TaxMail

20 September 2018

Regular commentary from our experts on topical tax issues

Issue 1

Tax Working Group's interim report released

Snapshot

The Tax Working Group's ("TWG's") highly anticipated interim report (the "**Report**") has been released.

It covers many areas of the tax system. In some cases, the work of the TWG has been closed-off (for example, it recommends keeping GST largely as is). In other cases, feedback and further work will influence the TWG's final recommendations, which are due by February 2019. Submissions are requested.

The TWG sees two key issues as the taxation of capital income and how the tax system can be used to achieve/encourage environmental/ecological outcomes. The Report sets out detailed options for extending taxation to certain capital assets, but no recommendations, and a framework for deciding when to apply taxes to address negative environmental outcomes.

For business, the TWG does not see the need for a reduction in New Zealand's company tax rate at present (or a lower rate for SMEs). And while BEPS is technically outside the scope, the Report recommends the Government be prepared to implement unilateral measures, if further multilateral action on BEPS fails.

The TWG Interim Report clocks in at a relatively thin 190 odd pages (including appendices)

There is a lot of detail supporting the interim conclusions and thinking, which needs to be carefully worked through and understood. In particular, how the different proposals interact needs consideration

This will ensure feedback is constructive and principled rather than simply reactive

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The Government has released its **response** to the Report. It broadly agrees with the direction the TWG is taking. It has set some direction for their future work.

Taxmail provides a summary of the key issues and some initial observations. We may provide further commentary following a more detailed review of the Report's 190+ pages.

Snapshot of the Report

The Report covers a lot of ground. We have focussed on some, but not all of the detail, in this taxmail.

Taxation of capital income

This is a key area of focus given the requirement for the TWG to focus on the structure, fairness and balance of the tax system. This has received detailed attention in the Report.

Some of the key features under consideration are:

- Extension of the capital income tax net to business/income assets not already taxed. Personal assets like cars and art would be excluded. The family home, per the terms of reference, is out of scope but second homes and holiday homes would be within scope.
- Possible taxing options include – a tax when gains (or losses) are realised (a traditional Capital Gains Tax) or a risk free return method ("RFRM"). The TWG has not ruled out recommending a combination of these.
- Any gain or loss, if taxed, will be calculated based on a valuation of assets on implementation (likely to be 1 April 2021). Any gains (or losses) from date of acquisition until implementation date would remain untaxed.
- Retention of the Fair Dividend Rate ("FDR") regime for foreign shares, but potential reconsideration of the rate (and removal of the Comparative Value alternative for individuals and family trusts).

A realised gains tax brings with it detailed design questions on when and how it applies as there a variety of ways in which the relevant assets can be owned. This includes questions about "rollover" relief (whether on death or a sale to acquire another asset, for example, there should be a deferral of the tax) as well as integration with trust, company and PIE taxation regimes.

The RFRM has been raised previously. The 2001 Tax Review considered its application to all assets. The TWG's consideration of an RFRM is not as comprehensive. A similar option was proposed by the Opportunities Party (TOP) during last year's election. Broadly, an RFRM would tax a deemed return on the net equity held in the relevant assets each year with no deductions. A key issue therefore is funding the tax if the cash-flow from the asset is insufficient.

The Report suggests that the tax system's impact on housing affordability is likely to be at the margins, but further work will be done pending final recommendations.

Retirement savings

The linkages with capital income taxation are noted. The Report recommends removing tax on employer contributions to KiwiSaver for employees on incomes of up to $48,000 and reducing the 10.5% and 17.5% PIE tax rates for KiwiSaver investors by 5% each. The target is those on low and middle incomes to make the taxation of retirement savings fairer and also to reduce the gender gap in savings.

Environmental and corrective taxation

The environment and sustaining and enhancing New Zealand's natural capital is seen as another key issue. The Report provides a framework for considering how and when the tax system should be applied to achieve environmental and ecological

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objectives. It also considers how any revenue collected may be used to support changes in behaviour.

The TWG is less certain on the impact of corrective taxes outside the environmental sphere. For example, the Report raises concerns about the impact of further increases in tobacco excise on low income households. It recommends a simplification of excise rates on alcohol as the current structure is not coherent. It is also not convinced that a sugar tax is better than regulation if the aim is to reduce the sugar content of particular foods, rather than reduce sugar consumption across the board. The TWG recommendations will depend on Government clarifying its policy objectives.

GST

This Report recommends no changes to current GST settings. It considers that while the GST should apply to financial services, this will be administratively complex. The TWG considers the Government is better to provide targeted relief for affected groups, rather than removing GST from certain items (such as food).

Business tax

The New Zealand company tax rate is recommended to remain unchanged at the present time. The evidence of additional investment from a lower tax rate is said to be lacking. The last two company tax rate reductions (in 2008 and 2011) have not materially increased foreign direct investment. This is consistent with the view that international investors are in New Zealand because they have to be here to carry on their business. The potentially adverse effect on coherence of the tax system (from a higher differential between the company and top personal rate) is also noted. The TWG considers a progressive business tax rate to be too difficult.

International tax

New Zealand's response to Base Erosion and Profit Shifting ("BEPS") is outside scope. While the Report recommends New Zealand's continued involvement with the OECD's multilateral work on BEPS, it considers New Zealand should be ready to act in its own best interest, particularly for digital services provided to New Zealand consumers by foreign multinationals. A digital equalisation tax is one option that the Report flags the Government should consider if other countries move in that direction.

Integrity of the tax system

The TWG recommends the implementation of measures similar to those proposed in Australia by its Hidden Economy Task force. It proposes extensions to Inland Revenue's powers to request datasets for the gig economy. A Taxation Bill currently before Parliament, which will increase disclosure and information requirements, is said not to go far enough.

The Report also recommends making directors personally liable for a company's GST and PAYE obligations and debt.

Charities

The Report suggests that Government should review the charitable sector to confirm the intended social outcomes are being achieved. It raises the accumulation of surpluses by charities, rather than their distribution and application for charitable purposes, as a potential issue. (In other countries, a tax exemption is generally only available for amounts applied for charitable purposes.) The TWG has also questioned the tax rules for private charitable foundations and trusts and whether existing GST concessions for charities are appropriate.

Tax administration

The TWG recommends greater public access to data (sanitised so as to ensure privacy). A taxpayer advocate service to assist taxpayers in disputes with Inland

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Revenue and strengthening the Office of the Ombudsman's capability in the tax area is also recommended.

Property-related tax issues

The Report notes the potential for tax depreciation to be reinstated for industrial, commercial and multi-unit residential buildings. (The Officials' analysis shows that these structures depreciate.) Decisions here are likely to be closely linked to the taxation of capital income. It also considers there may be a case to allow tax recognition for seismic strengthening expenditure, as the current tax policy settings appear to be working counter to the Government's disaster risk management agenda.

It is also worth noting that the TWG has ruled out a land tax on acceptability grounds.

Individuals' taxation and Future of Work

The TWG has not yet concluded its work on personal tax rates and income thresholds (keeping in mind that while the TWG is not able to increase rates, it can recommend rate reductions or adjusting income thresholds). The Report notes that addressing "bracket creep" (i.e. inflation adjusting income tax) is best done via periodic review of thresholds.

The Report suggests the further extension of withholding taxes to address the rise of the gig economy, including to platform providers, and greater use of technology tools to enable self-compliance. There is also a suggestion that the definition of employee should be aligned for income tax and employment law purposes.

Maori Authorities taxation

The TWG has confirmed the existing tax regime should continue with some technical amendments to allow subsidiaries of Maori Authorities to be included. The implications of any recommendations for extending capital income taxation for assets held by Maori in collective ownership is flagged as an area for further consideration.

The Government's response

The Government has released its response to the Report at the same time. The response asks the TWG, in its final report, to:

- Recommend a revenue neutral tax package with a focus on reducing inequality, increasing fairness across the tax system, and improving housing affordability.
- Consider whether a realised tax on gains or an RFRM is best for ensuring the tax system is fair and balanced.

The Government is comfortable that no further work should be done on land, wealth and financial transactions taxes or changes to GST.

The response also outlines areas the Government has asked for further work to be done by the TWG and comments on some of the Report's conclusions. These include:

- Whether there are better approaches to understanding the wealth, capital income and effective tax rates of individuals.
- Consideration of whether a tax-free threshold for the sale of businesses would be appropriate, under any potential extension of capital income taxation.
- Compliance reduction options that would be beneficial for small business.
- The taxpayer advocate recommendation will be discussed with Officials.
- The TWG's work on corrective taxes (on tobacco, alcohol, sugar and gambling) should be provided to the relevant Government agencies.

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- The TWG's work / recommendations on charities should be provided to the Department of Internal Affairs and Inland Revenue for the Charities Review and the Tax Policy Work programme, respectively.
- The TWG's work on the tax treatment of seismic strengthening has been welcomed and encouraged.

Some initial observations

KPMG's **submission** to the TWG's **submissions background paper**, earlier in the year, noted that it had a wide ranging and complicated task ahead. At this point, the TWG has effectively stopped its work on some areas. Either because it has concluded (e.g. no change to GST) or because it is being handed on for further policy development. (In some cases, to see whether/what non-tax policy response may be better/best.)

However, what remains is itself a substantial body of work to be done. This means that those interested need to consider not just the immediate effect of the interim conclusions but also the potential interactions of the TWG's direction (and the Government's response which will shape its future work streams).

For example, does the TWG's retirement savings interim recommendations affect the response to how capital income taxation (if extended) should apply to KiwiSaver funds? For property owners, how would the reinstatement of tax depreciation and possible tax relief for seismic strengthening costs trade-off against the imposition of tax on the property's sale?

The KPMG submission emphasised the importance of the overall coherence of the tax system. Therefore, the overall balance of the TWG's recommendations will be critical. Judgement on whether that coherence has been achieved will need to wait for the TWG's final report when all the pieces of the puzzle are clear.

In the meantime, the technical difficulty of designing and implementing a system of taxing capital income which treats investments as equitably as possible will be a key item of discussion and thought.

For further information

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