there is a strongly held view by some that New Zealand Super is a right. The threshold, if any, for the surcharge applying will create winners and losers.	
Non-residents — Digital Permanent Establishments ("PE") and Digital Taxes — Increase withholding tax rates — Remove Approved Issuer Levy ("AIL") — Reduce 60% thin capitalisation safe harbour percentage / EBITDA based test / no deductible debt	**Pros:** Taxes economic activity carried on without a New Zealand physical presence or where a non-resident debt funds. May be an opportunity to bring forward or "turbo" charge Base Erosion and Profit Shifting ("BEPS 2.0"). **Cons:** Digital PE measures may not raise much revenue in practice e.g. Digital Services Tax is estimated to raise $30-$80m in tax. This may make New Zealand less attractive for investment and/or for provision of goods and services to New Zealand consumers if other countries do not have similar rules. As a capital importer and given capital mobility, removing AIL/ increasing withholding tax rates/further interest limitation could discourage inbound financing and investment which would potentially offset any increase in revenue raised.	
Outbound investment — Remove **Controlled Foreign Company** ("CFC") active exemption — Increase **Fair Dividend Rate** ("FDR") rate or tax offshore dividends as well Back to the future? Current CFC regime provides only a deferral benefit for foreign profits due to imputation regime. BEPS Pillar 2 proposals may mean this occurs anyway or has the same effect.	***CFC*** **Pros:** Removing the active CFC exemption taxes foreign outbound investment on a similar basis to New Zealand based activity and removes a tax incentive to base activities in low/ no-tax jurisdictions ("capital export neutrality"). May be an option if intention is to incentivise certain activity to stay in New Zealand or companies to onshore activities. **Cons:** Reason for moving away from the previous accrual-based CFC regime was to improve competitiveness with foreign business. Removing active exemption would mean New Zealand would be out of step with comparable jurisdictions, such as Australia. ***FDR*** **Pros:** Current FDR rate is arbitrary and does not tax dividends in excess of 5%. **Cons:** Foreign shares are arguably over-taxed as some capital gains are captured in the FDR rate.	

Indirect tax	Pros and cons	What do you think?
GST rate increase May need compensation for low income households or more zero-rating	**Pros:** A GST rate increase is relatively easy to implement and is an efficient way to raise revenue. **Cons:** A GST increase will be regressive (and may increase pressure to introduce exemptions such as for essentials or provide offsetting benefit increases). Regressive effect may compound over time (as compensatory changes tend to be one-off).	
GST base extended to — Financial services — Residential rentals	***Financial services*** **Pros:** In theory, a major area of consumption would become subject to GST. **Cons:** There are arguments that financial services are not properly GST taxable. There are practical issues for "margin" services where the added value is unclear, so specific rules are required to be able to implement. ***Residential rentals*** **Pros:** Reduces cascading of GST (currently unrecoverable). Allows different arrangements to be treated equally and would reduce apportionment adjustments and costs. **Cons:** GST cost may be passed on to tenants. May be difficult to implement in practice, particularly for existing residential property. Input tax deductions may need to be deferred until the property is sold to manage fiscal cost. May not be feasible politically.	
GST rate decrease	**Pros:** May encourage greater spending/economic activity raising overall GST revenue over time. **Cons:** A GST rate decrease may not be passed on to consumers without legislation requiring pass through. (If you are prepared to pay $1.15 today, you will be prepared to pay $1.15 tomorrow, so the GST saving may be captured by the business).	
Financial transaction tax ("FTTs") — Increasingly being introduced overseas **Stamp duty** — Australian states have stamp duties, but Australian Tax Reviews have recommended replacing with land tax. (Stamp duty was not recommended by the TWG).	***FTT*** **Pros:** An FTT will raise more revenue from financial services (but, arguably, not needed if GST can be extended to financial services). **Cons:** May create incentive to relocate financial activity offshore to avoid the tax. ***Stamp duty*** **Pros:** Stamp duty is a relatively simple tax. **Cons:** One of the more inefficient taxes (for its impact on behaviour). May raise revenue but this can be volatile.	
Digital Services Tax (under consideration by New Zealand Government)	**Pros:** Arguably, levels playing field between domestic and foreign providers. **Cons:** New Zealand risks being an outlier (as OECD process is still ongoing). Projected revenue is not significant. As designed, it would also catch New Zealand companies.	

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Activity-based taxes	Pros and cons	What do you think?
General behavioural taxes — Alcohol, cigarettes gambling, sugar/fast food ("sin taxes") If successfully stops undesired activity will not raise revenue.	**Pros:** Can be used to address social harm (i.e. reduce consumption and pay for societal costs from activity, e.g. additional healthcare). **Cons:** Considered regressive. Whether they will raise sufficient revenue depends on elasticity of demand (tension between raising revenue and moderating behaviour). Tax may not be the best way to change the behaviour.	
Environmental taxes — Carbon tax — Waste/water levies	**Pros:** Revenue from environmental taxes can be used to address concerns around pollution and build a more sustainable economy (hypothecation of revenues raised). New Zealand does not currently have much in the way of environmental taxes relative to other OECD countries. **Cons:** Unclear how much revenue would be raised in practice, particularly if there is pressure for phased implementation or exclusions.	
Social security contributions	**Pros:** Used by many countries to explicitly fund social services such as healthcare, pensions and unemployment benefits. This may mean that the "tax" is seen as fair. **Cons:** Would add complexity and leaves those not earning income potentially outside the Government support system (if there is no other welfare net).	
Other hypothecated taxes (e.g. ACC)	**Pros:** Revenue is raised for a clear purpose, so greater transparency **Cons:** Temptation to use revenue for other purposes, if not legislatively "ring fenced".	
Fuel excise taxes — Hypothecated tax if used to fund transport infrastructure — Similar tensions as for behavioural taxes — As Electric Vehicle use increases will need new a tax base to replace fuel excise (e.g. EV surcharge?) **Congestion charges** — More likely a local Government than central Government revenue measure	**Pros:** Fuel excise may be helpful to encourage reduction in car use and/or switch to electric vehicles/public transport (but note congestion pricing as an alternative). **Cons:** Fuel excise can be regressive (i.e. lower income households are less likely to have newer, more fuel efficient, vehicles or EVs so will pay more). Congestion charges will also be regressive unless revenues are used to subsidise alternatives e.g. public transport.	

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Wealth taxes	Pros and cons	What do you think?
Broad wealth tax (would tax a percentage of the relevant net asset value each year rather than the return from the asset)	**Pros:** Proxy for taxing the underlying capital appreciation, which is arguably under-taxed under current rules if there is no cash flow. May reduce inequality as higher income earners will have a disproportionate share of such assets. **Cons:** In practice, wealth taxes have exemptions which can distort decision making. Complex design issues e.g. valuation issues for hard to value/illiquid assets and determining what's in/out. No cash to pay the tax is a common concern.	
Mansion or bach tax	**Pros:** A way to bring some owner-occupied or second houses into the tax base. **Cons:** A narrow tax base, so not favoured under standard tax policy principles. Design may be complex.	
Land tax	**Pros:** Efficient as land is fixed in supply and immobile. **Cons:** Efficiency benefit will be diluted depending on extent of any exclusions. Cash flow issues may arise.	
Inheritance tax	**Pros:** May improve equity (prevents tax free inter-generational wealth transfers). **Cons:** May require a number of exemptions to be workable.	

Notes

Contact us

John Cantin
Partner, Wellington Tax
T: +64 (4) 816 4518
E: jfcantin@kpmg.co.nz

Darshana Elwela
Partner, Auckland Tax
T: +64 (9) 367 5940
E: delwela@kpmg.co.nz

Nick Hope
Partner, Auckland Tax
T: +64 (9) 363 3210
E: nhope@kpmg.co.nz

Neesha Morar
Senior Manager, Auckland Tax
T: +64 (9) 367 5982
E: nmorar@kpmg.co.nz